DEPARTMENT OF TAXATION
2005 Fiscal Impact Statement

1. Patron Clarke N. Hogan

2. Bill Number HB 2919

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

3. Committee Senate Finance

4. Title Incentive Payments to Small Tobacco Product Manufacturers

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

5. Summary/Purpose:

This bill would authorize payment of tax incentives to eligible nonparticipating manufacturers ("NPMs") based on their purchases of domestic tobacco. The payments would be made from funds assigned by the NPMs to the Commonwealth from their escrow accounts.

The effective date of this bill is not specified.

6. Fiscal Impact Estimates are: Preliminary. (See Line 8.)

6a. Expenditure Impact:

Fiscal Year	***Dollars***	***Positions***	***Fund***
2004-05	$0	0	GF
2005-06	$59,400	1	GF
2006-07	$47,200	1	GF
2007-08	$48,100	1	GF
2008-09	$49,000	1	GF
2009-10	$49,900	1	GF
2010-11	$50,800	1	GF

7. Budget amendment necessary: Yes.
Item(s): 284 and 286, Department of Taxation

8. Fiscal implications:

Revenue Impact

The estimate below assumes passage of House Bill 2918 and House Bill 2629. House Bill 2918 allows NPMs to assign their escrowed funds and future payments to the Commonwealth. Assigned funds, net of the incentive payments, would be deposited into the Health Care Fund. NPMs may receive corporate income tax deductions (a General Fund reduction) for these amounts. For purposes of this estimate, it is assumed that all

NPMs that have made escrow payments and sought releases will elect to assign their payments and will qualify for the incentive payments.

House Bill 2629 eliminates the ability of NPMs to get an immediate release of their escrow payments starting with the April 15, 2007 escrow payment. NPMs would still be able to get release from their April 15, 2006 escrow payment regarding cigarettes sold between January 1, 2005 and June 30, 2005.

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. It is estimated that $20 million in payments will be made on April 15, 2005, with respect to their 2004 calendar year cigarette sales and $19 million will be released back to the NPMs soon thereafter. The escrow accounts will total $7.4 million at the close of Fiscal Year 2005.

It is estimated that $20 million in payments with respect to 2005 calendar year sales will be made on April 15, 2006. Assuming that House Bill 2629 is enacted and becomes effective on July 1, 2005, $10 million will be released to the NPMs in Fiscal Year 2006. Their escrow account balances will total $17.4 million at the close of Fiscal Year 2006.

If it is assumed that the NPMs will not assign the $17.4 million of escrow funds to the Commonwealth until after the release related to the April 15, 2006 payment is returned to them, the Health Care Fund will receive $17.4 million from the NPMs in the last quarter of Fiscal Year 2006. 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 which will be deposited into the Health Care Fund.

It is assumed that the NPMs that cede their escrow payments to the Commonwealth will be allowed to deduct such payments for corporate income tax purposes. It is assumed that all NPMs will be able to fully utilize the tax deduction and that the companies will reduce their last quarter of Fiscal Year 2006 estimated payment to recoup half of the deduction. The other half will be recouped by reducing the estimated payments for the first two quarters of Fiscal Year 2007. The future years will follow the same pattern.

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. Based on the assumptions above, the revenue impact of House Bill 2918 is as follows:

FY	Payments Assigned to **Health Care Fund**	Loss to **General Fund** from Deduction
2006	$17.4 million	<$.52 million>
2007	$20 million	<$1.12 million>

2008	$20 million	<$1.2 million>
2009	$20 million	<$1.2 million>
2010	$20 million	<$1.2 million>
2011	$20 million	<$1.2 million>

This bill authorizes payment of tax incentives to eligible NPMs from funds assigned by the NPMs to the Commonwealth from their escrow accounts. For purposes of this estimate, it is assumed that all NPMs that have made escrow payments and sought releases will elect to assign their payments and will qualify for the incentive payments. In the first year (Fiscal Year 2007), this bill provides an incentive payment of up to 25% of the amount that the NPM paid for all prior escrow payments, less any escrow amounts that had been released and reverted back to the NPM. In years two through five, the incentive payments would be limited to a specified percentage of the amount that the NPM paid into escrow for the prior calendar year. It is assumed that the NPMs will all qualify for the maximum incentive payment each year. The Commonwealth would not disburse incentive payments to NPMs until the third quarter of the next fiscal year. Assuming that both House Bill 2918 and this bill pass, the fiscal impact of this bill alone is estimated to be:

FY	Reduction in Payments to **Health Care Fund**	Gain to **General Fund** from tax on incentive payments
2006	$0	$0
2007	<$4.35 million>	$.13 million
2008	<$4 million>	$.25 million
2009	<$3 million>	$.21 million
2010	<$2 million>	$.15 million
2011	<$1 million>	$.09 million

The combined revenue impact of House Bill 2918 and this bill would be:

FY	Assigned Payments	Incentive Payments	Net Balance Available for **Health Care Fund**	Net Loss to **General Fund** from Deduction*
2006	$17.4 million	$0	$17.4 million	<$.52 million>
2007	$20 million	<$4.35 million>	$15.65 million	<$.99 million>

2008	$20 million	<$4 million>	$16 million	<$.95 million>
2009	$20 million	<$3 million>	$17 million	<$.99 million.
2010	$20 million	<$2 million>	$18 million	<$1.05 million>
2011	$20 million	<$1 million>	$19 million	<$1.11 million>
*Figure is net of the positive effect of including incentive payments in taxable income and the negative effect of deducting the assigned payments.				

Administrative Costs

It is estimated that the Department would incur administrative costs of $59,400 in Fiscal Year 2006, $47,200 in Fiscal Year 2007, $48,100 in Fiscal Year 2008, $49,000 in Fiscal Year 2009, $49,900 in Fiscal Year 2010, and $50,800 in Fiscal Year 2011 to implement this bill, including systems changes and one additional employee.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

If the intent of this bill is to prevent small tobacco product manufacturers from receiving incentive payments for purchases of tobacco grown by agents or directors of the manufacturer, the following amendment is suggested:

Page 1, Line 22, After Title 3.1.
Strike: Remainder of Line 22 and Lines 23 and 24.
Insert: A small tobacco product manufacturer shall not be eligible for any incentive payment under this section for domestic tobacco purchased that is grown by an agent or director of the small tobacco product manufacturer and used in the manufacture of cigarettes by the small tobacco product manufacturer.

If the intent of this bill is to allow the Department to administer this program in the same manner that state taxes are administered, the following amendment is suggested:

Page 2, Line 84, After the beginning of the line
Insert: D. The provisions of Chapter 18 of this title shall apply to the administration of this section, mutatis mutandis.

11. Other comments:

Master Settlement Agreement

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 authorize payment of tax incentives to eligible NPMs based on their purchases of domestic tobacco. The payments would be made from funds assigned by the NPMs to the Commonwealth from their escrow accounts.

This bill is a companion bill to House Bill 2918, which would authorize NPMs to assign all of the funds in their escrow accounts and all future escrow payments to the Commonwealth. House Bill 2918 would authorize the Commonwealth to withdraw the assigned funds from the escrow account. After making tax incentive payments to small tobacco product manufacturers for their use of domestic tobacco, the remaining funds would be deposited into the Virginia Health Care Fund.

"Domestic tobacco" would mean tobacco grown, produced, and processed entirely within the United States. "Small tobacco product manufacturer" would mean an NPM (1) who is in compliance with Virginia's NPM statute; (2) that has made an escrow assignment to the Commonwealth; (3) that directly and not exclusively through any affiliate manufactures fewer than 5 billion cigarettes; and (4) whose cigarettes contain a minimum of 75 percent tobacco.

The incentive payments would equal the total price paid for domestic tobacco purchased by the manufacturer in the taxable year. In the 2006 taxable year, the incentive payment would be limited to 25 percent of the amount that the manufacturer paid into its escrow account in all prior years, less any escrow funds released and reverted back to the manufacturer, as of April 16, 2005. In each of the taxable years 2007 through 2010, the incentive payment would be limited to the following percentage of the amount that the manufacturer paid into its escrow account in the prior calendar year as of April 16:

Taxable Year	Percentage
2007	20
2008	15
2009	10
2010	5

Small tobacco product manufacturers seeking incentive payments would be required to apply to the Department by March 1 of each year and establish the percentage of domestic tobacco contained their cigarettes and the total pounds of domestic tobacco purchased or expected to be purchased by the manufacturer in the calendar year. At the time of purchase, the manufacturer making the purchase would certify to the Department that the sale is occurring and the amount of domestic tobacco being purchased. Between January 1 and January 15, the Department would certify the amount of the incentive payment to be made to each manufacturer.

The Department would be required to issue guidelines governing the payments to small tobacco product manufacturers purchasing domestic tobacco. The development of such guidelines would be exempt from the provisions of the Administrative Process Act.

Other Legislation

House Bill 2918 would provide for the assignment of NPM escrow funds to the Commonwealth.

Senate Bill 1332 would authorize NPMs to assign their escrow accounts and future escrow payments to the Commonwealth. After payment of tax incentives to eligible NPMs based on their purchases of domestic tobacco, remaining funds would be deposited into the Virginia Health Care Fund.

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

cc : Secretary of Finance

Date: 2/11/2005 JEM