

SUBCOMMITTEE NO. 4

Agenda

Senator Richard D. Roth, Chair
Senator Steven M. Glazer
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**Upon adjournment of Joint Hearing of Senate Budget and Fiscal
Review, Subcommittee No. 2, 3 and 4
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ITEMS FOR DISCUSSION AND VOTE

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ISSUES PROPOSED FOR DISCUSSION AND VOTE

0860 BOARD OF EQUALIZATION

Department Overview. The State Board of Equalization (BOE) is comprised of five members – four members elected to the board on a district basis, and the State Controller. The BOE administers the sales and use tax (including all state and local components), oversees the local administration of the property tax, and collects a variety of excise and special taxes (including the gasoline tax, insurance tax, and cigarette and tobacco products taxes) and various fees (including the underground storage tank fee, e-waste recycling fee, and fire prevention fee). The BOE establishes the values of state-assessed property, including inter-county pipelines, railroads, and regulated telephone, electricity, and gas utilities. The BOE also hears taxpayer appeals of BOE-administered taxes and fees and Franchise Tax Board (FTB) decisions on personal income and corporation taxes. The BOE has been given additional responsibilities pursuant to the passage of Proposition 64, approved by the voters in November 2016.

Budget Summary. The Governor's budget proposes resource support of \$668.4 million (\$338.5 million General Fund), and 4,800 positions for the BOE in fiscal year 2017-18. The budget proposes total level funding and a slight General Fund support increase, compared with spending estimates for the current year. Proposed staffing in the budget would increase slightly (after accounting for vacancies) from the current-year due to new or expanded programs and services. The department's budget requests relate largely new programs and services stemming from legislation or voter initiatives.

Issue 1: Centralized Revenue Opportunity System (BCP)

Governor's Proposal. The budget includes a proposal from BOE to provide funding for its continued work on the Centralized Revenue Opportunity System (CROS). For 2017-18, the request is for \$30 million (\$17.2 million General Fund) and 65.4 positions. The five year request increases to \$50.9 million in 2018-19, \$66.6 million in 2019-20, and dropping to \$17.1 million in 2020-21 and \$19.2 million in 2021-22. Of the request, about one-half of the cost is for personnel – largely technology and tax professionals – and one-quarter of the cost is for professional consulting services. Resources would be distributed in the following areas: business management, contract management, organizational change management, technical management, and project management.

Background. BOE is in the process of consolidating and modernizing its existing taxpayer information systems through the CROS project. As designed, CROS would replace the BOE's two existing systems of tax information and return management, expand online business and taxpayer services, and provide an agency-wide data warehouse. CROS would replace two legacy systems, the Integrated Revenue Information System (IRIS) and the Automated Compliance Management System (ACMS).

The Feasibility Study Report (FSR) approved September 2011, redirected BOE resources to the CROS project in order to proceed with the procurement phase. Special Project Report 1 (SPR 1) was submit on March 2012, and based on this, staffing was authorized, as well as funding for audit, collection and registration backlogs. SPR 2 was submitted in December 2013, addressing a nine month change in the procurement schedule and extending the implementation by one year. The CROS project subsequently submitted SPR 3, which called for an additional delay of 19 months in the procurement phase. Based on SPR 3, BOE submitted a May Revision request in 2016 to begin its implementation phase. The request asked for five years of funding; the Legislature chose to fund the first year only. BOE approved the selection of the CROS contractor (Fast Enterprises) and the CROS solution (GenTax) in August 2016. SPR 4 was submitted in October 2016, which included a resource analysis, project deliverables, project schedule, project management plans and technical capabilities.

The acquisition of CROS will be achieved through a performance-based, benefits-funded procurement approach. This approach is similar to that used by the FTB and the Employment Development Department (EDD) for their respective information and data management systems. The approach does not require up-front vendor funding, as the development and implementation costs are paid under a benefits-funded contract, with payment allowed only when increased revenues are received. Contractor payments would be dependent on the generation of additional revenues attributable to the project and would be capped overall.

Staff Comments. The CROS project is a necessary undertaking for the state, given the age and status of the agency's legacy mainframe-based revenue and collection information systems. The budget proposal for continued funding of the CROS project is reasonable with respect to anticipated workload during the implementation phase. In addition, the benefits-based funding for the project is appropriate for the tax agency; a similar approach has been used successfully by the FTB. Nevertheless, as noted last year, staff has significant concerns regarding the ability of the agency to successfully undertake a project of this importance and magnitude. The governance of large and complex undertakings, like the CROS project, is a challenge for the best-managed organizations, and even more so for agencies with management issues, like the BOE. Clearly, the BOE, in most cases, functions adequately, but instances of questionable management and decision-making nevertheless raise concerns.

Previous information technology projects that have failed to meet expectations have generally fallen short, not because of technical challenges, but due to the failure of adequate oversight, management and governance. The state experienced the failure and termination of the 21st Century Project, in which the state invested approximately \$300 million dollars, and it is likely that the state will realize little by way of useful product from this investment. On the other hand, more positive examples are also available. FTB devoted much deliberation, effort and resources to working through project management and oversight issues related to its Enterprise Data to Revenue (EDR) project. Although this project was not without some uncertainties and delays, the structure of responsibility was such that the agency was able to adjust to these contretemps while keeping the overall project on track. Similarly, the Financial Information System for California (FI\$Cal) project has devoted considerable discussion to the governance and management issues in order to maintain the integrity of the final product.

Project governance models and management structures are crucial, not because of routine decisions or quotidian activities, but rather for instances of technical challenge and impediments to implementation. Staff notes that IT projects, by their very nature, carry with them inherent unknowns both in design and timeline. Nevertheless, the CROS history to date is not at all encouraging – the FSR was approved five years ago, in 2011; SPR 1, outlining two strategies for procurement, was submitted in March 2012; SPR 2 was then submitted in December 2013, addressing a nine month change in the procurement schedule and one year delay in implementation; and, SPR 3 was submitted in April 2016 to address an additional 19 month delay in the procurement phase. Meanwhile, the CROS project itself has experienced some leadership issues. The agency is currently recruiting for a new project director.

Budget Bill Language. The Administration has requested that the proposed budget bill language governing the CROS project be revised as follows:

The Department of Finance may augment the following items in the 2018–19 fiscal year by the amount of any unencumbered funds for vendor compensation payments related to the Centralized Revenue Opportunity System as of June 30, 2017, in those items: 0860-001-0004, 0860-001-0022, 0860-001-0061, 0860-001-0070, 0860-001-0080, 0860-001-0230, 0860-001-0320, 0860-001-0387, 0860-001-0439, 0860-001-0465, 0860-001-0623, 0860-001-0965, 0860-001-3015, 0860-001-3058, 0860-001-3063, 0860-001-3065, 0860-001-3067, 0860-001-3212, 0860-001-3251, 0860-001-3260, 0860-001-3270, 0860-001-3288, and 0860-001-3301, 0860-001-3304, and 0860-001-3308. Any augmentation pursuant to this provision shall be reported in writing to the Joint Legislative Budget Committee within 30 days.

Post Submission Changes. After the budget proposal was reviewed and approved by Department of Finance (DOF), it became apparent that the proposal, in its request for position authority, did not incorporate existing vacant positions at the agency. DOF has made adjustments to the request that account for these vacancies and reflects other factors. Final adjustments and documentation regarding the budget request will be provided to Subcommittee No. 4 prior to the May Revision.

Staff Recommendation. Hold open.

Issue 2: Cigarette and Tobacco Products Licensing Program (BCP)

Governor’s Proposal. The budget calls for \$286,000 (special funds) in 2017-18, and approximately \$200,000 in 2018-19 and ongoing, to administer recent legislation regarding the Cigarette and Tobacco Products Licensing program. The legislative changes call for annual rather than one-time, license renewal fees, and expand the definition of tobacco products to include nicotine products and vaping devices and accessories. The additional resources will

address ongoing overtime in the areas of: outreach, registration, account renewal, payment processing, refunds and account close-outs, enforcement, and administrative support. The agency indicates that it will use existing resources to address additional costs imposed in the current year.

Background. In 2003, the Legislature enacted statutes establishing the Cigarette and Tobacco Products Licensing Act which established a statewide licensing program administered by the BOE to address untaxed sales and illegal distribution of these products. The act requires the BOE to administer a statewide program to license cigarette and tobacco products manufacturers, importers, distributors, wholesalers and retailers. The most recent legislation increases the per-location fee from \$100 to \$265, changes the fee basis from one-time to annual, and expands tobacco products to encompass a wide range of products containing, made or derived from tobacco or nicotine, as well as nicotine delivery systems.

Staff Comments. Given that the agency indicates that it can meet the current year costs of the additional activities by redirecting resources, has the ability to redirect been accounted for in this budget request? That is, is the agency in a continuing position to absorb a portion of the costs in the new program responsibilities?

Staff Recommendation. Hold open.

Issue 3: Lead-Acid Battery Fee (BCP)

Governor's Proposal. The budget calls for \$1.2 million and 3.1 positions in 2016-17, \$837,000 and 6.3 positions in 2017-18, \$1.4 million and 8.6 positions in 2018-19 , and \$1.4 million and 10 positions in 2019-20 and ongoing (all special funds) to implement and administer the Lead-Acid Battery Recycling Act (LABRA) of 2016. The program implementation will be paid from a loan to the Lead-Acid Battery Clean-Up Fund from the California Tire Recycling Management Fee. Ongoing costs of the program will be paid by the new fee imposed by the LABRA. Imposing the new program and its ongoing administration requires additional activities related to registration, return process, collections, audits, appeals, refunds, allocation and other administrative functions.

Background. The LABRA imposes a new fee of \$1 on each battery until March 31, 2022 and \$2 per battery beginning April 1, 2022, on consumers and manufacturers of lead-acid batteries. Revenues collected, less refunds and expenses reimbursement to the BOE, will be deposited in the Lead-Acid Battery Clean-Up Fund and used for clean-up costs associated with the batteries. Ongoing costs of the program are paid from the fee, which is collected from retail dealers. The dealer is allowed to retain 1.5 percent of the fee collected to meet their own collection costs. The new fee program will add an addition 20,000 fee-payers to BOE's existing base.

Post Submission Changes. After the budget proposal was reviewed and approved by the DOF, it became apparent that the proposal, in its request for position authority, did not incorporate existing vacant positions at the agency. DOF has made adjustments to the request that account

for these vacancies and reflects other factors. Final adjustments and documentation regarding the budget request will be provided to Subcommittee No. 4 prior to the May Revision.

Staff Recommendation. Hold open.

Issue 4: Implementation of California Healthcare, Research and Prevention Tobacco Tax Act of 2016 (Proposition 56) (BCP)

Governor’s Proposal. The budget calls for \$6.9 million and 40.9 positions in 2017-18, \$5.6 million and 37.4 positions in 2018-19, \$5.3 million and 34.6 position in 2019-20, and \$910,000 and 4.9 positions in 2020-21 and ongoing (all special funds), to implement and administer the California Healthcare, Research and Prevention Tobacco Tax Act (CHRP) approved in November 2016. The measure increased the tax on cigarettes by \$2 per pack, indirectly imposed an equivalent tax on other tobacco products, imposed a one-time floor stock tax, and expanded the definition of tobacco products to include e-cigarettes and nicotine products and related delivery products. The positions include auditors, tax technicians, business tax specialists and representatives, attorneys, and compliance specialists.

Background. California imposes excise taxes on cigarettes and on other tobacco products, such as cigars and chewing tobacco. The state also licenses sellers, distributors, and manufacturers of these products, and BOE administers these tax and licensing programs. In 2016, the Legislature made significant changes to the tobacco licensing program, by expanding the licensing program to include electronic cigarettes (also known as e-cigarettes) raising license fees, and replacing the one-time fee for retailers with an annual fee.

In November 2016, California voters passed Proposition 56, effective April 1, 2017, increasing the state excise tax rate on cigarettes by \$2 per pack (from 87 cents to \$2.87), which indirectly increased the state excise tax on other tobacco products by a similar amount. The measure established a new special fund for the resulting tax revenue, and it laid out a variety of spending requirements, including a couple of provisions setting aside resources for BOE. Proposition 56 also expanded the tax base for the excise tax on other tobacco products to include e-cigarettes.

Legislative Analyst’s Office Comments. Legislative Analyst’s Office (LAO) indicates that the workload assumptions are reasonable. Proposition 56 contains two provisions that allocate funding to BOE – a broad allowance for administrative costs and \$6 million per year to enforce certain types of tobacco laws. BOE’s proposal includes \$5.8 million in 2017-18, \$5.0 million in 2018-19, \$4.8 million in 2019-20, and \$0.7 million in 2020-21 and ongoing, for enforcement of tobacco laws. These resources would be used for investigations, appeals, collections, and audits related to tobacco taxes, and would come from the new tobacco taxes.

The LAO notes the Administration’s request of \$5.8 million for enforcement in 2017-18 is less than the amount required by Proposition 56. This amount is one piece of a larger sum that, according to the measure, “annually shall be used for the purpose of funding law enforcement efforts.” Within the law enforcement category, the measure states that a specific amount “shall

be apportioned” to BOE. The Administration interprets “annually shall be used” and “shall be apportioned” to include not only current spending, but also money set aside for future spending. However, the Administration has not established a sub-account specifically for BOE, so revenue set aside for future BOE spending is not apparent. In addition, the vast majority of this money is limited-term.

Proposition 56 requires that a certain sum of money “annually shall be used for the purpose of funding law enforcement efforts” and that \$7.5 million “shall be apportioned” to BOE in 2017-18 (\$6 million per year thereafter). LAO interprets this requirement to mean that \$7.5 million – a larger amount than the Administration has requested – must be appropriated for this purpose in 2017-18. LAO recommends permanent funding of these enforcement activities and limited-term authority for other administrative positions.

Post Submission Changes. After the budget proposal was reviewed and approved by the DOF, it became apparent that the proposal, in its request for position authority, did not incorporate existing vacant positions at the agency. DOF has made adjustments to the request that account for these vacancies and reflects other factors. Final adjustments and documentation regarding the budget request will be provided to Subcommittee No. 4 prior to the May Revision.

Staff Comment. BOE has taken a reasonable approach to estimating the tobacco licensing and tax administration workloads for these proposals. Nevertheless, there are substantial uncertainties regarding the impact of the measure, including the amount of tax evasion given the significant increase in the tax, the lack of data regarding the e-cigarette industry and the likely number of registrants. LAO also notes that the workload estimates assume no reduction in the taxpayer or licensee population due to the new taxes imposed by Proposition 56 and indicates that some decline would be reasonable response.

Staff Recommendation. Hold open.