

## **Board of Equalization:**

*Its Implementation of the Cigarette and Tobacco Products Licensing Act of 2003 Has Helped Stem the Decline in Cigarette Tax Revenues, but It Should Update Its Estimate of Cigarette Tax Evasion*



June 2006  
2005-034

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# CALIFORNIA STATE AUDITOR

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ELAINE M. HOWLE  
STATE AUDITOR

STEVEN M. HENDRICKSON  
CHIEF DEPUTY STATE AUDITOR

June 29, 2006

2005-034

The Governor of California  
President pro Tempore of the Senate  
Speaker of the Assembly  
State Capitol  
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As required by Chapter 890, Statutes of 2003, the Bureau of State Audits presents its audit report concerning the Board of Equalization's (Equalization) implementation of the Cigarette and Tobacco Products Licensing Act of 2003 (act).

This report concludes that Equalization believes its implementation of the provisions of the act has increased cigarette tax compliance. Specifically, based on its analysis of cigarette tax stamps sold, Equalization estimates it received \$75 million in additional cigarette tax revenues between January 2004 and March 2006 because of the act and the new tax stamp. Although we agree that the act has increased cigarette tax compliance, we also believe that some of the factors Equalization uses to calculate the benefits of the act are overstated because they are based on the results of inspections in areas where illicit cigarette sales are more likely to occur. This resulted in Equalization estimating that annual cigarette tax evasion amounts to \$292 million, an estimate that may be at the high end of the range of potential tax evasion. Further, because a new less easily counterfeited tax stamp is now in use, increases in cigarette tax compliance since January 2005 can show only the blended effects of the act and the new tax stamp.

Respectfully submitted,

ELAINE M. HOWLE  
State Auditor

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# SUMMARY

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## Audit Highlights . . .

*Our review of the Board of Equalization's (Equalization) implementation of the Cigarette and Tobacco Products Licensing Act of 2003 (act) revealed the following:*

- Based on its analysis of cigarette tax stamps sold, Equalization estimates it received \$75 million in additional cigarette tax revenues between January 2004 and March 2006 because of the act and the new tax stamp.*
- Equalization's estimate of \$292 million in annual cigarette tax evasion is based on an unrepresentative sample and an overstated number of retailers of cigarettes and tobacco products.*
- Although the act and new tax stamp have caused a stabilization of the historical decline in cigarette tax revenues, these revenues will continue to decline as long as more Californians stop smoking.*
- In fiscal years 2003–04 and 2004–05, Equalization spent \$9.2 million to implement the provisions of the act, with most of that amount paid toward staff salaries and benefits for licensing and enforcement activities.*
- Equalization imposes penalties in accordance with the provisions of the act.*

## RESULTS IN BRIEF

The Cigarette and Tobacco Products Licensing Act of 2003 (act), which took effect in January 2004, requires the Board of Equalization (Equalization) to license all entities engaged in the sale of cigarettes and tobacco products in California. It also provides additional funding to Equalization to enforce the provisions of the act. The intent of the act is to lessen cigarette tax evasion and increase collections of cigarette tax revenues.

Because cigarette tax evasion by definition is taxpayers' failure to report information, estimates of its magnitude are only approximations. Equalization believes its implementation of the provisions of the act has increased cigarette tax compliance. Although we agree with this assessment, we also believe that some of the factors Equalization uses to calculate the benefits of the act are overstated because they are based on the results of inspections in areas where illicit cigarette sales are more likely to occur. This results in estimates at the high end of the range of potential tax evasion. Further, because a new, less easily counterfeited tax stamp is now in use, increases in cigarette tax compliance since January 2005 can show only the blended effects of the act and the new tax stamp.

Between fiscal years 2001–02 and 2003–04, collections of cigarette taxes fell, continuing a trend of declining revenues caused largely by the declining prevalence of smoking among Californians. Collections of cigarette tax revenues stabilized in fiscal years 2003–04 and 2004–05, the years during which Equalization was licensing sellers of cigarettes and performing inspections of retailers. Consequently, the stabilization and reversal of the historical decline in cigarette tax revenues is to some degree the result of Equalization implementing the provisions of the act, in addition to the effects of the new cigarette tax stamp.

## RECOMMENDATION

To provide a more accurate estimate of the extent of cigarette tax evasion, Equalization should update its calculation of cigarette tax evasion using data gathered after implementation of the act.

## **AGENCY COMMENTS**

Equalization stated that it agrees with the overall conclusions and finding of the report. It also noted that it has already taken action to address the recommendation. ■

# INTRODUCTION

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## BACKGROUND

The Cigarette and Tobacco Products Licensing Act of 2003 (act), which took effect in January 2004, seeks to lessen cigarette tax evasion by requiring the Board of Equalization (Equalization) to license all entities engaged in the sale of cigarettes and tobacco products in California.<sup>1</sup> These entities, described in the text box, may purchase cigarettes and tobacco products only from other licensed entities. The licensing process also allows Equalization to identify entities from which it should be receiving cigarette taxes and those that Equalization should be subjecting to enforcement activities related to the illegal sales of cigarettes and tobacco products.

### Entities Engaged in the Sale of Cigarettes and Tobacco Products

**Importer:** Any purchaser of cigarettes manufactured outside the United States for resale in the United States.

**Manufacturer:** Manufacturer of cigarettes sold in California.

**Distributor:** A person who sells or accepts orders for cigarettes or tobacco products to be transported to a person within California.

**Wholesaler:** Any person, other than a licensed distributor, who engages in making sales in California for the resale of tobacco products on which the cigarette tax has been imposed.

**Retailer:** A person who engages in the sale in California of cigarettes or tobacco products directly to the public from a retail location. A retailer may operate vending machines from which cigarettes and tobacco products are sold.

Source: Business and Professions Code, Section 22971.

Before the act took effect, Equalization issued cigarette licenses only to distributors, the entities responsible for remitting cigarette taxes. Any other entity selling cigarettes and tobacco products, and therefore collecting and remitting sales taxes, had to have a seller's permit, which Equalization also issued. Under the act, all importers, manufacturers, distributors, wholesalers, and retailers must obtain and maintain a California cigarette and tobacco products license, and every retailer is required to have a license for each location at which it sells cigarettes and tobacco products. Table 1 on the following page shows the administrative or license fee that the act required from each entity engaged in the sale of cigarettes and tobacco products and how many licenses Equalization issued to the various entities through May 16, 2006.

Cigarettes are subject to a cigarette tax, also known as an excise tax, as well as a cigarette and tobacco products surtax. Distributors pay the tax and surtax by purchasing cigarette tax stamps from Equalization. Each package of cigarettes must have a stamp affixed before it can be distributed.

<sup>1</sup> For the purposes of this report, the term *tobacco products* refers to cigars, smoking tobacco, chewing tobacco, snuff, and other products (besides cigarettes) containing at least 50 percent tobacco.

Currently, each stamp costs 87 cents per pack of 20 cigarettes; of that cost, 12 cents is for the cigarette tax and 75 cents is for the surtax. From the tax and surtax, 10 cents is deposited in the State's General Fund, and the remaining 77 cents is deposited in various special funds used for early childhood health and education programs, tobacco-related education and research, and breast cancer research.

**TABLE 1**

**Cigarette Licensing Activity Between January 2004 and May 16, 2006**

Entity	Fee Required	Licenses Issued
Manufacturers and importers	A one-time administrative fee, due by January 1, 2004, of 1 cent per package of cigarettes based on the amount of cigarettes manufactured or imported during the 2001 calendar year.	43
Distributors	Annual license fee of \$1,000.	626
Wholesalers	Annual license fee of \$1,000.	407
Retailers	One-time license fee of \$100 for each location selling cigarettes and tobacco products.	38,117

Sources: Cigarette and Tobacco Products Licensing Act of 2003; Board of Equalization, Excise Taxes and Fees Division.

Tobacco products—such as all forms of cigars, smoking tobacco, chewing tobacco, and snuff—are subject only to the cigarette and tobacco products surtax and are not required to have a tax stamp. Equalization's five-member board determines the surtax rate each year; for fiscal year 2005–06, the surtax rate is 46.76 percent of the product's wholesale price. The surtax from tobacco products is entirely allocated to the special funds used for early childhood health and education programs and tobacco-related education and research. The State's cigarette tax is in addition to a federal cigarette tax of 39 cents per pack and state and local sales taxes levied on the retail price (which includes the state and federal excise taxes on cigarettes and tobacco products).

**Evasion of the Cigarette and Tobacco Products Tax**

Equalization has estimated that before 1989, when California's cigarette tax was 10 cents per pack, the amount of tax evasion was not significant. However, for fiscal year 2001–02, Equalization estimated annual cigarette tax evasion at \$292 million. Equalization has also tracked cigarette consumption over time based on the sale of cigarette tax stamps and has noted an apparent decline in cigarette consumption by Californians. In fact, Equalization has determined that

### Types of Cigarette Tax Evasion Activity

**Stamp counterfeiting:** The replication of California's cigarette stamps and their placement on cigarette packs.

**Export redirection:** The redirection of cigarettes meant for export to other states, countries, or duty-free concerns (and therefore not subject to the State's excise tax) back into the State so as to circumvent taxation. This diversion can occur either at the cigarette manufacturing or distribution level.

**Cross-border smuggling:** The acquisition of cigarettes in other states or other countries (with lower excise taxes than California's) and their transportation into California without the payment of the tax. These would be distributed through legitimate retailers or through the underground economy, or directly consumed by the purchaser.<sup>2</sup>

**Internet purchases:** The purchase of cigarettes by individuals or companies from cigarette distributors in other countries or, more typically, other states with lower cigarette taxes than California. These can be resold, but more often are simply purchased for individual consumption.

**Unstamped products:** The unauthorized acquisition of unstamped cigarettes from tribal or military sources (both of which have legitimate access to unstamped cigarettes). In general, purchases from these sources by individuals other than those specifically eligible, is illegal. Cigarettes obtained in this manner are then consumed directly or resold through the underground economy to stamp counterfeiters.

**Overt criminal activity:** The robbery of cigarette manufacturers or the hijacking of distributors' trucks, before cigarette stamps are affixed to the packs.

Source: *Analysis of the 2003–04 Budget Bill*, Legislative Analyst's Office.

over the last 22 years, cigarette consumption, as measured by the sale of cigarette tax stamps, has fallen by an average of 3 percent each year. This rate of decline reflects decreased sales of cigarette tax stamps resulting from reduced numbers of cigarette smokers and estimated tax evasion. Tax evasion takes several forms but ultimately results in untaxed cigarettes available for consumption. The text box shows the types of cigarette tax evasion activity.

The Legislature's intent in implementing the act was to license the entities involved in the sale of cigarettes and tobacco products and require those entities to purchase their products only from other licensed entities. The effect of the act is a limit on the ways untaxed cigarettes and tobacco products can enter the legitimate market. In addition, Chapter 881, Statutes of 2002, required Equalization to replace the existing cigarette tax stamps with encrypted indicia by January 1, 2005, as a means of limiting tax evasion through tax stamp counterfeiting.

Tax evasion is committed not only by entities engaged in the sale of cigarettes and tobacco products but also by consumers, usually through the purchase of cigarettes and tobacco products in other states or over the Internet. In an effort to collect cigarette taxes on cigarettes that Californians purchase from other states through untaxed Internet purchases, Equalization contacted Internet sellers to obtain purchaser information, as allowed by the federal Jenkins

Act (United States Code, Title 15, sections 375 through 378). The Jenkins Act requires any person who sells and ships cigarettes across a state line to a buyer, other than a licensed distributor, to report the sale to the buyer's state tobacco tax administrator. Compliance with this federal law by cigarette sellers enables states to collect cigarette excise taxes from

<sup>2</sup> *Underground economy* refers to individuals and businesses making transactions only in cash or using other schemes to conceal their activities and true tax liability from government licensing, regulatory, and taxing agencies.

consumers. Regarding Equalization's enforcement of the Jenkins Act, the Legislative Analyst's Office published this statement in its *Analysis of the 2003–04 Budget Bill*:

During its Jenkins Act compliance program (May 1999 through September 2001), Equalization contacted 167 out-of-state sellers and received responses from 20 of them. As a result, approximately 23,500 residents of the state were notified of their tax obligation, 13,500 of which responded. Equalization's efforts at enforcing the Jenkins Act resulted in additional gross revenues of \$1.4 million. . . . Staff at Equalization indicated that additional reporting occurred in the initial stages of this effort, but that since this period ended, reporting by all out-of-state sellers is substantially reduced. California currently has no ability to force reporting by out-of-state sellers, and voluntary compliance by California residents is generally poor.

According to Equalization, tax evasion is likely to grow next among tobacco products. Because the tax rate for tobacco products is nearly 50 percent of wholesale prices, it would be lucrative for those engaged in illicit trade to focus on those items. Moreover, a tax stamp or other identifier is not required on tobacco product packages, so it is difficult to determine whether the tax has been paid on a product. According to Equalization, it has limited ways to test whether the appropriate tax has been paid on tobacco products at the retailer's location.

### **Equalization's Role in Implementing the Act**

The act added Section 22970.2 to the Business and Professions Code (code), requiring Equalization to administer a statewide program to license importers, manufacturers, distributors, wholesalers, and retailers of cigarettes and tobacco products. The act also added sections allowing Equalization's inspectors and investigators to have Limited Peace Officer status, which enables them to issue civil and criminal citations. Another section of the code allows Equalization's inspectors to conduct inspections of businesses to ensure their compliance with state cigarette tax laws. Finally, Section 22991 of the code appropriated \$11 million to Equalization for the purpose of implementing, enforcing, and administering the act. Through a budget change proposal, Equalization added 80 positions to its staff.

Within Equalization, the Excise Taxes and Fees Division (Excise Taxes) and the Investigations Division (Investigations) are the units most involved in implementing the provisions of the act. Excise Taxes is responsible for licensing all importers, manufacturers, distributors, wholesalers, and retailers of cigarettes and tobacco products and assessing any civil penalties for violating California laws related to the sale of cigarettes and tobacco products. Investigations is primarily responsible for enforcing the provisions of the act by conducting inspections of retailers, distributors, wholesalers, and importers and determining whether they are complying with California cigarette tax laws.

## **SCOPE AND METHODOLOGY**

Section 22971.1 of the code requires the Bureau of State Audits to conduct a performance audit of the licensing and enforcement provisions of the act and report its findings by July 1, 2006. The code section requires the report to include the following information: (1) the actual costs of the program, (2) the level of additional revenues generated by the program compared with the period before its implementation, (3) tax compliance rates, (4) the costs of enforcement at the various levels, (5) the appropriateness of penalties assessed, and (6) the overall effectiveness of enforcement programs.

To determine the actual costs of the program, we interviewed Equalization staff and obtained electronic data with expenditure information for fiscal years 2003–04 and 2004–05 from six sources within Equalization’s cost accounting systems. The U.S. Government Accountability Office, whose standards we follow, requires us to assess the reliability of computer-processed data. Based on our tests, we determined that the expenditure data contained in Equalization’s systems were sufficiently reliable for the purposes of this audit. In addition, we assessed and recomputed the cost allocation process Equalization uses to determine costs specific to program areas in which Equalization implements and enforces the act. We then summarized Equalization’s expenditures by category and function.

To determine the level of additional revenues generated by the program compared with the period before its implementation, we interviewed Equalization staff to understand the types of revenues generated by the cigarette tax laws and the act. We also obtained the electronic files related to those revenues from Equalization’s Integrated Revenue Information System and its

Cigarette Tax Stamp Order System and performed an analysis of the reliability of the data. We assessed the reliability of the data by performing electronic testing of required data elements, reviewing existing information about the data and the systems that produced them, and interviewing Equalization staff knowledgeable about the data. In addition, we traced a sample of data to source documents. We determined that the data were sufficiently reliable for the purposes of this audit. Further, we reviewed the methodologies that Equalization used to determine the additional revenues resulting from the act. We also calculated the total revenue and the incremental additional revenue generated as a result of the act by type and by fiscal year.

To determine tax compliance rates, we assessed how Equalization measures tax compliance and the methods Equalization used to calculate the cigarette tax evasion amounts and cigarette tax compliance rates. We then analyzed the reasonableness of the change in tax compliance rates that Equalization calculated.

To determine the costs of enforcement at the various levels, we used the expenditure information that Equalization maintains and sorted it by functional area. Because of the cost allocation methodology Equalization uses, we show Equalization's costs only for fiscal years 2003–04 and 2004–05.

To determine the appropriateness of the penalties Equalization assessed, we interviewed Equalization staff to understand how they select establishments for investigations or inspections. Further, we reviewed Investigations' policy and procedures manual to determine the processes Investigations uses to conduct its inspections and investigations. We obtained the Inspection Zone Database, which contains information on all the inspections that Investigations had completed from April 2004 through December 2005. We tested these data for reliability by tracing to inspection reports prepared at the time of the inspection and determined that the data were sufficiently reliable for the purposes of this audit. We then sampled inspections that resulted in penalties to determine whether Equalization appropriately assessed the penalties and the status of the penalty resolution. We also reviewed the penalty schedule that Equalization's five-member board approved and compared it with the applicable law to determine whether the penalties Equalization assessed were consistent with the law.

To determine the overall effectiveness of enforcement programs, we interviewed Equalization staff on the measures Equalization uses to evaluate its overall effectiveness. We then used the information and analyses we performed in the other audit areas previously described to assess the overall effectiveness of Equalization's enforcement programs. ■

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# AUDIT RESULTS

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## **ALTHOUGH THE BOARD OF EQUALIZATION MAY OVERSTATE THE EXTENT OF CIGARETTE TAX EVASION, CIGARETTE TAX COMPLIANCE HAS IMPROVED**

**B**ecause cigarette tax evasion naturally results in taxpayers not reporting required information, estimates of its magnitude are only approximations. The Board of Equalization (Equalization) has developed three estimation methods to quantify both cigarette tax evasion and changes in cigarette tax compliance rates in response to the Cigarette and Tobacco Products Licensing Act of 2003 (act). The three methods are (1) analyzing the number of cigarette tax stamps sold, adjusted for estimates of decreased cigarette consumption; (2) calculating the amount of estimated cigarette tax evasion based on the results of work that Equalization's inspectors performed in fiscal year 2001–02; and (3) continuously comparing counterfeit sales rates and seizure rates based on more recent investigations and inspections.

We agree that Equalization's implementation of the provisions of the act has increased cigarette tax compliance. However, we believe that some factors Equalization uses to calculate the benefits of the act are overstated because they are based on the results of inspections in areas and retail establishments where illicit cigarette sales are more likely to occur. The result is estimates at the high end of the range of potential tax evasion. Further, because a new, less easily counterfeited tax stamp is now in use, increases in cigarette tax compliance since January 2005 can show only the blended effects of the act and the new tax stamp.

### **Equalization Uses Its Analysis of Taxes Paid to Support Its Position That Cigarette Tax Compliance Has Improved**

At the request of Equalization management, Equalization's chief economist performed an analysis to determine the amount of additional revenues that the act has generated since its inception. According to the chief economist's estimate, the act generated \$75 million in additional revenues from cigarette sales between January 2004 and March 2006. This estimate is based on Equalization's calculation of an average annual decline in cigarette sales (and by extension, cigarette consumption) of 3 percent over the past 22 years as measured by the number

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*Based on its analysis of cigarette tax stamps sold, Equalization estimates it received \$75 million in additional cigarette tax revenues between January 2004 and March 2006 because of the act and the new tax stamp.*

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of tax stamps sold, which Equalization calls the tax paid distribution.<sup>3</sup> The 3 percent decline reflects several factors, including fewer people smoking and tax evasion. Equalization's 3 percent decline is consistent with the 2.3 percent average annual decline in smoking prevalence among California adults between 1997 and 2004, based on information published by the Tobacco Control Section of the Department of Health Services.

Equalization assumes that if all factors are equal and the market does not experience major changes, any variations in tax paid distributions are the result of Equalization's implementing the provisions of the act and, after January 2005, its new tax stamp. Equalization uses cigarette tax stamps sold as the basis for its analysis because it believes that the amount of cigarette tax revenues it receives can be distorted by timing issues, such as the collection of additional taxes as a result of an audit or the lag in collections because of bankruptcies. When Equalization compared its estimate of an annual average decline in cigarette consumption of 3 percent to the change in the rate of sales of cigarette tax stamps since the act went into effect, it found that sales of cigarette tax stamps were greater than it expected based on the historical data. In fact, in fiscal years 2003–04 and 2004–05, cigarette consumption, as measured by sales of cigarette tax stamps, declined at an average of less than 1 percent annually. By multiplying the difference in expected sales of cigarette tax stamps and actual stamps sold by the 87 cents cigarette tax rate per pack, Equalization calculated that cigarette tax revenues increased by \$75 million between January 2004 and March 2006. Equalization attributes the slower rate of decrease in cigarette tax stamps sold to its additional enforcement authorized by the act. However, Equalization concurs that the slowing of the rate of decrease in cigarette tax stamps sold may in part be a result of the replacement, starting in January 2005, of its old cigarette tax stamp with a new stamp encrypted with a unique digital signature. In addition, Equalization expects that the steeper downward trend of tax paid distributions will resume in the future as the number of smokers in the State continues to fall.

Rather than relying on cigarette tax stamps sold, we prepared an estimate of the effect of the act using actual revenues collected, and our results were similar to those of Equalization. To determine how the act affected actual collections of

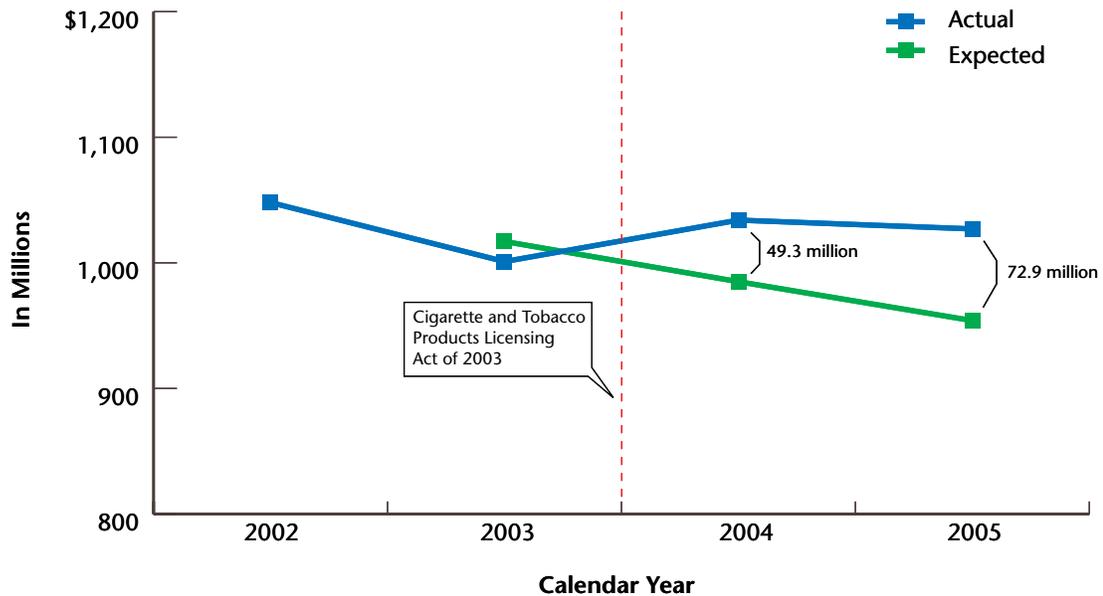
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<sup>3</sup> Equalization's calculation actually showed that the tax paid distribution had decreased by an average of 3.8 percent annually, but for the purposes of its analysis of the effects of the act, it reduced the estimate to the more conservative 3 percent.

cigarette tax revenues, we used Equalization’s methodology but replaced the tax paid distributions with the actual cigarette tax revenues that Equalization collected. We used the cigarette tax revenue of \$1.048 billion from calendar year 2002 as the basis for calculating the 3 percent annual decline. Our analysis indicated that the calendar year 2003 collection of \$1 billion was substantially less than what would have been expected, and the collections of \$1.034 billion in calendar year 2004 and \$1.026 billion in calendar year 2005 were greater than what would have been expected, based on historical declines in consumption. As shown in Figure 1, our analysis indicates that actual revenues were about \$49 million higher in calendar year 2004 and nearly \$73 million higher in calendar year 2005 compared with the revenues expected for the same years, assuming a 3 percent average annual decline in consumption.

**FIGURE 1**

**Estimate of Additional Cigarette Tax Revenues After Implementation of the Cigarette and Tobacco Products Licensing Act of 2003**



Source: Board of Equalization revenue data systems.

The substantial decrease in cigarette tax collections in calendar year 2003 is partly explained by the bankruptcy of a major cigarette distributor in that year. Equalization indicated that in calendar year 2004, it collected the amount the distributor

owed in cigarette taxes. If Equalization had collected that cigarette tax revenue when it was due in 2003, the actual total revenue in 2004 would have been about \$27 million higher than expected, instead of the \$49 million noted previously in Figure 1. Nevertheless, collections in calendar year 2004 showed a noticeable increase compared with the expected revenue based on the assumed 3 percent average annual decline.

The higher collection of cigarette tax revenues in calendar years 2004 and 2005 compared with the expected revenues shows that certain factors were causing the reversal of the historical decline in cigarette tax stamps sold. The smoking prevalence rates among California adults as determined by the Tobacco Control Section of the Department of Health Services for calendar years 2003 and 2004 show declines of 2.4 percent and 4.9 percent, respectively. Therefore, we assume that the increased collections of cigarette tax revenues are the result of increased compliance with cigarette taxes. The act was in place during both fiscal years and most likely accounts for much of the increased revenues. The new tax stamp was in effect during calendar year 2005 and also likely had an effect on revenue collections during that time. Neither Equalization nor we can isolate how much of the increased revenue in calendar year 2005 was the result of the act and how much was the result of the new tax stamp.

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*Neither Equalization nor we can isolate how much of the increased revenue in calendar year 2005 was the result of the act and how much was the result of the new tax stamp.*

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### **Equalization Based Its \$292 Million Estimate of Cigarette Tax Evasion on an Unrepresentative Sample**

In 2003, Equalization estimated that cigarette tax evasion—lost taxes to the State because of illegal sales of counterfeit cigarettes—amounted to \$292 million for fiscal year 2001–02.<sup>4</sup> However, we believe Equalization’s estimate is inflated because it reviewed a sample of retailers that is not representative of all retailers in the State and the number of retailers it used in its calculation of the estimate is overstated. Moreover, Equalization has not updated its tax evasion estimate since 2003 but continues to use that amount, without qualifiers, as the amount that the State loses each year from cigarette tax evasion.

Equalization attempted to determine the extent of California’s counterfeit cigarette problem by having its Investigations Division (Investigations) review roughly 1,300 retailer inspections conducted throughout California between July 2001

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<sup>4</sup> The term *counterfeit cigarettes* refers to cigarette packs that bear counterfeit tax stamps as well as truly counterfeit products—cigarettes manufactured overseas and patterned after major brands.

and September 2002. Based on the results of the inspections, 25 percent of the State's retailers were selling counterfeit cigarettes, resulting in an estimated \$238 million in cigarette tax evasion by retailers that purchase and distribute untaxed cigarettes to consumers. In addition, Equalization estimated that individual consumers evade cigarette taxes totaling about \$54 million each year by purchasing cigarettes over the Internet or by purchasing cigarettes in other states that have lower cigarette taxes. Thus, Equalization estimated that annual cigarette tax evasion totaled \$292 million for fiscal year 2001–02.

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*Because Equalization's inspectors typically visit stores and areas more likely to exhibit noncompliance—a reasonable approach given its workload and staff—Equalization likely overestimated retailer tax evasion for the entire State.*

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The \$292 million evasion estimate is in the same order of magnitude as the high end of the \$130 million to \$260 million range Equalization estimated as cigarette tax evasion in 1999 using a statistical model. Therefore, Equalization accepted as valid the estimate based on the results of its inspections. However, because Equalization's inspectors typically visit stores and areas more likely to exhibit noncompliance—a reasonable approach given its workload and staff—Equalization likely overestimated retailer tax evasion for the entire State.

The sample of cigarette retailers Equalization selected for the inspection is not representative of cigarette retailers across the State and thus does not constitute a statistically valid sample. Investigations did not visit major grocery and discount chains, which Equalization pointed out have not historically posed problems with cigarette tax compliance. Additionally, because of limited resources, Equalization focused its inspections on major metropolitan areas. Consequently, the actual percentage of retailers in California that carry counterfeit or untaxed cigarettes is likely less than the 25 percent identified by the inspections, and the amount of cigarette tax evasion Equalization estimated may be overstated. According to the chief of Investigations, the intent of the inspections was not for Investigations to review a statistically valid sample for the entire state. Although we would agree that resource limitations might make it imprudent for Equalization to change its approach simply to obtain a statistically significant noncompliance rate, Equalization should ensure that it discloses the basis for its analyses and any necessary qualifiers.

In addition, the number of retailers Equalization used to estimate cigarette tax evasion appears to be overstated, which also results in an overestimation of the \$238 million in cigarette tax evasion by businesses. Assuming that retail locations that sell alcohol also sell cigarettes, Investigations originally estimated

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***Using the number of retailers who were licensed results in an estimated amount of cigarette tax evasion by retailers of \$112 million, which is \$126 million less than Equalization's estimate.***

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that about 85,000 retail locations in California sold cigarettes, because this was the number of retail locations licensed by the California Department of Alcoholic Beverage Control. However, after the passage of the act, only about 40,000 retailers registered as selling cigarettes. Thus, Equalization's original estimate of 85,000 retailers was overstated, although the number of small businesses that stopped selling cigarettes because of the act's licensing requirements may have accounted for a portion of the difference. Using 40,000 as the number of retailers in Equalization's formula results in an estimated amount of cigarette tax evasion by retailers of \$112 million, which is \$126 million less than Equalization's estimate. Since the act was implemented, Equalization has not updated its cigarette tax evasion estimate. Because many of the factors have changed since Equalization prepared its 2003 estimate, particularly Equalization's implementation of the provisions of the act, we believe Equalization should update its estimate of cigarette tax evasion.

Although Equalization estimated \$292 million in tax evasion for fiscal year 2001–02, a 2003 report from the Center for Tobacco Control Research and Education at the University of California, San Francisco (Center), estimated that 1 percent to 4.2 percent of cigarettes smoked in California were smuggled into the State, resulting in annual cigarette tax evasion ranging from only \$7 million to \$45 million. The Center criticized Equalization's analyses for (1) using an estimate of the level of smuggling based on national experience during the 1980s, ignoring the effect of California's large and effective tobacco control program on cigarette consumption; and (2) using a biased sample of small retail outlets where illicit sales would most likely occur. Equalization agrees that its sample is not representative of the entire State but believes that it relied on well-established methodologies and the best available data under the circumstances. Equalization counters that the Center's low estimate is the result of the Center not accounting for retailer tax evasion. Our review of Equalization's estimates and the Center's study indicates that the amount of cigarette tax evasion is most likely between their respective estimates, even though we have not made a specific calculation of cigarette tax evasion.

## Investigations Has Used Its Monthly Workload Reports to Track Retailer Tax Compliance Since Implementing Provisions of the Act

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*Investigations' monthly workload reports suggest that after the implementation of the act, two metrics of tax compliance have decreased: seizures of counterfeit products at retail locations and the percentage of retailers carrying counterfeit products.*

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If Equalization were to update its estimate of cigarette tax evasion, it would use, among other sources, information that Investigations maintains in its monthly workload reports about the results of its investigations at distributors, wholesalers, and retailers. Investigations' monthly workload reports suggest that after the implementation of the act, two metrics of tax compliance have decreased: seizures of counterfeit products at retail locations and the percentage of retailers carrying counterfeit products. However, because Equalization did not consistently seize counterfeit products before the act, the seizure rate only reflects changes in retailer compliance since 2004.

In some instances, Investigations staff select sites to inspect based on complaints or referrals, which means they are locations where problems are more likely to occur. We believe that this practice may inflate Equalization's noncompliance rates. Using information from its monthly workload reports, Equalization calculates noncompliance rates that reflect activities only at inspected retailers and thus may be higher than the actual rates among retailers statewide. Equalization's workload report is a management report that, compared with its year-end report of tax paid distributions, provides a more immediate assessment of compliance by allowing Equalization to perform calculations throughout the year rather than waiting until the year's end. Investigations' management primarily uses the workload reports to determine the workload and productivity of each inspection team, identify staffing needs, and determine tax compliance percentages.

Investigations also used its workload reports to calculate the percentage of inspected establishments that sold cigarettes with counterfeit stamps before the act and compared that with the percentage selling cigarettes with counterfeit stamps after the act. This comparison revealed a drop in illegal sales from 25 percent in fiscal year 2001–02 to 9 percent in fiscal year 2004–05. However, part of that decrease may be attributable to legislation that as of January 2005 required a cigarette tax stamp that is more difficult to counterfeit. Additionally, the sample used to calculate this metric was not representative of the retailers in the entire State but only of the locations that Equalization inspected.

Investigations uses the monthly reports to track retailer compliance by determining whether the number of product seizures at retail locations changes. If that number drops, Investigations

concludes that compliance is improving. For fiscal year 2004–05, Investigations calculated the seizure rate at 13.7 percent by dividing the number of inspections with seizures by the total number of inspections. The seizure rate for the first few months of fiscal year 2005–06 was 8.6 percent. Equalization attributes the reduction in the seizure rate to retailers' compliance with the act.

## THE ACT HAS HAD A POSITIVE EFFECT ON TAX REVENUES FROM CIGARETTES AND TOBACCO PRODUCTS

Collections of cigarette tax revenues fell between fiscal years 2001–02 and 2004–05, although they stabilized in fiscal years 2003–04 and 2004–05. Based on our analysis, collections of cigarette tax revenue for fiscal year 2005–06 are on track to be similar to those in the previous two fiscal years. However, collections of the tobacco products surtax have varied from year to year and are not demonstrating a consistent trend. Revenues from license and administrative fees increased the total revenue for fiscal year 2003–04 but have not had a significant continuing effect on revenues, although fines and penalties may increase over time. Table 2 shows revenues collected by revenue category from July 1, 2001, through March 31, 2006. Because revenues from fines and penalties were low in fiscal years 2003–04 and 2004–05, they are not shown separately on Table 2 but are included in the amounts for retail licenses and distributor and wholesaler licenses.

**TABLE 2**

### Cigarette Licensing and Tax Revenues Fiscal Years 2001–02 Through 2005–06

Revenue Category	Fiscal Year					Totals
	2001–02	2002–03	2003–04	2004–05	2005–06*	
Cigarette tax	\$1,076,368,270	\$1,017,169,358	\$1,025,452,399	\$1,025,429,737	\$764,477,649	\$4,908,897,413
Tobacco products surtax	45,662,838	39,556,181	43,175,802	57,331,933	43,813,127	229,539,881
Retail licenses	0	2,000	3,745,385	687,821	161,125	4,596,331
Distributor and wholesaler licenses	342	0	981,040	1,336,755	86,301	2,404,438
Administrative fee	0	0	13,561,840	894,606	615,388	15,071,834
<b>Totals</b>	<b>\$1,122,031,450</b>	<b>\$1,056,727,539</b>	<b>\$1,086,916,466</b>	<b>\$1,085,680,852</b>	<b>\$809,153,590</b>	<b>\$5,160,509,897</b>

Source: Board of Equalization revenue data systems.

\* The revenue in this column is through March 2006, which was the most recent available at the time of our fieldwork.

## Collections of Cigarette and Tobacco Products Taxes Are Improving

Between fiscal years 2001–02 and 2003–04, collections of cigarette taxes fell, continuing a trend of declining revenues caused largely by the decline in smoking prevalence among Californians. One component of the significant reduction in cigarette tax revenue in fiscal year 2002–03 was the bankruptcy of a major cigarette distributor in that year. According to Equalization, in calendar year 2004, it collected the amount the distributor owed (reflected in Table 2 in fiscal years 2003–04 and 2004–05). Collections of cigarette tax revenues in those two fiscal years stabilized at about \$1.025 billion. As we noted in the previous section, the stabilization and reversal of the historical decline in cigarette tax revenue is to some degree the result of the implementation of the act, in addition to the effects of the new cigarette tax stamp. However, collections of cigarette tax revenues will continue to decline as long as more Californians quit smoking.

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*Although the stabilization and reversal of the historical decline in cigarette tax revenue is to some degree the result of the implementation of the act, collections of cigarette tax revenues will continue to decline as long as more Californians quit smoking.*

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Since fiscal year 2001–02, revenues for the tobacco products surtax have fluctuated. According to Equalization, the tobacco products category comprises several different products, including cigars, snuff, and chewing tobacco, and the market for each product relies on unique demographic and income characteristics. Thus, sales and revenues depend on diverse factors. In fact, Equalization’s data demonstrate that tobacco product sales vary from one year to the next. Two factors, tax evasion and consumer behavior, cause some of the variation, but Equalization cannot quantify the extent to which each factor is responsible for changes in tobacco product sales.

During fiscal year 2002–03, Equalization estimated that tax evasion related to sales of tobacco products amounted to an additional loss in tax revenue of \$50 million. According to Equalization, because tobacco products bear no tax stamp that would help it conduct tests at retail locations, the methodology it uses to estimate evasion of taxes on tobacco products is more subjective than the methodology it uses to estimate evasion of taxes on cigarettes. In fiscal year 2002–03, Equalization surmised that evasion of taxes on tobacco products was five times greater than the average annual revenue from the cases of tobacco product tax evasion it investigated. Thus, given that these tax evasion cases averaged \$10 million per year in total revenue, Equalization estimated that evasion was \$50 million per year. Because Equalization measures tobacco product tax evasion in a more subjective manner, we did not perform audit work on its estimate.

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*In calendar year 2004, tax revenue from tobacco products increased by an estimated \$14 million, although national data do not show an increase in tobacco product sales during that period.*

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Equalization believes that the act also increased tax compliance among tobacco product retailers. Without the act, Equalization believes that wholesale sales of tobacco products would not have changed from calendar years 2003 to 2004. However, wholesale sales for tobacco products jumped 38.9 percent in calendar year 2004. As a result of improved compliance, at a tax rate of 46.76 percent of wholesale sales, the 38.9 percent increase in wholesale sales led to an estimated \$14 million increase in tax revenue from tobacco products. Because national data do not show an increase in tobacco product sales during that period and Equalization is unaware of any anecdotal evidence demonstrating why the rise occurred, it appears that the most likely reason for the increase in sales of tobacco products in calendar year 2004 is the set of regulatory changes brought about by the act. With these changes, Equalization believes, legitimate products have substituted for illicit products, reversing some of the decreases in tobacco product consumption of previous years.

#### **License Fees and Fines for Noncompliance Are Not Major Factors in Revenues**

Actual revenues for the administrative and license fees that the act instituted were greatest in fiscal year 2003–04, with some collections occurring in fiscal year 2004–05. This pattern was expected because the act took effect in January 2004 and Equalization continued to issue the initial licenses until September 2004. As described in the Introduction, the administrative fee is a one-time fee that will continue to generate some revenue as new manufacturers and importers qualify to do business in California. A modest amount of revenue will continue to be realized from distributors and wholesalers paying the \$1,000 annual renewal fee. Also, a retailer that changes ownership or opens a new sales location must obtain a license and pay the license fee.

Collections of fines assessed on civil citations do not currently play a large role in total revenues and are not specified in Table 2 on page 18. Since the inception of the act, many of the penalties that Equalization has assessed have been for first-time offenses and have resulted in warnings or suspensions rather than monetary fines, which for first offenses are generally minimal. In the first year of the program, Investigations staff used their inspections to educate retailers about the new requirements of the law. Further, with the addition of the new tax stamp, Investigations postponed its inspections of distributors until

***As the program continues and entities better understand the provisions of the law, Equalization plans to impose incrementally higher penalties to penalize entities that repeatedly choose not to comply with the cigarette tax laws.***

January 2006 to allow distributors time to adjust to the new stamping process. As the program continues and retailers, distributors, and wholesalers better understand the provisions of the law, Equalization plans to impose incrementally higher penalties to penalize entities that repeatedly choose not to comply with the cigarette tax laws. Moreover, as criminal cases close out through the court systems, Equalization expects an increase in penalty-based revenues.

**COSTS OF CARRYING OUT THE PROVISIONS OF THE ACT LARGELY COMPRISE STAFF SALARIES AND BENEFITS**

In fiscal years 2003–04 and 2004–05, Equalization spent \$9.2 million to implement the provisions of the act, with most of that amount paid toward staff salaries and benefits. A large portion of the costs in the first two years were for enforcing the provisions of the act, although licensing activities and overhead costs to make programming changes to Equalization’s information systems were a large proportion of costs that Equalization incurred in fiscal year 2003–04.

**Through June 2005, Equalization Spent \$9 Million to Carry Out the Provisions of the Act**

The act appropriated \$11 million for Equalization to use to carry out the licensing and enforcement provisions of the act. Table 3 shows that for fiscal years 2003–04 and 2004–05, Equalization spent \$9.2 million, mostly for the salaries and benefits of its staff. This expenditure amount is not surprising given that Equalization is performing licensing and enforcement activities.

**TABLE 3**

**Board of Equalization’s Expenditures to Implement the Cigarette and Tobacco Products Licensing Act of 2003 by Function  
Fiscal Years 2003–04 and 2004–05**

Function	Fiscal Year		Totals
	2003–04	2004–05	
Personal services	\$1,336,824	\$5,865,280	\$7,202,104
Operating expenses	1,133,842	895,980	2,029,822
<b>Totals</b>	<b>\$2,470,666</b>	<b>\$6,761,260</b>	<b>\$9,231,926</b>

Source: Board of Equalization expenditure data systems.

Equalization uses a cost allocation process to accumulate costs for the programs it administers. This process is complex, and the proportion of the work performed for the various programs can fluctuate during the fiscal year. Therefore, Equalization cannot provide final numbers for the costs attributable to the program activities related to the act for fiscal year 2005–06 until the fiscal year closes; Table 3 on page 21 shows Equalization’s expenditures only through June 2005. For example, an inspector performing field inspections may be conducting work for more than one of Equalization’s programs. Therefore, the personal services costs incurred for that inspector would be allocated among the programs in which he or she typically works. The actual processes Equalization uses to perform cost allocations vary by the type of cost. Personal services costs are generally allocated by the average salary of the job classification and the number of hours spent on a program’s activities. In contrast, the method Equalization uses to allocate mailroom costs depends on the number of pieces of mail the mailroom processed for that program.

### **Most of Equalization’s Costs in the First Two Years Were to Enforce the Provisions of the Act**

The Excise Taxes and Fees Division (Excise Taxes) and Investigations are responsible for the implementation and enforcement of the act. The distribution of duties between the two divisions stems from the licensing and enforcement components of the act. Excise Taxes is responsible for licensing all importers, manufacturers, distributors, wholesalers, and retailers of cigarettes and tobacco products and assessing any civil penalties for violating California laws relative to the sale of cigarettes and tobacco products. Investigations is primarily responsible for enforcing the provisions of the act. The two divisions coordinate their efforts to ensure that all entities involved in the sale of cigarettes and tobacco products comply with the act and that any entity found not in compliance is penalized accordingly.

As shown in Table 4, the costs Equalization incurred to implement the act through its licensing and enforcement activities increased significantly from fiscal year 2003–04 to fiscal year 2004–05. Because of the timing of the act’s implementation, including the enforcement start-up date of July 1, 2004, and the initial licensing deadline of June 30, 2004, we would expect to see an increase in enforcement expenditures and a decrease in licensing expenditures from the first fiscal year to the second. As expected, Investigations’ expenditures reflect its increased

workload in fiscal year 2004–05 as the division expanded to include a new civil audit branch and an inspection team composed of 40 new inspectors. However, spending on licensing did not decrease between fiscal years 2003–04 and 2004–05, as expected. As described in the paragraphs that follow, because of unforeseen problems, Excise Taxes experienced an increased licensing workload and maintained high levels of involvement in the licensing process in fiscal year 2004–05. Further, Excise Taxes continues to license new vendors as well as handling a growing workload in assessing and following up on penalties for violations of the act. Thus, Excise Taxes will continue to incur expenditures related to the act in subsequent years.

**TABLE 4**

**Board of Equalization’s Expenditures to  
Implement the Cigarette and Tobacco  
Products Licensing Act of 2003 by Function  
Fiscal Years 2003–04 and 2004–05**

Function	Fiscal Year		Totals
	2003–04	2004–05	
Licensing	\$ 801,098	\$1,604,242	\$2,405,340
Enforcement	399,405	4,384,593	4,783,998
Overhead	1,270,163	772,425	2,042,588
<b>Totals</b>	<b>\$2,470,666</b>	<b>\$6,761,260</b>	<b>\$9,231,926</b>

Source: Board of Equalization expenditure data systems.

***Licensing Costs Are Allocated to Excise Taxes***

Excise Taxes has been responsible for the licensure of all entities involved in the sale of cigarettes and tobacco products since the inception of the act. To ensure that all applicable vendors were licensed under the program by the cutoff date of June 30, 2004, Excise Taxes sent out license registration packets to all manufacturers and importers in November 2003 and to wholesalers, distributors, and potential retailers of cigarettes and tobacco products in February 2004. An amendment to the law extended the June 30 deadline and allowed Equalization to issue temporary licenses that would expire when Equalization issued permanent licenses or on September 30, 2004, whichever came first. This helped to ensure that all potential licensees would be made aware of the obligation to be licensed to sell cigarettes and tobacco products.

Despite its outreach effort, Excise Taxes had unexpectedly low numbers of license applications in the originally designated time frame. Equalization determined that many of the businesses that sold cigarettes and tobacco products were working under less obvious business codes, and Excise Taxes had to allow extra time to identify and contact potential licensees. According to Equalization, although Excise Taxes issued most licenses before the final deadline of September 30, 2004, it continues to license new entities, ensure that all transfers of existing businesses are properly licensed, and collect all applicable fees. Additionally, Excise Taxes maintains information on all licensees, ensures that wholesalers and distributors stay current with their annual license fees, and makes certain that retailers renew their licenses annually.

### ***Enforcement Costs Are Allocated to Investigations***

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***The act provided additional funding that Equalization used to create 51 new positions to monitor and enforce compliance with all California laws relating to the sale of cigarettes and tobacco products.***

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The act provided additional funding that Equalization used to create 51 new positions in Investigations to monitor and enforce compliance with all California laws relating to the sale of cigarettes and tobacco products by all applicable entities. Before the act, Investigations consisted of administrative staff and investigative staff. All investigators were required to conduct inspections and felony investigations and perform any resulting audits. The increase in staff allowed Investigations to add a civil audit branch and create a division of duties among its staff. As a result, Investigations should be able to complete inspections, investigations, and audits more efficiently. The increase in personnel was further used to bolster the investigative staff. Investigations used 40 additional staff members to create new inspection teams in its eight sections divided between Northern and Southern California, with each team composed of four inspectors and one team leader. The inspection teams are responsible for ensuring compliance with the act by all importers, wholesalers, distributors, and retailers within their respective regions of California. Investigations does not inspect manufacturers because they handle only untaxed cigarettes and tobacco products and typically operate out of state. The increase in positions in Investigations is consistent with the increased expenditures shown in the "Enforcement" category in Table 4 on page 23.

Since implementation of the act, Investigations has modified the responsibilities of its inspections staff to more efficiently carry out inspections and issue citations. In August 2004, Equalization's five-member board (board) approved Limited Peace Officer (LPO) status for 27 members of Investigations' staff. LPO status provides citation-writing authority and is a key

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*Limited Peace Officer status provides citation-writing authority to inspections staff and is a key element in Equalization's implementation of the act.*

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element of Equalization's implementation of the act because it is viewed favorably by the local criminal justice system on which Equalization depends for prosecution of tax evaders. Initially, only team leaders and investigators had LPO status, with each team leader assigned two inspection teams, each comprising two inspectors. A person with LPO status must be present to write a citation and testify in court; therefore, under the original system, a staff member with LPO status would have to travel between the two inspection teams. This resulted in long delays for the inspections staff, an extended inspection process for the taxpayer, and additional travel expenses. Additionally, only the person with LPO status who issued the citation could write documentation on the citation and any subsequent seizures, making that person unavailable to issue citations in the field. Consequently, his or her inspection team had to remain in the field office while the reports were written. On September 1, 2005, the board approved the continuation of LPO status for 24 members of Investigations' staff and the phase-in of 53 additional staff members for Investigations.<sup>5</sup>

#### ***Overhead Charges Are Mainly for Information Systems***

Costs related to overhead units for fiscal year 2003–04 were nearly \$1.3 million, which is slightly more than half of the costs allocated to implementing the program in that year. For the allocation of costs by function, we included data entry, mailroom, and information systems support as overhead units. Based on Equalization's budget change proposal related to the act, it anticipated needing nearly \$1 million in fiscal year 2003–04 to make all the necessary programming changes to its information systems to allow Equalization to implement the provisions of the act. This is consistent with the costs charged to overhead in fiscal year 2003–04, as previously shown in Table 4. In fiscal year 2004–05, the proportion of costs allocated to overhead fell to about 11 percent of the costs, which appears reasonable.

#### **IN ADDITION TO HAVING A REASONABLE INVESTIGATIVE PROCESS, EQUALIZATION IMPOSES PENALTIES IN ACCORDANCE WITH THE ACT**

Investigations has a clearly defined and reasonable process for conducting all inspections and investigations relating to cigarettes and tobacco products. Furthermore, Excise Taxes has

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<sup>5</sup> Three of the initially delegated LPO positions were vacant at that time.

documented and the board has approved procedures to assess penalties in accordance with the provisions of the act. Based on our testing of felony investigations and inspection citations, we determined that Investigations and Excise Taxes follow the procedures for conducting inspections and investigations, issuing citations, and assessing penalties for civil citations. By following board-approved procedures, Equalization can maintain case-to-case consistency and ensure that it is enforcing the provisions of the act. The Appendix shows the penalty guidelines the board approved.

### **Investigations Has a Clearly Defined and Reasonable Process for Conducting Inspections and Investigations**

Investigations had investigative authority before passage of the act and has established procedures for conducting inspections and felony investigations in the enforcement of California codes relating to cigarettes and tobacco products. In the period before the act, Investigations staff had authority to develop cases on criminal activities but lacked LPO status and had to rely on local law enforcement to issue criminal citations. Furthermore, cases relating to minor offenses would often result in the seizure of untaxed products, but unable to impose penalties and lacking LPO status, inspectors could only remind vendors to operate in compliance with the various California codes. Staff at Investigations told us that since the act went into effect, it has increased most of its staff's status to LPO and has expanded its procedures to include the issuance of criminal and civil citations. Investigations has updated its policies and procedures manual to include these procedures, and its staff has received training and supervisory support while learning their new duties.

Although the act has increased the authority of the investigators, Equalization's felony investigative process has not changed much since the adoption of the act. Felony investigations are based on complaints and referrals and generally consist of cases estimated to exceed a specific dollar threshold. Complaints and referrals may stem from an inspection, a taxpayer, an informant, other Equalization units, or an outside agency. During an initial intake process, an Investigations staff performs a basic screening to determine if the complaint meets the established criteria for assignment as a felony investigation case. If the complaint meets the criteria, it is assigned to an investigator, who then coordinates with the appropriate authorities to identify criminal violations and gather evidence.

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*Since the act went into effect, Investigations has increased most of its staff's status to Limited Peace Officer and has expanded its procedures to include the issuance of criminal and civil citations.*

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The investigator is responsible for documenting elements of each offense to develop a criminal complaint, which is then presented to the appropriate district attorney or local prosecutor for prosecution. Once a local prosecutor accepts the case, a felony investigation can take three to five years from complaint to prosecution. The investigator submits periodic reports to Investigations management on the case's status as it moves through the courts. Once the case is closed, the investigator receives a copy of the court's disposition and routes the case to Excise Taxes to be processed for any civil penalties.

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*Based on Equalization's data, Investigations completed 8,490 inspections in 2004 and 6,896 inspections in 2005.*

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As a result of additional funding generated by the act, Equalization created an inspections team within Investigations that has enabled Equalization to more closely monitor and enforce compliance with cigarette tax laws by conducting more inspections per year. Before the act, inspectors would complete about 1,200 inspections annually. Further, despite the presence of inspectors in the field, the consequences to vendors for selling counterfeit and untaxed cigarettes and tobacco products were limited, and although inspectors could seize all untaxed products, no penalties were associated with misdemeanor violations. With the addition of a formalized inspections team, Equalization's chief of Investigations is aiming for a goal of 10,000 inspections annually to reduce the amount of tax evasion relating to cigarettes and tobacco products. Based on Equalization's data, Investigations completed 8,490 inspections in 2004 and 6,896 inspections in 2005.

Equalization determines inspection sites based on complaints, referrals, or the judgment of the team leader. The most prevalent type of inspections are those chosen by the team leader, who selects all sites from a designated zip code or civic area from the Inspection Zone Database (inspection database). The inspection database contains information on all potential licensees. In addition, it includes businesses not registered with Equalization as licensed vendors of cigarettes and tobacco products to ensure that Equalization is regulating not only licensed vendors but also vendors that may be selling cigarettes and tobacco products illegally. The team leader also accesses Equalization's Integrated Revenue Information System (IRIS) to pull historical information on the selected sites regarding ownership, reported sales, and any relevant audit information. The information from the IRIS helps the inspectors determine what types of licenses and products should be found at the inspection location. Finally, the team

leader pulls information from Investigations' tracking system to ensure that there is no open case on the potential site and to determine if any complaints have been filed against the site.

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*For any violation related to cigarettes or tobacco products, inspectors can issue either a criminal or civil citation and seize untaxed cigarettes or tobacco products.*

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At the site, the inspectors check to ensure that each pack of cigarettes bears a valid tax stamp and is not a counterfeit product, all tobacco products have invoices supporting their legal purchase, and the retailer maintains all required documentation on site. Additionally, the inspectors check to ensure that the retailer displays all other applicable licenses, the data that Equalization has on file for the establishment are in accordance with the products it sells, and the proportion of taxable products seem in line with the reported taxes. If the inspectors discover any unlicensed or questionable activities outside the area of cigarettes and tobacco products, they have procedures to ensure that they make the appropriate referrals to other divisions within Equalization or any other applicable state department. For any violation related to cigarettes or tobacco products, inspectors can issue either a criminal or civil citation to the licensed or unlicensed person found to be in violation and seize untaxed cigarette or tobacco products that meet the specified conditions.

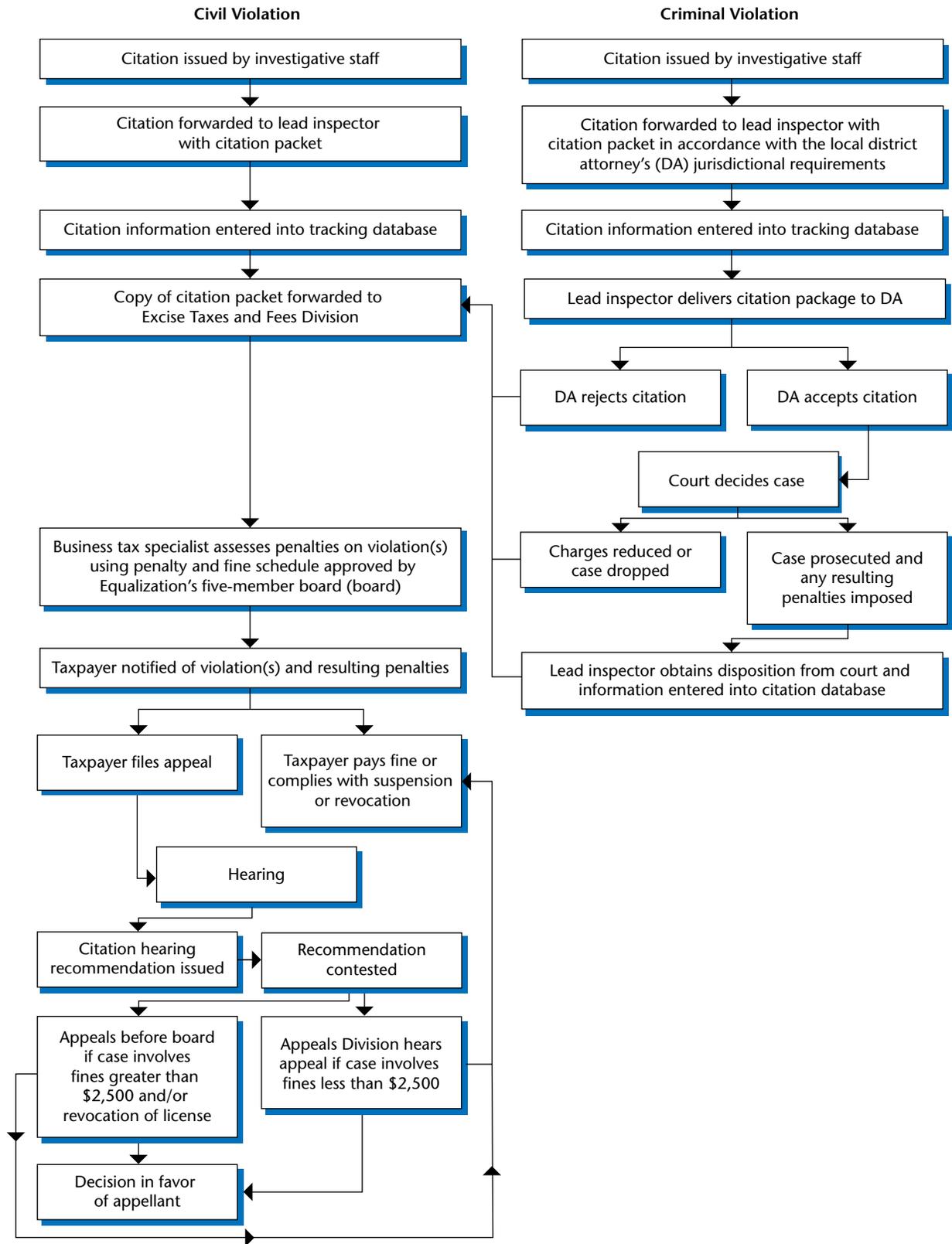
### **Equalization Assesses Penalties Generated From Inspections Using Board-Approved Guidelines**

The board has approved guidelines that appear to capture the requirements of the act. The board approved the penalty guidelines for civil violations on November 4, 2004. These board-approved guidelines dictate the specific penalty that accompanies each violation of the act along with any additional penalties for repeat offenses. Based on our testing of Equalization's penalty assessment process, we found that these guidelines meet the requirements of the act and that Excise Taxes adheres to the guidelines when assessing civil penalties.

Excise Taxes uses documented procedures to assess penalties on all civil citations once they are received from the inspection team. Figure 2 shows how Equalization processes civil and criminal citations. Initially, the information is routed to a business tax specialist within Excise Taxes to determine the penalties based on the board-approved guidelines. Equalization then sends information to the taxpayer informing him or her of the violation and the resulting penalty. At that time, the taxpayer is allowed 10 days to file an appeal to discuss any mitigating circumstances regarding the violation.

**FIGURE 2**

**Board of Equalization's Citation Processing**



Source: Board of Equalization.

The first level of the appeal process for civil penalties is typically a telephone conference between the petitioner and the appropriate Equalization representatives. Excise Taxes will issue a citation hearing recommendation upholding or dismissing the penalty within two weeks after the conference. Either the petitioner or Investigations can appeal the recommendation within 10 days of its determination. In the case of an approved appeal, when the fine is more than \$2,500 or if it results in the revocation of the taxpayer's license, the appeal is presented to the board. Equalization's Appeals Division is responsible for all other appeal hearings. If no appeal is filed, Equalization issues a final decision to the taxpayer, and the taxpayer is responsible for compliance with all payments of fines and any resulting suspensions or revocations of their licenses. Equalization is currently drafting regulations regarding penalties and appeals.

Once a criminal case has been prosecuted, the court may assess a fine for each violation, and the case is closed out in the court. The case is then transferred back to Excise Taxes to be processed for any civil penalties. If the court did not assess a fine as large as the penalty requirements of the act, Excise Taxes is responsible for assessing additional fines until the total fine is in accordance with the act. (See the Appendix for the penalty schedule Equalization uses.) If the court assessed a fine that is equal to or greater than the fine determined in the act, Equalization does not assess additional fines. Excise Taxes then evaluates all violations committed by the taxpayer and determines whether license suspension or revocation is warranted. The taxpayer is then informed of any civil penalties resulting from the violation(s). Subsequently, the taxpayer can petition Equalization's decision and has 10 days to request an appeal, similar to the process Equalization has for appeals of penalty decisions it makes.

## **RECOMMENDATION**

To provide a more accurate estimate of the extent of cigarette tax evasion, Equalization should update its calculation of cigarette tax evasion using data gathered after implementation of the act.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

A handwritten signature in black ink that reads "Elaine M. Howle". The signature is written in a cursive style with a large initial 'E' and a long, sweeping underline.

ELAINE M. HOWLE  
State Auditor

Date: June 29, 2006

Staff: Steven M. Hendrickson, Chief Deputy State Auditor  
Nancy C. Woodward, CPA, Audit Principal  
Julianna N. Field  
Claudia Orsi

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# APPENDIX

## **Cigarette and Tobacco Products Licensing Act of 2003 Civil Penalty and Fine Schedule**

Table A shows the schedule of penalties and fines that the Board of Equalization (Equalization) uses when it cites importers, distributors, wholesalers, and retailers of cigarette and tobacco products for not following the provisions of the Cigarette and Tobacco Products Licensing Act of 2003. Equalization's five-member board approved this schedule on November 4, 2004.

**TABLE A**

**Cigarette and Tobacco Products Licensing Act of 2003  
Civil Penalty and Fine Schedule**

Nature of Offense	1 <sup>st</sup>	30-Day Suspension or Revocation Plus Civil Fine				
		2 <sup>nd</sup>	3 <sup>rd</sup>	4 <sup>th</sup>	5 <sup>th</sup>	6 <sup>th</sup> and Subsequent
False statements on application	10- to 30-day suspension	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
No certification by participating manufacturer	Warning letter	1,000	1,000	1,000	1,000	1,000
1 year of purchase invoices not on premises	Warning letter	1,000	2,000	3,000	4,000	5,000
1 year of all sales-related records not on premises	Warning letter	1,000	2,000	3,000	4,000	5,000
No retention of purchase records (4 years)	Warning letter	1,000	2,000	3,000	4,000	5,000
No retention of all sales-related records (4 years)	Warning letter	1,000	2,000	3,000	4,000	5,000
1 <sup>st</sup> seizure of less than 20 packs of untaxed cigarettes (various types)	30-day suspension	NA	NA	NA	NA	NA
2 <sup>nd</sup> seizure within 5 years of less than 20 packs of untaxed cigarettes (various)	NA	2,000	3,000	4,000	5,000	5,000
1 <sup>st</sup> seizure of more than 20 packs of untaxed cigarettes (various)	30-day suspension	NA	NA	NA	NA	NA
2 <sup>nd</sup> seizure within 5 years of more than 20 packs of untaxed cigarettes (various)	NA	5,000	5,000 up to 10,000*	5,000 up to 15,000*	5,000 up to 20,000*	5,000 up to 50,000*
Sale or possession of untaxed tobacco products for which tax is due	Warning letter	1,000	2,000	3,000	4,000	5,000
Failure to comply with invoice requirements	Warning letter	1,000	2,000	3,000	4,000	5,000
Refusal to allow inspection	30-day suspension	1,000	2,000	3,000	4,000	5,000
Failure to display license	500	500	500	500	500	500

*continued on next page*

Nature of Offense	1 <sup>st</sup>	30-Day Suspension or Revocation Plus Civil Fine				
		2 <sup>nd</sup>	3 <sup>rd</sup>	4 <sup>th</sup>	5 <sup>th</sup>	6 <sup>th</sup> and Subsequent
Sale of cigarettes or tobacco products to unlicensed, suspended, or revoked entity	Warning letter	\$1,000	\$2,000	\$3,000	\$4,000	\$5,000
Cigarettes purchased from unlicensed, suspended, or revoked manufacturer	Warning letter	1,000	2,000	3,000	4,000	5,000
Cigarettes or tobacco products purchased from unlicensed, suspended, or revoked entity	Warning letter	1,000	2,000	3,000	4,000	5,000
Each separate sale is a separate violation	Warning letter	1,000	2,000	3,000	4,000	5,000
Sale of cigarettes or tobacco products to retailer or wholesaler that has been revoked or suspended until debts are clear	Warning letter	1,000	2,000	3,000	4,000	5,000
Acquiring cigarettes in violation of Revenue and Taxation Code, Section 30163	Warning letter <sup>†</sup>	1,000	2,000	3,000	4,000	5,000
Unlicensed sale of cigarettes or tobacco products	Warning letter	1,000	2,000	3,000	4,000	5,000

Source: Board of Equalization.

Note: Civil fines are reduced by the amount of any imposed fine resulting from a criminal misdemeanor citation.

NA = Not applicable.

\* Not to exceed the maximum allowed by statute.

<sup>†</sup> Warning letter is for retailers only. Wholesalers and distributors receive a 10-day suspension.

*Agency's comments provided as text only.*

State Board of Equalization  
Office of the Executive Director  
P.O. BOX 942879  
Sacramento, California 94279-0073

June 16, 2006

Ms. Elaine M Howle, State Auditor  
Bureau of State Audits  
555 Capitol Mall, Suite 300  
Sacramento, CA 95814

Dear Ms. Howle:

This is the Board of Equalization (BOE) response to the draft audit report entitled "Board of Equalization: Its Implementation of the Cigarette and Tobacco Products Licensing Act of 2003 Has Helped Stem the Decline in Cigarette Tax Revenues, but It Should Update Its Estimate of Cigarette Tax Evasion". We appreciate the opportunity to comment on your draft report, as well as the work of your staff in reviewing our policies and procedures in this area.

The BOE agrees with the overall conclusions of the Bureau of State Audits (BSA) draft report and its one finding that:

- The BOE should update its calculation of cigarette tax evasion using data gathered after the implementation of the act.

The BOE has already taken action to address the recommendation. We look forward to our sixty day follow up review to demonstrate our compliance with BSA's suggestion.

Sincerely,

*(Signed by: Ramon J. Hirsig)*

Mr. Ramon J. Hirsig, Executive Director

cc: Members of the Legislature  
Office of the Lieutenant Governor  
Milton Marks Commission on California State  
Government Organization and Economy  
Department of Finance  
Attorney General  
State Controller  
State Treasurer  
Legislative Analyst  
Senate Office of Research  
California Research Bureau  
Capitol Press