DEPARTMENT OF TAXATION
2005 Fiscal Impact Statement

1. Patron Phillip P. Puckett

2. Bill Number SB 1332

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

3. Committee Passed House and Senate

4. Title Nonparticipating Manufacturers; Contribution of Escrow Funds to Commonwealth, Tax Incentive Payments

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

5. Summary/Purpose:

This bill would authorize nonparticipating manufacturers ("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.

The effective date of this bill is not specified.

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

7. Budget amendment necessary: No.

8. Fiscal implications:

<u>Revenue Impact</u>

The estimate below assumes passage of Senate Bill 1202. Senate Bill 1202 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 for 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 Senate Bill 1202 is enacted and becomes effective on July 1, 2005, $10 million will be released to the NPMs in Fiscal Year 2006. Their escrow accounts balances will total $17.4 million at the close of Fiscal Year 2006.

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. 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 for deposit into the Health Care Fund.

It is assumed that the NPMs will 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.

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. The NPMs will also be required to include the incentive payments as taxable income. 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 payments 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 this bill is as follows.

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: No.

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 NPMs to assign all of the funds in their escrow accounts and all future escrow payments to the Commonwealth. The Commonwealth would be authorized to withdraw the assigned funds from the escrow account. A portion of the funds would be used to make 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. A manufacturer would not be eligible for any incentive payment regarding the purchase of tobacco grown by an agent or director of the manufacturer.

"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 be equal to the price of the domestic tobacco purchased by the NPM in the prior calendar year. The incentive payment for domestic tobacco purchased by the NPM in calendar year 2006 would be limited to 25 percent of the amount that the manufacturer paid into its escrow account in calendar year 2005 and prior years as of April 16, 2005 less any escrow funds released and reverted back to the manufacturer that are attributable to calendar year 2005 and prior years escrow payments. In each of the calendar years 2007 through 2011, 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:

Calendar Year	Percentage Limitation
2007	20
2008	15
2009	10
2010	5
2011	5

In addition, the aggregate amount of the incentive payments to all qualifying NPMs for domestic tobacco purchased in calendar year 2006 would be capped at $9 million. In subsequent years the aggregate amount of the incentive payments to NPMs would be capped at the following amounts:

Calendar Year	Total Incentive Payments Limitation
2007	$8 million
2008	$6 million
2009	$4 million
2010	$3 million
2011	$3 million

In the event that the aggregate amount of the incentive payments to NPMs to be made in any calendar year exceeds the aggregate limitation for incentive payments for the year, the payment to each qualifying NPM for the year would be a pro rata share of the aggregate limitation based upon the amount of the incentive payment that would have been made to each NPM for the year if there were no aggregate limitation.

Starting in 2007, NPMs seeking incentive payments would be required to apply to the Department by January 1 of each year and certify the percentage of domestic tobacco contained their cigarettes and the amount paid for domestic tobacco used in manufacturing cigarettes in the prior calendar year. Within 30 days thereafter, the Department would certify to the Comptroller the amount of the incentive payment to be made to each NPM. Within 15 days thereafter, the Comptroller would draw his warrant from funds in the NPM’s escrow account on the state Treasurer in the amount of the payment.

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 2919 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: 3/10/2005 JEM