DEPARTMENT OF TAXATION
2005 Fiscal Impact Statement

1. Patron David B. Albo

2. Bill Number HB 2886

House of Origin:
X **Introduced**
_____ **Substitute**
_____ **Engrossed**

Second House:
_____ **In Committee**
_____ **Substitute**
_____ **Enrolled**

3. Committee House Finance

4. Title Nonparticipating Manufacturers

5. Summary/Purpose:

This bill would provide that in order for a nonparticipating manufacturer ("NPM") to have an escrow payment released to it prior to the expiration of 25 years, the NPM must establish that the amount it was required to place into escrow on account of units sold in Virginia in a particular year was greater than the Master Settlement Agreement (MSA) payments that the NPM would have been required to make on account of such units sold had it been a participating manufacturer. This bill would also provide a Virginia corporate income tax subtraction to a NPM for amounts deposited into a qualified escrow fund during the taxable year to the extent that such amounts have not been deducted in determining federal taxable income. In order to qualify for this subtraction, the NPM must agree to (1) permanently release the escrowed funds to the Commonwealth or (2) receive in refund only those escrowed funds that would have otherwise reverted back to the NPM after 25 years reduced by the value of the subtraction claimed relating to the escrowed funds.

The effective date of this bill is not specified. The corporate income tax subtraction would be available for taxable years beginning on or after January 1, 2005.

6. Fiscal Impact Estimates are: Not available. (See Line 8.)

7. Budget amendment necessary: No.

8. Fiscal implications:

Administrative Costs

TAX is in the final stages of preparing for an August changeover to an entirely new system developed over many years through a public-private partnership. Legislative changes that become effective before the new system is in place must be made to both the old and new systems. However, TAX must "freeze" both systems for several months while its existing records and other data are converted to the new system, and will not be able to resume system modifications until the new system is stable. This freeze is required both by the physical requirements of a major system upgrade and the fact that all personnel capable of modifying either system will be fully committed to the changeover.

TAX would incur costs of minimal costs in Fiscal Year 2005 and $89,000 in Fiscal Year 2006 to implement this bill, including necessary systems changes. TAX believes that there will be sufficient time available to make the necessary systems changes required by this bill without affecting the system changeover. However, if numerous changes must be implemented within the same time frame TAX may not be able to accomplish all of the modifications without additional resources or the ability to delay the effective date of some of the changes.

Revenue Impact

As it is not known how many NPMs will chose to assign their escrow balances and escrow payments to the Commonwealth, the impact of this bill on General Fund revenues is unknown.

The following estimate is provided only to illustrate the mechanics of the revenue flows under the provisions of this bill and would change depending on the assumptions made. It is limited to the 8 NPMs that have obtained releases from their escrow funds in the past and which may take advantage of the provisions of this bill.

Every NPM is required to make an annual payment into its escrow fund by April 15 of each year based on the number of cigarettes sold during the previous calendar year. These 8 NPMs currently have escrow balances that total $6.4 million. Based on historical data regarding these 8 NPMs, it is estimated that they will make payments totaling $20 million on April 15, 2005, with respect to their 2004 calendar year cigarette sales and $19 million will be released back to them soon thereafter. As a result, their escrow accounts will total $7.4 million at the close of Fiscal Year 2005.

It is estimated that these NPMs will make escrow payments totaling $20 million with respect to their 2005 calendar year sales on April 15, 2006. Under this bill, only the portion of the escrow payments that is attributable to sales of cigarettes between January 1, 2005 and June 30, 2005 will be eligible for release to the NPMs. As a result, it is assumed that only $10 million will be released to the NPMs in Fiscal Year 2006 and their escrow accounts will total 17.4 million at the close of Fiscal Year 2006.

It is estimated that these NPMs will make escrow payments totaling $20 million with respect to their 2006 calendar year sales on April 15, 2007. Under this bill, no part of these escrow payments will be eligible for release to the NPMs. As a result, it is assumed that their escrow accounts will total $37.4 million on April 15, 2007 and they will assign this amount to the Commonwealth in the last quarter of Fiscal Year 2007 for deposit into the General Fund. In subsequent years, it is estimated that the NPMs will assign $20 million of escrow payments to the Commonwealth on April 15 of each year for deposit into the General Fund.

As it is assumed that NPMs will chose to receive their release rather than to forgo it for the corporate income tax subtraction, it is assumed that the first ceding of funds to the Commonwealth will occur shortly after the April 15, 2007 payment and the Commonwealth will receive $37.4 million. If the NPMs deducted all $20 million of their escrow payments made on April 15, 2007 from their taxes and received the full benefit of such, the impact on the General Fund would be a $1.2 million loss. It is assumed that the companies will reduce their last quarter of FY 07 estimated payment to recoup half of the deduction and the other half will be recouped by reducing the estimated payments for the first two quarters of FY 08. The result of the deduction of the $20 million escrow payments in FY 07 will be a general fund loss of $.6 million in FY 07 and FY 08. The future years will follow the same pattern as shown below:

Deposit for	Deposit Amount	Deduction Claimed	Loss to GF
CY 2006	$37.4 million	$1.2 million	$.6 million in FY 07 and $.6 million in FY 08
CY 2007	$20 million	$1.2 million	$.6 million in FY 08 and $.6 million in FY 09
CY 2008	$20 million	$1.2 million	$.6 million in FY 09 and $.6 million in FY 10
CY 2009	$20 million	$1.2 million	$.6 million in FY 10 and $.6 million in FY 11
CY 2010	$20 million	$1.2 million	$.6 million in FY 11 and $.6 million in FY 12

The estimate assumes, in the first year, that NPMs would recognize half of the corporate income tax deduction associated with the assignment in the last quarter of the fiscal year, (in all subsequent years this portion of the impact will be reflected in the third and fourth quarters of the fiscal year in which the assignment is made) and the other half in the first two quarters of the next fiscal year. The estimated fiscal impact of this bill would be as follows:

FY	Gain to **General Fund** from Escrow Payments	Loss to **General Fund** from Deduction	**Net Impact on General Fund**
2007	$37.4 million	$0.6 million	$36.8 million
2008	$20 million	$1.2 million	$18.8 million
2009	$20 million	$1.2 million	$18.8 million
2010	$20 million	$1.2 million	$18.8 million
2011	$20 million	$1.2 million	$18.8 million

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

<u>Master Settlement Agreement</u>

On November 23, 1998, leading United States tobacco product manufacturers, called participating manufacturers (PMs) entered into the Master Settlement Agreement (MSA) with the Commonwealth and 45 other states. The agreement obligated PMs, in return for release from past, present and certain future claims against them, to pay substantial sums to the Commonwealth. Tobacco product manufacturers who are not parties to the MSA, called nonparticipating manufacturers (NPMs), must pay sums into a qualified escrow fund from which claims may be paid if such manufacturers are determined in future years to have acted culpably. The escrow fund serves as a financial responsibility mechanism to guarantee a source of compensation and to prevent NPMs from becoming judgment proof before liability may arise. The NPM statute must be diligently enforced to ensure a state is exempt from the application of the NPM adjustment contained in the MSA. Although PMs are allowed an income tax business expense deduction for MSA payments, NPM escrow payments are not deductible.

Virginia's Nonparticipating Manufacturers Statute

The NPM Statute requires any tobacco product manufacturer selling cigarettes after July 1, 1999, who does not participate in the MSA to make deposits into a qualified escrow fund. Under current law, escrowed funds may not be released to the NPM until 25 years after the date they were placed in escrow unless the NPM establishes that the amount it was required to place into escrow in a particular year was greater than the Commonwealth's allocable share of the total payments that the NPM would have been required to make in that year under the MSA had it been a PM.

Proposal

This bill would provide that in order for a NPM to have an escrow payment released to it prior to the expiration of 25 years, the NPM must establish that the amount it was required to place into escrow on account of units sold in Virginia in a particular year was greater than the MSA payments that the NPM would have been required to make on account of such units sold had it been a PM. This bill contains a "revival clause" that would restore the current law that is being changed by this provision if this provision is determined to be invalid by the courts. In addition, this bill contains a "severability clause" that would allow any other part of this bill to remain in effect that is not determined to be invalid by the courts.

This bill would also provide a Virginia corporate income tax subtraction to a NPM for amounts deposited into a qualified escrow fund during the taxable year to the extent that such amounts have not been deducted in determining federal taxable income. This subtraction would be available for taxable years beginning on or after January 1, 2005. In order to qualify for this subtraction, the NPM must agree to (1) permanently release the escrowed funds to the Commonwealth or (2) receive in refund only those escrowed funds that would have otherwise reverted back to the NPM after 25 years reduced by the value of the subtraction claimed relating to the escrowed funds. For purposes of determining the amount to be released in 25 years, the value of the subtraction would be the amount subtracted multiplied by the Virginia corporate income tax rate in effect in the taxable year the subtraction was claimed.

This bill would also clarify that civil penalties imposed by courts on NPMs for failing to make required escrow payments are to be paid into the General Fund.

Other Legislation

House Bill 2035 and **Senate Bill 1204** would impose an excise tax on cigarette manufacturers at the rate of 2 cents for every cigarette sold in Virginia.

House Bill 2392 would authorize all counties to impose a local cigarette tax at a rate not to exceed 50 cents per pack.

House Bill 2625 would increase the cigarette tax dealers discount from 2.5 cents per carton to 2 percent of the price of the cigarette stamps.

House Bill 2629 and **Senate Bill 1202** would modify the conditions under which escrow funds may be released to nonparticipating manufacturers.

House Bill 2899 would exempt exclusive distributors and manufacturers from affixing tax revenue stamps to cigarettes if they are being sold to Virginia stamping agents.

House Bill 2918 and **Senate Bill 1331** would provide for the assignment of NPM escrow funds to the Commonwealth.

House Bill 2919 and **Senate Bill 1332** would require the Department to use funds from small tobacco product manufacturers to make payments to tobacco farmers from whom the manufacturers have purchased domestic tobacco leaf.

House Bill 2933 would permit stamping agents to receive a credit for the cost of the tax stamps on cigarettes they have sold but for which payment is uncollectible.

House Joint Resolution 664 would require the Department of Taxation study the feasibility of establishing uniformity and consistency among Virginia's localities in the design and use of tax stamps for local cigarette taxes.

Senate Bill 478 would amend Roanoke County’s charter to authorize the imposition of a local cigarette tax at a rate not to exceed 15 cents per pack of twenty cigarettes.

Senate Bill 876 would change the cigarette tax laws to provide consistency with the non-participating manufacturer reporting requirements and to enhance compliance and administration.

Senate Bill 1038 would provide that one cent of the 30 cents per pack cigarette tax be deposited into the Uninsured Medical Catastrophe Fund.

Senate Bill 1137 would allow counties to impose a local cigarette tax at the state cigarette tax rate.

cc : Secretary of Finance

Date: 1/30/2005 JEM