

Memorandum

To : Honorable Carole Migden, Chairwoman
Honorable Claude Parrish, Vice-Chairman
Honorable Bill Leonard
Honorable John Chiang
Honorable Steve Westly

Date : April 8, 2004

From : Ramon J. Hirsig
Executive Director



Subject : ***Alternative Cigarette Tax Stamp (ACTS) Project Status Report***
(April 13, 2004 Administrative Agenda)

Background

During discussions of the ACTS Project at the March 23, 2004 Board Meeting, a number of concerns were raised, and the Board directed staff to report back on those issues at the April 13, 2004 meeting.

Since the last Board Meeting, BOE management and staff have met with Assemblymen Jerome Horton's and Herb Wesson's offices; Senate and Assembly Budget Committee staff; and Department of Finance (DOF) staff. Discussions were focused on resolving the funding issue for a new cigarette tax stamp and, if necessary, delay of the implementation date mandated by Senate Bill 1701 (Peace, 2002).

A summary of each of the issues with follow-up information and staff recommendations is provided below.

Funding—Finance Letter

During the March 23, 2004 Board Meeting it was agreed that due to the significant funding needs identified by the Invitation for Bid (IFB), the funding source issue must be resolved prior to proceeding with another solicitation and awarding of a contract.

The DOF staff has indicated a willingness to consider a Finance Letter (see Attachment A) for funding in the May Revise of the 2004-2005 Budget for a new cigarette tax stamp contract if the BOE is able to obtain a 5:1 General Fund revenue to cost return goal. Staff has determined that this can be accomplished by establishing a spending cap for the price of the stamps at \$8.68 per thousand. This is based on the anticipated purchase of nearly 1.3 billion stamps per year (see Attachment B). Only six months funding will be necessary, assuming a January 1, 2005 implementation date, for fiscal year 2004-2005. The cost of the contract would be paid based on each fund's proportional amount of revenue; e.g., the General Fund receives approximately 11.49 percent of the revenue, therefore it will pay 11.49 percent of the contract cost.

ITEM M
04/13/04

January 1, 2005 Implementation Date

At the March 23, 2004 Board Meeting, staff recommendation for the ACTS project was to seek legislation for a delay in the implementation date of January 1, 2005.

At this time it is not known if a delay will be necessary. However, Assemblyman Horton is amenable to carrying legislation for extending the implementation date.

Interested Parties Meeting

BOE staff has scheduled an Interested Parties Meeting for April 21, 2004. This meeting will be convened to provide the Licensed Cigarette Distributors (LCD) information on the efforts to implement the provisions of Senate Bill 1701, the reasons for cancellation of the initial procurement, and to allow the LCDs the opportunity to provide staff with their concerns regarding the stamp application equipment and service needs for that equipment.

Solicitation Document—Invitation for Bid

BOE staff would like to reissue an IFB as soon as possible after Board Member approval of the Finance Letter, and upon confirmation of anticipated funding included in the May Revise. Staff believes that the Department of General Services could release the IFB immediately following the May Revise and that the result of the submitted bid proposal evaluations would be an agenda item for approval at the June 30th Sacramento Board Meeting. A tentative schedule highlighting the release and evaluation of the IFB is attached (see Attachment C).

Staff Recommendation

At this time, the staff recommendation regarding the Alternative Cigarette Tax Stamp project is to approve the Finance Letter and be prepared to release a new IFB that coincides with the release of the May Revise on approximately May 14, 2004.

I will contact each of your offices before the April 13th meeting date to discuss this matter. If you have any questions regarding this report, please contact David Gau at (916) 445-1516 or Dennis Maciel at (916) 327-3276.

RJH:rs
ACTSbdmemstatus6
Attachments

cc: Ms. Marcy Jo Mandel
Mr. Timothy W. Boyer
Mr. David J. Gau
Ms. Raye Zentner
Mr. Dennis Maciel

STATE BOARD OF EQUALIZATION
FISCAL YEAR 2004-05
FINANCE LETTER No. 2

TITLE OF PROPOSED CHANGE:

Alternative Cigarette Stamps Contract

SUMMARY OF PROPOSED CHANGES:

This proposal requests a total of \$4,904,000 (\$564,000 General Fund, \$113,000 Breast Cancer Fund, \$1,409,000 Cigarette and Tobacco Products Surtax Fund, and \$2,818,000 California Children and Families First Trust Fund in FY 2004-05 and \$9,808,000 (\$1,127,000 General Fund, \$226,000 Breast Cancer Fund, \$2,818,000 Cigarette and Tobacco Products Surtax Fund, and \$5,637,000 California Children and Families First Trust Fund in FY 2005-06 and ongoing to fully implement the provisions of SB 1701 (Chapter 881, Statutes of 2002). This legislation requires the Board of Equalization, as of January 1, 2005, to replace the current cigarette stamps and meter impressions with a stamp or meter impression that can be read by a scanning or similar device and encrypted with specified information. In addition, this request would protect the existing tax base and increase tax revenue by \$28.2 million.

FISCAL IMPACT:

	<u>Appropriation No.</u>	<u>Dollars (in Thousands)</u>		
	<u>(Org) - (Ref) - (Fund)</u>	<u>Past Year</u>	<u>Current Year</u>	<u>Budget Year</u>
Existing Program:	0860 - 001 - 0001	\$ 4,082	\$ 3,936	\$ 3,936
	0860 - 001 - 0004	\$ 124	\$ 124	\$ 124
	0860 - 001 - 0230	\$ 1,892	\$ 1,901	\$ 1,901
	0860 - 001 - 0623	\$ 1,674	\$ 1,670	\$ 1,670
Reimbursements	0860 - 501 - 0995	\$ ---	\$ ---	\$ ---
	TOTAL	<u>7,772</u>	<u>7,631</u>	<u>7,631</u>
Positions		<u>74.4</u>	<u>71.5</u>	<u>71.5</u>
Personnel Years		<u>71.5</u>	<u>68.7</u>	<u>68.7</u>
Proposed Changes:	0860 - 001 - 0001	\$ ---	\$ ---	\$ 564
(by appropriation)	0860 - 001 - 0004	\$ ---	\$ ---	\$ 113
	0860 - 001 - 0230	\$ ---	\$ ---	\$ 1,409
	0860 - 001 - 0623	\$ ---	\$ ---	\$ 2,818
Reimbursements	0860 - 501 - 0995	\$ ---	\$ ---	\$ ---
	TOTAL	<u>\$ ---</u>	<u>\$ ---</u>	<u>\$ 4,904</u>
Positions		_____	_____	_____
Personnel Years		_____	_____	_____

For EDP requests, include date Special Project Report (SPR) or Feasibility Study Report (FSR), approved _____.

State Board of Equalization
Property and Special Taxes Department
Alternative Cigarette Stamps Contract
Fiscal Year (FY) 2004-05

A. Nature of Request

The State Board of Equalization (BOE) requests a budget augmentation to establish funding to support a new contract involving developing an alternative to the existing cigarette tax stamp. This alternative stamp is mandated by the provisions of Senate Bill (SB) 1701 (Chapter 881, Statutes of 2002) with the intent of reducing counterfeiting and decreasing tax evasion.

The BOE is submitting this May Revision request for half-year funding of \$4.9 million to implement the provisions of SB 1701. The full year augmentation funding will be \$9.8 million.

BOE estimates cigarette tax revenue evasion at \$238 million annually. Additionally, BOE estimates an accompanying evasion of \$43.6 million in state and local sales and use taxes. BOE believes that the alternative cigarette stamp will reduce this evasion by an estimated \$28.2 million. (\$23.8 million in cigarette taxes, \$2.9 million in state sales taxes, and \$1.5 million in local and special district sales taxes.) If the May Revision request is not approved and the project does not proceed, this reduction in tax evasion will not occur.

B. Background/History

As of January 1, 2005, SB 1701 will require the Board of Equalization (BOE) to implement a cigarette tax stamp or meter impression capable of being read by scanning or similar device, and, at a minimum, include specific data encrypted within the new stamp.

In anticipation of the proposed legislation, the BOE's Alternative Cigarette Tax Stamp (ACTS) Project team: 1) conducted a nationwide Market Interest Survey in February 2002; 2) met with these interested parties in May 2002 and solicited preliminary proposals; and 3) in October 2002 met with two vendors who presented their proposed cigarette tax stamps and stamping systems.

Since the Fall of 2002, the ACTS Project team completed a Budget Change Proposal and Feasibility Study Report requesting funding and resources for the project. At that time, the procurement cost for a new stamp was unknown. Approvals of these documents were received from the Department of Finance (DOF) in December 2002, and January 2003, respectively.

In addition, the ACTS Project team met with other state and federal agency representatives to discuss current encryption techniques and to identify what current anti-counterfeiting techniques would be effective in BOE's stamp requirements.

B. Background/History (continued)

From these meetings, BOE and the Department of General Services (DGS) staff documented specific program and technical requirements. In December 2003, the BOE and DGS released an Invitation for Bid (IFB). Two responses to the IFB were received by the DGS and evaluated by the BOE evaluation team. One response did not meet the requirements in the IFB and was deemed "non-responsive". The other response exceeded the budgetary limitations of the BOE. As a result, the procurement was canceled.

Although the contract amount is unknown at this time, the BOE is submitting this May Revision request for approval of the concept and funding authority prior to proceeding with another procurement.

DOF staff indicated that any proposal requiring General Fund support should provide a 5:1 return of General Fund revenue to cost before DOF could consider funding.

C. State Level Considerations

This proposal is consistent with BOE's Strategic Plan, Issue II – Modernizing Tax Compliance Practices," Strategy 4 – "Pursue changes to the tax laws to make them more relevant to current and evolving business practices."

D. Justification/Analysis of All Feasible Alternatives

SB 1701 requires implementation of a new stamp beginning January 1, 2005.

Alternative 1

Approve contingency funding of \$4.9 million beginning FY 2004-05 and \$9.8 million in FY 2005-06 to accommodate the potential budgetary impact of the new contract (See Exhibit I, page 6 of 9).

Pros:

- Assures compliance with the requirements of SB 1701 and the objectives of the project.
- Reduces fraud and revenue loss.
- Protects the tax revenue base and increases revenue to the State and local government.

Cons:

- Requires a half-year augmentation of \$4.9 million beginning in FY 2004-05.
- Requires a full year augmentation of \$9.8 million in FY 2005-06.

D. Justification/Analysis of All Feasible Alternatives (continued)

Alternative 2

Request a deficiency to fund the new contract in the FY 2004-05.

Pros:

- Assures compliance with the requirements of SB 1701 and the objectives of the project.
- Reduces fraud and revenue loss.
- Protects the tax revenue base and increases revenue to the State and local government.

Con:

- Request a deficiency funding with Section 27.00 notification to the Department of Finance. This option is not feasible since the Department of Finance will not approve deficiencies per Budget Letter 03-18.

Alternative 3

Do not approve the additional funding to establish the new contract.

Pro:

- Requires no additional expenditure authority.

Cons:

- The BOE does not have additional General Fund resources to fund this new contract. Due to major reduction to the BOE's General Fund, the BOE can not absorb the additional amount within its budget.
- If the project does not proceed, the BOE estimates that as much \$28.2 million in cigarette tax and sales and use tax revenue evasion will continue due to counterfeit stamps.

E. Timetable

Effective July 1, 2004.

F. Recommendation

It is recommended that Alternative 1 be approved and that the BOE be authorized additional funding of \$4.9 million in FY 2004-05 and \$9.8 million in FY 2005-06 to avert a potential revenue loss. Taxpayer services, and in turn revenue, would be adversely affected if BOE is forced to redirect monetary resources that would otherwise be used to support revenue operations.

G. Fiscal Detail

See attached "Fiscal Detail" schedules.

Alternative Cigarette Stamp Contract

Revenue:	<u>Excise Tax</u>	<u>Sales Tax</u> (General Fund)	<u>STJ and Local Government</u>	<u>Total</u>
Tax Evasion	\$238,000,000	\$29,000,000	\$14,600,000	\$281,600,000
10% Reduction in Tax Evasion (SB 1701)	23,800,000	2,900,000	1,460,000	28,160,000
General Fund (\$0.10 of \$0.87, e.g. 11.49%)	2,734,620 <u>a/</u>	2,900,000 <u>a/</u>		5,634,620
Breast Cancer (\$0.02 of \$0.87, e.g. 2.30%)	547,400			547,400
Proposition 99 (\$0.25 of \$0.87, e.g. 28.74%)	6,840,120			6,840,120
Proposition 10 (\$0.50 of \$0.87, e.g. 57.47%)	13,677,860			13,677,860
STJ and Local Government Funding			1,460,000	1,460,000
Total Recovered Revenue	<u>\$23,800,000</u>	<u>\$2,900,000</u>	<u>\$1,460,000</u>	<u>\$28,160,000</u>

Alternative Stamp Contract Based on Recovered Revenue

General Fund (\$0.10 of \$0.87, e.g. 11.49%)	\$1,126,924 <u>a/</u>		\$1,126,924
Breast Cancer (\$0.02 of \$0.87, e.g. 2.30%)	225,581		225,581
Proposition 99 (\$0.25 of \$0.87, e.g. 28.74%)	2,818,781		2,818,781
Proposition 10 (\$0.50 of \$0.87, e.g. 57.47%)	5,636,582		5,636,582
Total Annual Cost of Contract (All funds)	<u>\$9,807,868</u>		<u>\$9,807,868</u> <u>b/</u>
May Revision (Half Year)	\$4,903,934		\$4,903,934

a/ Breakdown of cost is only associated with the \$0.87 revenue (Excise Tax). DOF mandates a 5 to 1 benefit/cost ratio. A General Fund revenue recovery of \$5,634,620 (\$2,734,620 + \$2,900,000) translates into a maximum cost of \$1,126,924.

b/ Given the 5 to 1 benefit/cost requirement and funding split that matches the proportion of funds of the 87 cent stamp, BOE estimates the highest value of the needed funding to be \$9,807,868.

BUDGET CHANGE PROPOSAL
 FISCAL DETAIL
 FISCAL YEAR 2004-05
 (\$ in Thousands)

Title of Proposed Change: Alternative Cigarette Stamps Contract

Program/Element/Component: 45 Cigarette and Tobacco Products Tax Program
 45.30 Auditing Accounts/45.40 Enforcement Activities

	Personnel Years		Current Year	Budget Year
	CY	BY		
TOTAL SALARIES AND WAGES				
Salary Savings				
NET TOTAL SALARIES AND WAGES				
Staff Benefits				
TOTAL PERSONAL SERVICES				
OPERATING EXPENSE AND EQUIPMENT				
General Expense				
Printing				
Communications				
Postage				
Travel--In-State				
Travel--Out-of -State				
Training				
Facilities Operations				
Consulting & Professional Services: Interdepartmental				
Consulting & Professional Services: External				4,904
Stephen P. Teale Data Center				
Data Processing				
Equipment				
Other Items of Expense: (Specify Below)				

Finance Letter No. 2

Current Year Budget Year

TOTAL OPERATING EXPENSE AND EQUIPMENT

_____ \$4,904

TOTAL EXPENDITURES (State Operations)

===== \$4,904

Source of Funds

General Fund	(0001)	\$564
Special Funds:		
Breast Cancer Fund	(0004)	113
State Emergency Telephone	(0022)	
Propane Surcharge Fund	(0051)	
Motor Vehicle Fuel	(0061)	
Occupational Lead Prevention Fund	(0070)	
Childhood Lead Poisoning Prev. Fund	(0080)	
Cig. and Tobacco Prod. Surtax Fund	(0230)	1,409
Oil Spill Prevention and Admin. Fund	(0320)	
Integrated Waste Management	(0387)	
Underground Storage Tank Fund	(0439)	
Energy Resources Programs Account	(0465)	
CA. Children and Families First Trust Fund	(0623)	2,818
Timber Tax Fund	(0965)	
Gas Consumption Fund	(3015)	

Federal Funds

Other Funds

Reimbursements (0995)

SUMMARY OF PROPOSED CHANGES

	Current Year (\$ in Thousands)	Budget Year (\$ in Thousands)	Budget Year + One (\$ in Thousands)
Proposed Equipment:			
N/A			
Total			
Proposed Contracts:			
Consulting and Professional Services - External Cigarette Tax Stamps Contract		\$4,904	\$9,808
Total		\$4,904	\$9,808
One-Time Costs:			
N/A			
Total			
Future Savings:			
N/A			
Total			
Full-Year Cost Adjustments:			
N/A			
Total			

**Estimated Stamp Price Per Thousand
(Based on Dollar Cap)**

	Dollars	Stamps
Cigarette Tax Evasion Due to Counterfeiting	\$ 238,000,000	273,563,218
Recoverable @ 10%	\$ 23,800,000	27,356,322

Estimated Annual Stamps Needed Without New Stamp 1,250,825,886

Estimated Annual Stamps Needed With New Stamp 1,278,182,208

Amount of Contract Not to Exceed \$ 11,100,000

	Annual	Requested	Price
Stamp Sales Level	Stamp Sales	Annual Amount¹	Per 1,000
2004 Stamp Sales w/10% Increase	1,278,182,208	\$ 11,100,000	\$ 8.68

¹ Calculation of Requested Amount

Current Amount in BOE budget for stamps	\$ 1,300,000
Amount Requested in Finance Letter	\$ 9,800,000
Total	<u>\$ 11,100,000</u>

Tentative ACTS Invitation For Bid (IFB) Implementation Schedule

Task	Approximate Duration	Approximate Date(s)
BOE & DGS Develop/Approve IFB Document	4 Weeks (from April 13, Board Hearing to May Revise release)	April 14–May 14, 2004
Release IFB Document	1 Day (coincides with May Revise release)	May 14, 2004
Bidder's Conference (if necessary)	1 Day (1 week from IFB release)	May 21, 2004
Written Question and Answer Period	2 Weeks (from IFB release date)	May 14–28, 2004
Bids Due to DGS	1 Day (approximately 5 weeks from IFB release date)	June 16, 2004
Bid Opening	1 Day	June 16, 2004
Evaluation of Submitted Bid(s)	1 Week (approximate from bid opening)	June 16–25, 2004
Board Approval of Contract	1 Day	June 30, 2004 (Sacramento Board Hearing)
Post Award Equipment Testing	4 Weeks (from contract approval)	June 30–July 23, 2004