Analysis

Item 40: Department of Revenue

Ballot Measure 108 (2020)

Analyst: John Borden

Request: Increase the Other Funds expenditure limitation by $842,230 and establish six permanent full-time positions (1.67 FTE) and three limited duration positions (0.88 FTE) for the implementation of Ballot Measure 108 (2020).

Analysis: The Legislature in 2019 enacted HB 2270 (Chapter 525, Oregon Laws 2019), which referred an act to the people for a vote in the general election in 2020. The referral increased the cigarette tax, imposed a cigarette floor tax, increased the cap on the cigar tax, and imposed a tax on inhalant delivery systems. The act became Initiative Petition 402 and then Ballot Measure (BM) 108, which voters approved on November 3rd, 2020. BM 108 has an operative date of January 1, 2021.

Key provisions of the ballot measure include: (a) imposes an additional 100 mill increase to the cigarette tax ($2 per pack of 20, $2.50 per pack of 25); (b) increases the cigarette tax to $3.33 per pack of 20; (c) imposes a floor, or inventory, tax for inventories in the possession or control of a cigarette retailer, as well as stamped cigarettes and unaffixed stamps held by cigarette distributors; (d) requires cigarettes to be sold in sealed packages of at least 20; (e) increases the Other Tobacco Tax (OTP) cap on cigars to $1 per cigar; (f) defines little cigars as cigarettes; and (g) imposes the OTP tax on the sale of inhalant delivery systems.

The Revenue Impact Statement for HB 2270 projected that the ballot measure would raise an additional $115 million of revenue in the 2019–21 biennium and $350 million in revenue in the 2021–23 biennium. The new tax revenue is dedicated to the Oregon Health Plan and tobacco and nicotine prevention and cessation programs. The Department of Administrative Services - Office of Economic Analysis is responsible for forecasting tobacco tax receipts. The current overall 2019-21 biennium forecast (December 2020) for tobacco taxes, including the impact of BM 108, is estimated at $481.1 million for cigarette tax revenue, $116.6 million for all Other Tobacco Product taxes, and $4.7 million for Inhalant Delivery Distribution for a combined total of $602.4 million. For the 2021-23 biennium, cigarette taxes are estimated to total $679.7 million, $121 million for Other Tobacco Product taxes, and $19.7 million for Inhalant Delivery Distribution for a combined total of $820.4 million, a $218 million (36%) increase over the prior biennium.

The Department of Revenue (DOR)'s Cigarette and OTP or Tobacco Program is included within the Special Program Administration Section of the Business Division. Key functions also take place in other sections within the Business Division, such compliance activities, as well as other Divisions within the agency, such as Information Technology Services and the Administration Division.

DOR's tobacco tax administration is based on a voluntary compliance model consisting of the following activities: licensure of cigarette distributors, management of stamp orders, retailer inspections, seizure of unstamped or partially stamped or not-approved product(s), tax collections, return processing, compliance, filing enforcement, auditing, taxpayer education and assistance, and the accounting and distribution of tax receipts. Most of these activities are managed using GENTAX, which is the agency's primary tax administration application. Statute provides DOR with broad authority to pay administrative expenses out of gross tobacco tax receipts (ORS 323.455 for cigarette taxes and ORS 323.625 for OTP).

The cigarette program differs from most other tax programs in that revenue is pre-collected through the sale of tax stamps to distributors along with self-reporting of the tax liability through the submission of returns. Tax returns are submitted to reconcile prior stamp purchases and tax return information is useful in identifying potential audit leads and instances of failure-to-pay and filing enforcement. The cigarette program has a quarterly filing requirement. For the OTP program, Oregon imposes a tax on the sale, storage, use, consumption, handling, or distribution of tobacco products other than cigarettes. Generally, OTP taxes are paid quarterly by the distributor.

Presently there is no statutory or administrative requirement for a retailer of tobacco products to register with DOR. Retailers must purchase product which has already been taxed; however, the agency anticipates that retailers of inhalant delivery system products may register as tobacco distributors given the large stock of inventory. The benefit of this approach is that the retailer acting as a distributor will be able to acquire tobacco products directly from manufacturers and pay and report tax when they distribute the product in the state rather than have to acquire product with tax having already been paid. DOR notes that there are approximately 4,000 retailers of cigarettes and tobacco products in the state and approximately 150 vape only stores.

DOR's diligent enforcement of the tobacco laws, in collaboration with the Oregon Department of Justice, is critical to ensuring compliance with the tobacco Master Settlement Agreement (MSA) and the associated revenue stream produced by that agreement, which is estimated at $130 million per biennium. DOR also works with other state's taxing entities on tobacco products imported from or exported to other states.

In order to meet the January 1, 2021 operative date of BM 108, DOR has had to undertake administrative activities in advance of budgetary approval by the Legislature or the Emergency Board. The agency has spent $113,183 General Fund (to be reimbursed by cigarette and tobacco tax revenues) and $92,907 Other Funds for a total of $206,090. This has included information technology work to configure the GENTAX application and work on updating policies and procedures and taxpayer communication planning. One particularly important note is that DOR information technology developers updated the GENTAX application rather than contractors. This continues to reflect a maturing of DOR's internal capability to manage and support the GENTAX application and at a cost less than presumably would have been charged by the vendor.

DOR's cigarette and OTP 2019-21 legislatively approved budget is estimated to total $3.8 million, which provides the Other Funds revenue to support portions of over 616 positions and 34.83 FTE, according to DOR. The revenue source is from gross tobacco taxes prior to the distribution to statutory beneficiaries.

For BM 108, DOR is requesting $842,230 in supplemental Other Funds expenditure limitation, including personal services of $473,437 and the authorization for nine positions (2.54 FTE), $324,909 for services and supplies, and $43,884 for capital outlay. DOR states that the agency has ongoing hiring pools that are capable of filling the requested positions in a timely manner or will otherwise fill the positions through temporary job rotations. The request includes:

- Business Division - Compliance: One limited duration Operations and Policy Analyst 3 position

(0.29 FTE); two permanent full-time Compliance Specialist 1 positions (0.58 FTE); one permanent full-time Compliance Specialist 3 position (0.29 FTE); and one permanent full-time Principal Executive Manager C position (0.29 FTE). All five positions have a December 1, 2020 start date.

- Business Division - Audit: One permanent full-time Tax Audit 1 position (0.25 FTE) and one permanent full-time Tax Audit 2 position (0.25 FTE), which have a January 1, 2021 start date.
- Information Technology Services Division - GENTAX: One limited duration Information System Specialist 6 position (0.29 FTE) and one limited duration Operations and Policy Analyst 3 position (0.29 FTE). The two positions have a December 1, 2020 start date.

DOR's 2021-23 agency request budget includes a policy package (#104) related to BM 108. The package totals $1.3 million Other Funds and includes six positions (6.00 FTE). This package will be reviewed by the Joint Committee on Ways and Means during the 2021 session.

If DOR's request is approved by the Emergency Board, the agency plans to consolidate all existing tobacco compliance staff into a new Compliance Unit, which in total will include 15 existing positions managed by one new permanent full-time Principal Executive Manager C position that is part of this request as well as the three new Compliance Specialist positions. The new unit will oversee more than just cigarette and OTP compliance activities, by including some other tax programs within the Business Division. The Compliance Specialist 3 position will oversee audit and compliance plans, develop and maintain investigation and inspection procedures for inhalant delivery systems and "little cigar" products, as well as serve as a liaison with the Oregon Health Authority. DOR believes that the increase of the cigarette tax may encourage more non-compliance from cigarette retailers in the state.

Lastly, while DOR appears prudent in managing the agency's administrative costs, the agency needs to continue to improve its budgeting practices as related to discrete revenue sources. For example, rather than budgeting expenditures for a particular revenue source, as is the typical practice for state agencies, DOR instead allows any legitimate expense to be charged against a revenue source, which is akin to a revenue rather than a budget model. Under such an approach, there is no established budget attributable to each revenue stream. Instead, the agency and its programs operate within the legislatively approved Other Funds expenditure limitation by charging actual expenditures to revenue sources as needed. The fluidity of such an approach becomes problematic for several reasons: (a) neither the Legislature nor the agency is able to ascertain the budget attributable to each specific revenue stream; and (b) the agency itself establishes the priority for expending funds between various revenue sources by employing such an approach, rather than the Legislature, making oversight difficult. Why this is particularly important is that net revenues, after DOR's cost of administration, flow to beneficiary agencies or entities, some of which have a direct General Fund impact, such as, for example, the portion of cigarette and OTP revenues that are distributed to the General Fund. Therefore, budgeting the cost of administration for each revenue source is essential for more precisely determining estimated net revenues and for controlling the agency's administrative costs.

Legislative Fiscal Office Recommendation: The Legislative Fiscal Office recommends that the Emergency Board increase the Department of Revenue's Other Funds expenditure limitation by $842,230 and authorize the establishment of six permanent full-time positions (1.67 FTE) and three limited duration positions (0.88 FTE) for the implementation of Ballot Measure 108 (2020).

Request: Increase Other Funds expenditure limitation by $842,230 and establish nine positions (2.55 FTE) for implementation of Ballot Measure 108.

Recommendation: Approve the request.

Discussion: The Department of Revenue (DOR) is requesting to increase Other Funds expenditure limitation by $842,230 and establish nine additional positions (2.55 FTE) for its Business Division Cigarette and Tobacco programs. This will allow DOR to implement Ballot Measure 108, which increases taxes on cigarettes and cigars and establishes a tax on e-cigarettes and vaping devices. This request uses the same underlying assumptions as the initial fiscal impact for House Bill 2270 (2019), with modifications for implementation timelines. After drafting the DOR fiscal impact for House Bill 2270, the bill was amended to refer the legislation to voters at the next general election. Voters passed Measure 108 on November 3, 2020.

This request includes six permanent full-time positions (1.67 FTE), including two Compliance Specialist 1s, one Compliance Specialist 3, one Tax Auditor 1, one Tax Auditor 2, and one Principal Executive/Manager C. The Compliance Specialists will conduct onsite inspections and examinations, the Auditors will audit distributors, and the management position will provide guidance for the consolidated compliance unit. Three limited duration positions (0.88 FTE) will work on the transitional requirements. These include one Information Systems Specialist 6 to make necessary adjustments to the Gen Tax system, and two Policy Analyst 3 positions who will develop administrative rules and monitor adherence to legislation and support the technology project.

The request also includes Other Funds expenditure limitation for services and supplies. The six permanent positions and associated Services and Supplies are included in the Governor's proposed 2021-23 budget at a level consistent with this request and the 2019 draft fiscal impact statement for House Bill 2270.

Legal Reference: Increase the Other Funds expenditure limitation established by chapter 612, section 2(4), Oregon Laws 2019, for the Department of Revenue Business Division, by $634,463 for the 2019-21 biennium.

Increase the Other Funds expenditure limitation established by chapter 612, section 2(7), Oregon Laws 2019, for the Department of Revenue Technology Services Division, by $123,527 for the 2019-21 biennium.

Increase the Other Funds expenditure limitation established by chapter 612, section 2 (1), Oregon Laws 2019 (enrolled House Bill 5033), for the Department of Revenue, Administration, by $84,240, for the 2019–21 biennium.

Oregon
Kate Brown, Governor

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November 4, 2020

The Honorable Senator Peter Courtney, Co-Chair
The Honorable Representative Tina Kotek, Co-Chair
State Emergency Board
900 Court Street NE
H-178 State Capitol
Salem, OR 97301-4048

Dear Co-Chairpersons:

Nature of the Request

The 2019 Legislature passed House Bill (HB) 2270 that included a referral to voters on the 2020 General Election ballot. With the passage of Measure 108, the Department of Revenue (department) is requesting resources to administer changes to the Cigarette and Tobacco tax programs included in HB 2270 .

Specifically, the department requests an increase to its Other Funds (OF) expenditure limitation of $842,230. Of this amount, $473,437 will be used for Personal Services including hiring six permanent, full-time positions (1.67 FTE) and three limited-duration positions (.88 FTE); $324,909 for Services and Supplies; and $43,884 will be used for Capital Outlay for the 2019–2021 biennium.

Agency Action

During the 2019 Legislative Session, the department provided an estimated fiscal impact statement for the cost of implementing and administering the provisions of HB 2270. This legislation included a referral to the ballot during the 2020 General Election in November 2020 for a tax increase and floor (inventory) tax effective January 1, 2021 as well as changes to the Tobacco and Cigarette Tax programs. The legislation imposes the tobacco tax on inhalant delivery systems, or vaping products, for the first time.

As a result of the referral, the final Fiscal Impact Statement issued by the Legislative Fiscal Office noted that because the legislation included a referral to the ballot through the initiative and referendum process, a financial impact committee would be created. No positional authority or Other Funds increase was thus provided to the department with the passage of HB 2270.

The department has already begun the work to implement the tax increase and prepare for the January 1, 2021 effective date of the changes. This includes the configuration and testing of a floor tax in core systems, configuration and testing of the changes to all existing tax returns for the Cigarette and Tobacco tax programs, and associated policy work necessary to provide guidance to taxpayers impacted by the changes to Oregon Law by HB 2270 and Measure 108.

The addition of new products subject to the tobacco products tax as well as the minimum wholesale price for cigars will extend the length of time to perform a single inspection, therefore, additional compliance specialists are needed to maintain the current inspection rate. The department will need to audit additional tobacco product tax returns to maintain current audit levels because of the addition of inhalant delivery systems to the existing taxable products. The department will also need to audit cigarette and tobacco product tax returns as a result of the increase to the cigarette tax as well as modification to taxation of cigars and reclassification of little cigars as cigarettes to ensure taxpayers are complying with the new law. Maintaining inspection and audit levels ensures retailers of cigarettes and tobacco products are complying with state and federal sales regulations. Inspection and audit rates must also be maintained for the state to comply with the Settling State obligations under the Tobacco Master Settlement Agreement (MSA) to ensure that Oregon receives approximately $70 million in MSA payments annually.

Centralizing management of all compliance staff included in the existing Cigarette and Tobacco programs will ensure that the program succeeds, especially given the additional five permanent full-time positions required to ensure the department meets the mandates of HB 2270. The unit will have additional audit responsibilities and a larger footprint for compliance investigations given the addition of inhalant delivery systems and the large increase to the tax rate.

In the 2019–21 biennium, the department will incur an additional $842,230 in expenditures as detailed below.

The department needs the following new positions, to accomplish the work necessary to implement HB 2270:

- Two permanent full-time compliance specialist 1s to conduct onsite inspections and inventory counts of inhalant delivery systems for use in filing enforcement; perform additional inspections of distributors, wholesalers, and retailers for increased cigarette tax and little cigars; and conduct onsite inspections and inventory counts of cigarettes for use in filing enforcement, audit case selection, and audit adjustments.
- One permanent full-time compliance specialist 3 to lead program staff and inspect inhalant-delivery distributors, wholesalers, and retailers, perform audits of tobacco tax returns; develop and maintain procedures to investigate and inspect for inhalant delivery systems; develop procedures to investigate and identify retail locations that should file floor tax; and serve as liaison with the Oregon Health Authority and develop procedures for information sharing.
- One permanent full-time tax auditor 1 to audit additional cigarette tax program distributors due to cigarette distributor tax increase; audit presence for increase to cigarette tax, additional products considered cigarettes, and assist with inhalant delivery system audits; audit additional cigarette distributors for small cigars; and audit floor tax returns.
- One permanent full-time tax auditor 2 to audit additional tobacco tax program distributors not previously subject to tobacco distributor tax; expand audit presence for inhalant delivery systems; and audit additional tobacco distributors for cigar tax cap removal and minimum wholesale price.
- One permanent full-time principal executive manager C to consolidate the existing compliance positions in the Cigarette and Tobacco programs and provide oversight and direction for managing staff required by this legislation. Existing staff are managed in multiple areas by the Special Programs Area manager, as well as in the Payroll Withholding Registration, Compliance and Administrative Unit (RCAS).

Additionally, the following positions will be necessary in the 2019–21 biennium to support the necessary policy and system configuration changes to meet the January 1, 2021 effective date:

- One limited duration half-time operations and policy analyst 3 to assist in bringing up changes to the programs; and conducting policy work to include monitoring legislation, administrative rules, systems design and testing support, and collaboration with stakeholders.

- One limited duration information systems specialist 6 to configure and develop GenTax functionality for the changes to the Cigarette and Tobacco Tax programs as well as the new floor tax configuration.
- One limited duration operations and policy analyst 3 to support the information technology project as business analyst and assist in system configuration and testing.

Finally, for the 2019–21 biennium, the department will also incur the following expenses:

- $84,000 for in-state travel to support the one-time floor tax inspection plan.
- $20,160 for out-of-state travel.
- $19,594 in office expenses including postage.
- $9,600 in employee training.
- $17,400 in telecommunications.
- $3,647 in data processing services.
- $10,000 in professional services for a one-time change in the cigarette tax stamp.
- $3,300 in expendable property.
- $84,240 for facilities rental.
- $43,884 for office furniture and fixtures.
- $19,800 in IT expendable property.
- $53,168 in additional Attorney General expenses for legal advice and assistance with litigation and appeals.

During the 2021–23 biennium, the department expects to incur $1,409,855 in additional expenditures made up of $1,214,826 for Personal Services and $195,029 for Services and Supplies.

The department expects the continued need for the following positions during the 2021–23 biennium with a projected expense of $1,214,826:

- Two permanent full-time compliance specialist 1s in the Special Programs Administration unit.
- One permanent full-time compliance specialist 3.
- One permanent full-time tax auditor 1.
- One permanent full-time tax auditor 2.
- One permanent full-time principal executive manager C.

In addition, the department will also incur the following expenses during the 2021–23 biennium based on the nature of the work involved in administering the Cigarette and Tobacco Programs:

$46,505 for in-state travel.

- $20,764 for out-of-state travel.
- $9,560 in office expenses including postage.
- $9,888 in employee training.
- $17,922 in telecommunications.
- $3,756 in data processing services.
- $1,700 in expendable property.
- $56,362 for facilities rental.
- $10,197 in IT expendable property.

- $18,375 in additional Attorney General expenses for legal advice and assistance with litigation and appeals.

Action Requested

The department requests for the 2019–2021 biennium, that the Legislature increase Other Funds expenditure limitation by $842,230, and approve the establishment of nine positions (2.55 full-time equivalent) to support the software configuration changes, and policy and operations work for HB 2270 (2019). The positions are detailed below:

Position Title	Projected Start Date
Compliance Specialist 1	December, 2020
Compliance Specialist 1	December, 2020
Compliance Specialist 3	December, 2020
Tax Auditor 1	January, 2021
Tax Auditor 2	January, 2021
Principal Executive Manager C	December, 2020
Operation and Policy Analyst 3 LD	December, 2020
Operation and Policy Analyst 3 LD	December, 2020
Information Services Specialist 6 LD	December, 2020

Legislation Affected

Increase the Other Funds expenditure limitation established by chapter 612, section 2 (4), Oregon Laws 2019 (enrolled House Bill 5033), for the Department of Revenue, Business Division, by $634,463 for the 2019–21 biennium.

Increase the Other Funds expenditure limitation established by chapter 612, section 2 (7), Oregon Laws 2019 (enrolled House Bill 5033), for the Department of Revenue, Information Technology Services Division, by $123,527, for the 2019–21 biennium.

Increase the Other Funds expenditure limitation established by chapter 612, section 2 (1), Oregon Laws 2019 (enrolled House Bill 5033), for the Department of Revenue, Administration, by $84,240, for the 2019–21 biennium.

Respectfully submitted,

Betsy A. Imholt

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