REPORT OF

THE

STATE AUDITOR

Tobacco Enforcement Program
Department of Revenue

Performance Audit
June 2007

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Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the Department of Revenue's tobacco enforcement program. The audit was conducted in accordance with Section 39-28-102 (2), C.R.S., which requires the State Auditor to conduct an audit of the Department's compliance with federal requirements regarding a state enforcement program designed to reduce tobacco products sales to minors. The statute also requires the State Auditor to audit specific procedures related to license renewal requirements for cigarette wholesalers and tobacco products distributors and to report the results of the audit to the Legislative Audit Committee by July 1, 2007.

The audit work, performed from January through April 2007, was conducted in accordance with generally accepted government auditing standards. The report presents our findings, recommendations and the responses of the Department of Revenue.

Sally Symanski

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Tobacco Enforcement Program

Federal Requirements

In 1992 the United States Congress enacted Section 1926 of Title XIX of the federal Public Health Service Act, commonly called the Synar Amendment. The Synar Amendment requires states to pass and enforce laws prohibiting the sale of tobacco products to minors (individuals under the age of 18). Specifically, the Synar Amendment and its associated regulations require each state to:

- Make it unlawful for any manufacturer, retailer, or distributor of tobacco products to sell or distribute any product to anyone under the age of 18.
- Conduct annual, random, unannounced inspections to ensure compliance with the laws.
- Develop a strategy and time frame for ensuring that no more than 20 percent of tobacco outlets sell products to minors.
- Submit an annual report detailing enforcement activities, including the overall success in reducing the availability of tobacco products to minors, the results of the random unannounced inspections, and future enforcement plans.
- Maintain a list of all cigarette and tobacco products retailers within the state. The list must be as comprehensive as possible by including at least 80 percent of all tobacco retailers within the state.

Compliance with the Synar Amendment is a condition of funding for states receiving the Substance Abuse Prevention and Treatment (SAPT) Block Grant. Forty percent of a state's funding can be withheld for not complying with Synar.

In Colorado the Department of Human Services' Alcohol and Drug Abuse Division (ADAD) is the designated SAPT Block Grant recipient. The SAPT Block Grant is used by ADAD to fund services for alcohol and drug treatment, detoxification, and prevention. More than one-half of ADAD's total funding derives from the SAPT Block Grant. For Federal Fiscal Year 2007 Colorado received more than $23.7 million in SAPT Block Grant funding. If Colorado were to fall out of compliance with the Synar Amendment, more than $9 million in SAPT funding could be withheld by the federal government.

State Tobacco Enforcement Program

Prior to the passage of the Synar Amendment in 1992, Colorado had a statutory prohibition on the sale of cigarettes and/or tobacco products to minors. In 1998 the General Assembly directed the Liquor Enforcement Division (Division) within the Colorado Department of Revenue (Department) to enforce state laws relating to the sale of tobacco to minors (Section 24-35-504, C.R.S.). Prior to 1998 there was no state agency designated to enforce tobacco laws. Instead, enforcement was conducted at the local level. Today, Colorado's tobacco statutes contain a number of provisions related to the sale of tobacco products to minors. These include:

- A requirement that the Division work with the Departments of Human Services and Public Health and Environment to ensure compliance with federal regulations for the continued receipt of federal funds.

- Penalties in the form of administrative fines for retailers that violate the statutory prohibition on the sale of tobacco products to minors.

- Limits on retailer sales of cigarette and tobacco product through vending machines.

- A requirement that retailers display warning signs stating that it is illegal for minors to purchase tobacco products.

- Prohibitions on retailer sales of individual cigarettes or packs containing fewer than 20 cigarettes.

As stated above, three agencies are to collaborate to ensure Colorado meets it federal Synar obligations. These three agencies are the Liquor Enforcement Division, the Alcohol and Drug Abuse Division, and the Colorado Department of Public Health and Environment's State Tobacco Education and Prevention Partnership (STEPP).

Within the Liquor Enforcement Division, the Tobacco Enforcement Unit (Unit) is directly responsible for administering and enforcing Colorado's tobacco laws, including those prohibiting sales to minors. For Fiscal Year 2007 the Unit has a budget of about $444,500. Approximately 67 percent, or $297,440, of this total derived from a portion of the state Tobacco Education Program Fund. The Tobacco Education Program Fund is financed with revenues from a portion of state cigarette and tobacco taxes imposed in Article X, Section 21 of the Colorado State Constitution (Amendment 35). Although these revenues are not subject to TABOR limitations, the statutes do limit the amount the Unit can receive to $350,000 per year. The General Fund finances the remaining one-third of the Unit's budget.

While the Unit enforces state tobacco laws, ADAD is responsible for organizing, analyzing, and reporting on all Synar-related activities. As part of this responsibility, ADAD hires a contractor to serve as the Synar coordinator. One of the coordinator's responsibilities is to randomly select tobacco retailers from a list created by the Unit. The Unit then conducts inspections of the selected retailers, and the Synar coordinator compiles, analyzes, and reports the outcomes to ADAD. The Alcohol and Drug Abuse Division annually submits a report to the federal Center for Substance Abuse Prevention (CSAP). The report details the results of the Synar compliance testing, the State's progress in enforcing youth tobacco access laws, and future plans to ensure compliance with Synar requirements. Additionally, every three years the Unit and the Synar coordinator conduct a coverage study by gathering and analyzing tobacco retailer data to verify that the State's tobacco retailer list contains at least 80 percent of all tobacco retailers in the State.

The Colorado Department of Public Health and Environment's role in Synar implementation relates primarily to its awards of STEPP program funds for community-based and statewide education programs that reduce the initiation of tobacco use by minors. Additionally, STEPP is responsible for requiring local health agencies to support Synar enforcement activities and for providing the Synar Implementation Team, comprising of representatives from all three agencies, with the results of surveys relevant to the prevention of adolescent tobacco use.

Tobacco Retailer Inspections

In Fiscal Year 2006 the Tobacco Enforcement Unit conducted 3,503 inspections of tobacco retailers. Of this total, 1,213 inspections (35 percent) were specifically for Synar compliance testing purposes. The additional 2,290 inspections (66 percent) were conducted by the Unit in response to complaints and surveillance, or to address retailers or geographic areas that previously had not been inspected. From July 2006 through January 2007 the Unit conducted a total of 2,199 inspections. Of this figure, 759 were Synar compliance inspections and 1,440 were in addition to the inspections required by Synar.

Each year, the Tobacco Enforcement Unit develops a list of the State's tobacco retailers (hereafter referred to as the industry code list) from which the retailers to be inspected are selected. The Unit develops the list using a combination of five liquor industry codes and nine North American Industry Classification System (NAICS) codes. The NAICS codes were developed by the U.S. Census Bureau and exist for almost every type of business and industry in the nation. The codes identify specific types of retailers who, in the experience of the Tobacco Enforcement staff, sell tobacco products. The nine NAICS industry codes are supermarkets and grocery stores, convenience stores, pharmacies and drugstores, gasoline stations with convenience stores, other gasoline stations, newsdealers and newsstands, department stores with general merchandise, warehouse clubs and supercenters, and tobacco stores. The five liquor industry codes are those for retail liquor stores, liquor-licensed drugstores, businesses with a 3.2 percent fermented malt beverage on-premise license, businesses with a 3.2 percent fermented malt beverage off-premise license, and businesses with a 3.2 percent fermented malt beverage on-/off-premise license.

In conducting inspections of retailers, the Unit uses minors as operatives to attempt to purchase tobacco products. The Alcohol and Drug Abuse Division pays the wages and other related expenses of these minors. Federal guidelines encourage the use of minors aged 15 and 16 as operatives. According to the federal guidelines, the use of minors is the most reliable method for states to determine retailer compliance levels. We reviewed the Unit's use of minor operatives and found the following for Fiscal Year 2006:

- For Synar inspections, about 55 percent of the inspections involved male minors and 45 percent involved female minors.

- For all enforcement checks, including Synar, the Unit used male minor operatives 64 percent of the time and females 36 percent of the time.

For retailers that sold to minor operatives:

- For Synar inspections, about 56 percent of tobacco sales were to male minors and 44 percent were to females.

- For Synar inspections, more than 50 percent of sales were to minors aged 16, and 22 percent were to 15-year-olds.

Cigarette Wholesaler and Tobacco Distributor Licensing Requirements

Unlike most states, Colorado does not license tobacco retailers. In recent years legislation has been proposed that would have required tobacco retailer licensing. In both the 2006 and 2007 Legislative Sessions, these bills failed. The Department of Revenue does, however, license cigarette wholesalers and tobacco products distributors. The primary purpose for licensing wholesalers and distributors is tax related. Wholesalers and distributors must be licensed to purchase tax stamps from the Department of Revenue. The wholesalers and distributors are required to affix the stamps on tobacco products to ensure the State is collecting the appropriate tax revenues. In addition, wholesalers and distributors must be licensed to purchase tobacco products from manufacturers.

In 2001 the General Assembly enacted legislation designed to assist the State in complying with Synar retailer inspection requirements. Specifically, Sections 39-28-102 and 39-28.5-104, C.R.S., require cigarette wholesalers and tobacco products distributors seeking license renewals to provide identifying information on all persons who purchased tobacco products for resale during the 12-month period immediately preceding the filing of a renewal application. The intent of this provision was to enhance the accuracy and comprehensiveness of the data that serves as the basis for the list of all cigarette and tobacco products retailers required by the Synar Amendment. Thus, wholesalers and distributors are to submit this information to the Liquor Enforcement Division as part of their tobacco sales license renewals. In 2004 the General Assembly further strengthened the above law by allowing the Department to fine wholesalers and distributors, up to $15,000, for failure to submit required information.

Prior Audit

In an August 2003 performance audit of the Department of Revenue's Liquor Enforcement Division, we reviewed the procedure whereby information on tobacco retailers is submitted by wholesalers and distributors as part of the license renewal process. Additionally, we reviewed the outstanding tax liabilities of a sample of licensees, the process by which a license is issued, and the sell-rate to minors. We made four recommendations for improvement in these areas. An update on the Department's implementation of these recommendations may be found in Appendix A.

Purpose and Scope of Current Audit

The purpose of our current audit is prescribed in Section 39-28-102(2), C.R.S. The statute requires the Office of the State Auditor to conduct an audit of:

- The procedure by which cigarette wholesalers and tobacco products distributors, when renewing their licenses, submit information to the Department on the persons who purchased cigarettes or tobacco products for resale and the accuracy and completeness of that information.

- The Department's compliance with federal requirements regarding a state enforcement program designed to reduce the number of tobacco products sales to minors.

As part of our audit work we reviewed retailer lists submitted by wholesalers and distributors for Fiscal Year 2006. We conducted a file review of Division documents, including the fines assessed by the Division during Fiscal Years 2006 and 2007. We analyzed the Division's database containing approximately 6,000 enforcement records for July 2005 through January 2007. Our audit work included interviews with staff from the Departments of Revenue and Human Services, the U. S. Department of Health and Human Services, and the State's Synar coordinator. Finally, we accompanied Tobacco Enforcement Unit staff on 68 Synar compliance inspections at tobacco retailers in Jefferson and Logan Counties.

Findings

Synar Compliance

The U.S. Department of Health and Human Services' Substance Abuse and Mental Health Services Administration (SAMHSA) is responsible for overseeing state compliance with Synar regulations related to SAPT Block Grant funding. According to SAMHSA staff, since at least Federal Fiscal Year 2004, Colorado has been in compliance with Synar regulations. In addition to SAMHSA's confirmation regarding the State's compliance, we evaluated Colorado's efforts to comply with Synar. Our work centered on the Department of Revenue's tobacco enforcement program. As we describe below, we found the Department's tobacco enforcement program to be in compliance with federal requirements to reduce tobacco sales to minors.

Laws Prohibiting Sales to Minors. The Synar Amendment requires states to adopt laws prohibiting the sale of tobacco products to minors. As mentioned earlier in this report, Colorado had adopted such legislation prior to the Synar mandate in 1992. Since that time, the General Assembly has enacted additional statutory provisions to strengthen the original legislation.

Annual, Random, Unannounced Inspections. To ensure compliance with laws prohibiting tobacco sales to minors, Synar requires states to conduct random, unannounced inspections on an annual basis. Each year, the State submits to the federal Center for Substance Abuse Prevention (CSAP) its methodology for randomly selecting the tobacco retailers to be inspected. Colorado's methodology has been approved by CSAP. In Fiscal Year 2006 the State reported to CSAP that it conducted unannounced inspections of 1,114 randomly pre-selected businesses. From July 2006 through January 2007 the Unit conducted 759 Synar inspections. In February 2007, we accompanied the Unit's investigators on 68 Synar inspections. We determined that the 68 Synar inspections had been randomly pre-selected by the Synar coordinator, appeared to be unannounced to the retailers, and were conducted in keeping with state and federal policies and procedures (e.g., ages of the minor operatives employed and information recorded by inspectors).

Inspection Failure Rate No More Than 20 Percent. Federal regulations require Synar inspection failure rates to be no more than 20 percent. That is, for a state's Synar enforcement program to be deemed adequate, the state's sell-rate to minor operatives conducting Synar inspections must be less than 20 percent. Colorado's Synar failure rate for Fiscal Years 2003 through 2006 was well within the 20 percent limit, ranging from a low of 7.2 percent in 2006 to a high of 12.2 percent in 2005. We also reviewed Synar data from July 2006 to January 2007 and found the failure rate to be about 7 percent.

Annual Report. As noted previously, Synar requires states to annually report the results of their tobacco enforcement efforts. In Colorado, responsibility for this task is assigned to the Alcohol and Drug Abuse Division. Each September, ADAD submits the results from the most recent federal fiscal year to the federal Center for Substance Abuse Prevention. The State's report to CSAP is the basis for the following year's SAPT Block Grant funding. The public is also able to access the most current Synar report on ADAD's Web site. We determined that since our last audit in 2003, ADAD submitted all of the required annual reports for 2004-2007. According to SAMSHA, all of the reports complied with Synar regulations.

List Contains 80 Percent of All Tobacco Retailers. Federal requirements specify that the list from which states randomly select the retailers to be inspected contain at least 80 percent of all tobacco retailers accessible to minors. Every three years, states must verify to CSAP that their lists comply with this requirement. In Fiscal Year 2004 Colorado reported that its list contained 83 percent of retailers, or slightly above the federally required 80 percent. At the time of our audit, the Unit and ADAD, through its outside contractor, were collaborating on the 2007 three-year coverage study and the subsequent report to CSAP. Therefore, the results were not available to include in this report. However, Colorado's current methodology for establishing its retailer list and the State's coverage study plan have both been approved by SAMHSA.

Mandated Wholesaler and Distributor Lists

Central to the success of the Department's tobacco enforcement efforts is the list of retailers used for inspection purposes. To comply with federal requirements, the list must be as accurate and complete as possible. As previously noted, in 2001 the General Assembly enacted legislation designed to assist the State in ensuring compliance with the requirement that retailer lists include at least 80 percent of all retailers in the State. Pursuant to statutes and Department regulations, as a condition of license renewal, wholesalers and distributors are required to provide the names and other identifying information for all persons who purchased tobacco products for resale during the 12-month period immediately preceding the filing of a renewal application. Failure to comply can result in graduated fines of up to $15,000 and, ultimately, denial of the renewal license.

We reviewed the Department's implementation of this specific statutory provision. It should be noted that we did not review the Department's enforcement of other statutory licensing requirements such as tax delinquency. In accordance with Section 39-28-102(2), C.R.S., we also evaluated the accuracy and completeness of the information provided by the wholesalers and distributors. We found that the Department does require wholesalers and distributors to submit the required data as a condition of license renewal. However, we found that the data do not result in a list of retailers that is cost-effective to administer or reliable for inspection purposes.

Overall, we concluded that the Department should propose legislative change to eliminate this requirement from the statutes. Our conclusion was based on several factors. First, the information provided by the wholesalers/distributors is inaccurate, incomplete, and out of date. For example, for the most recent renewal cycle, Fiscal Year 2007, we found discrepancies between the retailers identified by wholesalers/distributors and the retailers found on the industry code list used by the Unit. As previously mentioned, Colorado uses the industry code list to identify those businesses that are most likely to sell tobacco products. We compared the two lists for Fiscal Year 2007. The wholesaler/distributor list contained a total of 6,689 retailers. We found however, that only 47 percent (3,125) of these retailers could be located on the industry code list. Of the 3,564 retailers that did not appear on the industry code list, we analyzed a sample of 87 records to identify the reasons the records did not appear on the industry code list. We found that more than 80 percent of the records we reviewed were for businesses that had closed or contained inaccurate information, such as an incorrect sales tax number, address, or business name.

For the retailer information submitted by the wholesalers/distributors, we also found incomplete and inaccurate information. Specifically, about 9 percent of the 6,689 retailers identified by wholesalers and distributors lacked the required 7- or 11-digit sales tax license number. The sales tax number is a unique identifier used by the Department's investigators to validate the existence of retailers. Also, valid street addresses were lacking for 4 percent of the 6,689 retailers. Invalid street addresses included post office boxes, street intersections, or simply no address at all. The Tobacco Enforcement Unit needs physical addresses to locate retailers for inspection.

These results indicate that although wholesalers and distributors generally comply with the statutory requirement to submit retailer information, they do not ensure the accuracy of the information they provide to the Department. In addition, we found that wholesalers/distributors do not necessarily submit information related to retailer sales that occurred within the most recent renewal cycle, as required by statute and Department rules. Rather, some appear to maintain a running list of retailers. That is, they submit information for retailers they sold to at any time in the past. Because businesses change ownership, close, or undergo other changes, the most current information is typically more accurate. The Department is aware of the weaknesses in the wholesaler/distributor information and reports that it would be costly, in terms of staff resources, to verify, update, and generally improve the data. Consequently, the Department does not use the information provided by wholesalers and distributors for enforcement or Synar purposes. As noted earlier, the Department uses another more reliable and effective method of establishing a retailer list for inspection purposes. As we describe later in this report, although this industry code list can be strengthened, it is a more accurate source of retailer information.

A second consideration in possible legislative change is that by providing the retailer information, wholesalers/distributors are not fulfilling any compelling criteria in terms of demonstrating fitness or qualifications for licensure. Often licensing requirements exist to provide assurances about the qualifications, experience, and overall fitness of licensees to engage in the activity being regulated. Although requiring submission of retailer information was intended to address the Synar list requirement, it has not been effective. Eliminating the requirement will not weaken the overall wholesaler/distributor licensing process. The Department will continue to license tobacco wholesalers and distributors for tax purposes.

Finally, in our 2003 performance audit of the Liquor Enforcement Division we reached a similar conclusion about the value of the wholesaler/distributor data on retailers. At that time we recommended that the Department determine whether the information could be improved. If improvements were not possible, we suggested the Department seek legislative change. In 2004 the General Assembly gave the Division the authority to fine those distributors and wholesalers that did not submit the required information. Other than an overall increase in submission rates by wholesalers/distributors, the Division reports, and our audit confirms, that the accuracy of retailer information provided by the wholesaler/distributors has not improved. We believe the Department's use of the industry codes is a more effective means of establishing a retailer list for Synar purposes. Continued submission of the information is an unnecessary burden on wholesalers/distributors, and the collection and compilation of the data does not improve the Department's efficiency. Therefore, we believe the Department should seek legislative change to eliminate this requirement of license renewal.

Recommendation No. 1:

The Department of Revenue should seek statutory change to eliminate the requirement that cigarette wholesalers and tobacco products distributors submit retailer information as a condition of license renewal.

Department of Revenue Response:

Agree. Implementation date: January 2008.

The Department of Revenue will seek statutory change in the next legislative session to eliminate the requirement in Title 39 that requires cigarette wholesalers and tobacco products distributors to annually submit retailer information as a condition of license renewal. Upon legislative change to eliminate the reporting requirement, the Department will take appropriate steps to repeal related regulations.

Industry Code List

As explained above, the Tobacco Enforcement Unit uses industry codes as the basis for its list of all cigarette and tobacco products retailers. Our audit found that while the industry code list compiled by the Unit is more accurate than the retailer information submitted by wholesalers/distributors, the accuracy of the industry code list can also be improved. In accordance with Synar, the list used to select the sample of retailers to be inspected must contain at least 80 percent of all retailers within the State. Therefore, the Department should ensure the list is as accurate and comprehensive as possible. According to the Synar coordinator, the annual industry code list contains numerous businesses that do not sell tobacco, are not accessible to minors, or have gone out of business. As a result, the Synar coordinator must increase the sample size used by the Unit to test Synar compliance by 25 to 33 percent to compensate for these deficiencies. Consequently, inspection efforts are unnecessarily inefficient because Unit staff must attempt to locate and inspect more retailers than would be required if the retailer list were more accurate.

We found that the Tobacco Enforcement Unit pulls a new industry code list each year but fails to update the list based on information obtained through its enforcement activities. For example, staff do not remove from the list businesses that have been found not to sell tobacco or those that have closed. Other states we contacted such as Arizona, Kentucky, Michigan, Missouri, and Oregon regularly update their respective retailer lists based on the findings of their enforcement activities.

Unit investigators stated that there are some retailers they identify during their inspections that sell tobacco but are not included on the list of businesses that could potentially be selected for inspection. For example businesses such as laundromats are not among those that fall into the current 14 industry codes; however, they may sell tobacco products. The individual investigators maintain manual records of these businesses. However, the Unit does not routinely or systematically consolidate the individual investigator's information and add that data to the master industry code list. Neither does the Department systematically analyze the industry codes to determine whether other codes might be added to the current set. Not including these businesses reduces the comprehensiveness of the master list. This in turn increases the likelihood that Colorado could fail to comply with the requirements of the Synar Amendment and jeopardize funding from the SAPT Block Grant.

The last coverage study of retailers was conducted in 2004. The study found that the list contained 83 percent of retailers. This figure is slightly more than the 80 percent requirement. The State's Synar coordinator is currently conducting the three-year coverage study but has expressed concerns that the State will not meet the 80 percent requirement. The Department needs to continually ensure that the list is as accurate and comprehensive as possible by using investigator information and by periodically reevaluating the industry codes.

Recommendation No. 2:

The Department of Revenue should strengthen the accuracy and comprehensiveness of the tobacco retailer list by periodically analyzing industry codes for possible inclusion and by incorporating investigator information into the master retailer list.

Department of Revenue Response:

Agreed. Implementation date: August 2007.

The Department's Liquor Enforcement Division will perform an analysis of North American Industry Classification System (NAICS) codes by August 2007, and annually thereafter, to determine if certain classes should be included in, or omitted from, the NAICS list used by the Division for tobacco enforcement purposes. This process will allow updates to the master retailer list prior to the selection of the annual sample of cigarette retailers for Synar inspections during the coming year.

In addition, the Department is developing a process to incorporate retailer-specific data, collected by investigators in their field operations during Fiscal Year 2006 and Fiscal Year 2007, into the master retailer list to be used to select the Fiscal Year 2008 sample. For Fiscal Year 2009 and each succeeding year, the Department will annually incorporate the previous fiscal year's field data into the master retailer list to ensure that the master retailer list is as current as possible each year.

Appendix

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Appendix A

Liquor Enforcement Division Performance Audit, August 2003
Status Report from the Department of Revenue
Update on Tobacco Enforcement Unit Recommendations, April 2007

The following is a summary of the recommendations from the August 2003 Performance Audit related to tobacco enforcement and the Tobacco Enforcement Unit. Please note that the Department has included its October 2004 implementation update, as well as an update provided in April 2007. Information from the Department is self-reported.

Recommendation No. 11:

The Department of Revenue should determine whether the current information submitted by cigarette wholesalers and tobacco products distributors can be improved. If it cannot be improved, the Tobacco Enforcement Unit should seek statutory authority to eliminate this requirement. At the same time, the Tobacco Enforcement Unit should consider methods for improving the accuracy of its industry codes-based tobacco retailer list and implement any identified changes either through rules or by amending the statute.

Department of Revenue Response:

1. Implemented **X** In Progress ___ Not Implemented ___

Implementation Status (October 2004): Implemented. The Legislative Audit Committee (LAC) sponsored House Bill 04-1248, "Concerning the Distribution of Tobacco Products," which became law on August 4, 2004. This legislation requires cigarette and tobacco retailers to provide requisite information to their suppliers, who in turn are required to provide information to the Division which will significantly improve the accuracy of the information the Liquor Enforcement Division (Division) is required to collect. During August 2004, the Division held a rule-making hearing to provide additional clarification and detail of the data required to be submitted. The rule was not opposed and will be effective upon final notice and publication in the Colorado Register in November or December 2004.

Implementation Update (April 2007): The aforementioned rule(s) were not adopted by the Department of Revenue Executive Director until March of 2005. At the close of Fiscal Year 2005 and Fiscal Year 2006, the Tobacco Enforcement Unit saw an improvement in the format that wholesalers and distributors were using to submit retailer information (more electronic filings in Microsoft Excel), which can be attributable to the new rules. Secondly, more lists were filed on or before June 30, as a result of the Unit's pre-renewal warnings letters that advised wholesalers and distributors of the monetary fines that would be imposed if the June 30 deadline was not met. The specific rules that were promulgated pursuant to this recommendation are as follows:

Regulation 28-102 Wholesaler List Requirements

A. Wholesalers of cigarettes must provide identifying information of persons conducting business in the State of Colorado who purchased cigarettes for resale from the licensee in the twelve-month period immediately preceding the filing of the application.

B. Licensees are required to provide such lists to the Department electronically (by disc or e-mail) in an Excel (Microsoft) format or in hard copy form via standard mail. The minimum information submitted shall consist of:

   1. The eleven digit Colorado sales tax identification number (including the specific four digit extension code) of the retail business/individual purchasing tobacco;

   2. The retail business name (trade name); and

   3. The physical address of each retail business/individual to include street address, city, state, and zip code.

Regulation 28.5-104 Distributor List Requirements

A. Distributors of tobacco products must provide identifying information of persons conducting business in the State of Colorado who purchased tobacco products for resale from the licensee in the twelve-month period immediately preceding the filing of the application.

B. Licensees are required to provide such lists to the Department electronically (by disc or e-mail) in an Excel (Microsoft) format or in hard copy form via standard mail. The minimum information submitted shall consist of:

   1. The eleven digit Colorado sales tax identification number (including the specific four digit extension code) of the retail business/individual purchasing tobacco;

   2. The retail business name (trade name); and

   3. The physical address of each retail business/individual to include street address, city, state, and zip code.

Auditor Note:
See Recommendation No. 1 in our current report.

Recommendation No. 12

The Department of Revenue should seek statutory authority to allow the Department to refuse an initial or renewal cigarette wholesaler or tobacco products distributor license on the basis of the applicant's failure to pay outstanding tax delinquencies.

Department of Revenue Response:

1. Implemented **X** In Progress ___ Not Implemented ___

Implementation Status (October 2004) Implemented. The Legislative Audit Committee (LAC) sponsored House Bill 04-1248, "Concerning the Distribution of Tobacco Products" which became law on August 4, 2004. This legislation created statutory authority to allow the Department to refuse issuance of a cigarette wholesaler or tobacco products distributor license if all required taxes are not paid. The Liquor Enforcement Division coordinates with the Taxpayer Services Division within the Department to ensure pertinent delinquent taxes are collected before issuing new licenses or renewing existing licenses.

Implementation Update (April 2007) Statistics requested by the Office of the State Auditor follow:

For the cigarette and tobacco licenses valid from July 1, 2004 to June 30, 2005 period:

- ✓ 8 cigarette licenses were held because of delinquent tax due.
- ✓ 6 of the 7 resolved the delinquency and were issued a license.
- ✓ 1 of the licenses was a new application and was never issued because the applicant rescinded the license request.
- ✓ 1 of the licenses was not renewed because the account was closed by request of the taxpayer. The delinquency was later resolved.
- ✓ 61 tobacco licenses were held because of delinquent tax due.
- ✓ 60 of the 61 resolved the delinquency and were issued a license.
- ✓ 1 of the licenses was not renewed because the account was closed by the request of the taxpayer. The delinquency was later resolved.

For the cigarette and tobacco licenses valid from July 1, 2005 to June 30, 2006 period:

- ✓ 11 cigarette licenses were held because of delinquent tax due.
- ✓ All 11 resolved the delinquency and were issued a license.
- ✓ 43 tobacco licenses were held because of delinquent tax due
- ✓ 40 of the 43 resolved the delinquency and were issued a license.
- ✓ 1 account was not renewed because the company closed.
- ✓ 1 account was a new application and was never issued because the taxpayer rescinded the application request.

- ✓ 1 account was a new application where the applicant never submitted the correct application fee and was never issued a license.

For the cigarette and tobacco licenses valid from July 1, 2006 to June 30, 2007 period:

- ✓ 15 cigarette licenses were held because of delinquent tax due.
- ✓ 14 of the 15 resolved the delinquency and were issued a license.
- ✓ 1 license was not renewed because the taxpayer requested the account be closed.
- ✓ 25 tobacco licenses were held because of delinquent tax due
- ✓ 20 of the 25 resolved the delinquency and were issued a license.
- ✓ 2 accounts were not renewed because the taxpayers requested the accounts be closed.
- ✓ 2 accounts were not renewed because they did not meet other licensing requirements (i.e. non-filing, EFT registration).
- ✓ 1 account was a new application that resolved the delinquency, but has not been issued a license because they have not provided the required information.

Recommendation No. 13:

The Department of Revenue should consider transferring licensing authority for cigarette wholesalers and tobacco products distributors to the Liquor Enforcement Division's Tobacco Enforcement Unit, since it has the responsibility for enforcing the State's tobacco laws.

Department of Revenue Response:

1. Implemented **X** In Progress ___ Not Implemented ___

Implementation Status (October 2004): Implemented. The Department considered transferring the licensing authority for cigarette wholesalers and tobacco products distributors to the Liquor Enforcement Division (Division). However, the passage of House Bill 04-1248 provided a foundation for the Department to effectively collect delinquent taxes in a timely manner. Should this statutory remedy prove to be ineffective, the Department will consider other alternatives, including the transferring of the licensing authority to the Tobacco Enforcement Unit within the Division.

Implementation Update (April 2007): Recently, the Department again reviewed the pros and cons of moving the responsibility for licensing of cigarette wholesalers and tobacco product distributors (referred to here collectively as "Tobacco Licensees") to the Division. For a number of reasons, including those listed below, the Department determined that tobacco licensing is properly placed, and will remain in, the Tax Group (which includes Taxpayer Service Division (TPS)).

Tobacco licensing is the means by which cigarette and tobacco products taxes are administered, tax accounts established, and tax statutes and regulations enforced. Licensing is an appropriate function of tax administration and related processes are already in place in the Tax Group (e.g., Colorado's sales tax license is administered by the Tax Group).

Moreover, the Division's enforcement activities are directed primarily at the retail level, not at wholesalers. Tobacco licensing, on the other hand, occurs at the wholesale level where the tax is levied and paid. The Tax Group also enforces payment bonds for sales of cigarette stamps to wholesalers, which is also tied to tobacco licensing. Although there is some overlap because wholesalers provide the Division the names of retailers to whom they sell, TPS and the Division have implemented relatively simple procedures that allow the Division to enforce the "sales to minor" statute without transferring licensing of wholesalers to the Division. The Division and TPS recently reviewed these procedures and will slightly modify them to further simplify the process.

Recommendation No. 14:

The Department of Revenue's Tobacco Enforcement Unit needs to analyze the increase in the number of tobacco retailers selling to minors between Fiscal Year 2002 and Fiscal Year 2003 to determine of any pattern exits.

Department of Revenue Response:

1. Implemented **X** In Progress ___ Not Implemented ___

Implementation Status (October 2004): Implemented. The Division analyzed the increase of tobacco retailers selling to minors and found that the increase was due to elimination of two investigative FTE. It appears as though there was an assumption within the Tobacco Industry that the entire Tobacco Enforcement Unit was eliminated and therefore, there existed no perceived deterrent to violate the law. Subsequently, the two investigative FTE were restored and noncompliance rates were significantly reduced from a high of 12.4 percent to approximately 6.5 percent.

Implementation Status (April 2007): This recommendation was fully implemented prior to the October 2004 update as described above. Since then, the average yearly noncompliance rates have remained relatively stable.

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