NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: House Bill 58 (First Edition)

SHORT TITLE: Exempt Tobacco Payments From Income Tax

SPONSOR(S): Rep. Baker, et al.

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	($million) FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06
REVENUES					
General Fund					
Phase I	No estimate available				
Phase II	($4.88)	($7.07)	($8.89)	($8.89)	($8.89)
Federal aid	No estimate available				
EXPENDITURES					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Department of Revenue

EFFECTIVE DATE: This act is effective for taxable years beginning on or after January 1, 2001.

BILL SUMMARY: The bill exempts from corporate (G.S. 105-130.5(b)) and individual (G.S. 105-134.6(b)) income tax those payments made to tobacco farmers, tobacco workers, allotment holders, and others as compensation for losses that have resulted from tobacco litigation, federal tobacco legislation, or reduced tobacco purchases by tobacco manufacturers. This bill specifically exempts payments from the Golden Leaf, Inc., the Settlement Reserve Fund, voluntary agreements with tobacco manufacturers, the earnings from any trust that addresses the declining demand for tobacco products, and federal aid programs based on the reduction in tobacco quota.

ASSUMPTIONS AND METHODOLOGY:

PHASE II SETTLEMENT

The Phase II Settlement is an agreement between tobacco manufacturers and tobacco growers/ tobacco quota holders. The tobacco manufacturers will pay $5.15 billion over twelve years to 14 tobacco producing states to compensate growers and quota owners for the loss of income due to the reduction in the national marketing quota. North Carolina will receive 37.95% of these funds based on its share of the flue-cured and burley tobacco market. In 1999, the first year of the program, North Carolina received $144,210,000. However, in 2000 North Carolina received only 90% of its proposed share due to a downward adjustment caused by a decline in domestic cigarette sales. The chart below assumes future year distributions will also be reduced by a minimum of 10%.

Year	U. S. Amount	N.C. Share 37.95%	N.C. Actual Payment	Admin. Expense	Tax Year Disbursements	Effective Tax Rate 5.328%
1999	$380,000,000	$144,210,000	$144,210,000	$5,000,000	$139,210,000	
2000	$280,000,000	$106,260,000	$95,690,337	$4,076,736	$91,613,601	$7,417,109
2001	$400,000,000	$151,800,000	$136,700,481	$4,000,000	$132,700,481	$4,881,173
2002	$500,000,000	$189,750,000	$170,875,602	$4,000,000	$166,875,602	$7,070,282
2003	$500,000,000	$189,750,000	$170,875,602	$4,000,000	$166,875,602	$8,891,132
2004	$500,000,000	$189,750,000	$170,875,602	$4,000,000	$166,875,602	$8,891,132
2005	$500,000,000	$189,750,000	$170,875,602	$4,000,000	$166,875,602	$8,891,132
2006	$500,000,000	$189,750,000	$170,875,602	$4,000,000	$166,875,602	$8,891,132
2007	$500,000,000	$189,750,000	$170,875,602	$4,000,000	$166,875,602	$8,891,132
2008	$500,000,000	$189,750,000	$170,875,602	$4,000,000	$166,875,602	$8,891,132
2009	$295,000,000	$111,952,500	$100,816,605	$4,000,000	$96,816,605	$8,891,132
2010	$295,000,000	$111,952,500	$100,816,605	$4,000,000	$96,816,605	$5,158,389
2011						$5,158,389
Total	**$5,150,000,000**	**$1,954,425,000**	**$1,774,363,241**	**$49,076,736**	**$1,725,286,505**	**$91,923,265**

The 14-member North Carolina Phase II Tobacco Certification Entity, Inc. oversees the disbursement of Phase II funds in the state. This board hired Chase Manhattan Bank to serve as depository and trustee for the Phase II funds. The Womble Carlyle Sandridge and Rice Settlement Administration Group in Winston-Salem were chosen to administer and disburse Phase II checks. The Womble Carlyle firm is being paid $5 million in the first year and $12 million over the next four years to certify growers and quota owners for payments. John Ray Davis, Sr., the Executive Director of the Phase II Tobacco Certification Entity, Inc., set aside $4.08 million for Womble and other administrative expenses in year 2000 and expects $4 million a year administrative costs will continue for the duration of the program.

The Board disbursed $139.2 million in funds to 20,242 growers and 90,417 quota owners in 1999 and 2000. The payments were split evenly between growers ($69.8 million) and quota owners ($69.4 million). Flue-cured growers and quota owners received 94.5% of the funds at a rate of $1.37 per pound of basic quota lost between 1998 and 1999. Burley growers and quota owners received 5.5% of the funds at a rate of $.68 per pound of basic quota lost between 1998 and 1999.

These cash payments are a source of income and are fully taxable at the state and federal level. According to an IRS opinion, the payments are taxable in the year received, not in the year the checks were mailed. The 1999 and 2000 checks were all received in tax year 2000. Upon the request of the Fiscal Research Division of the General Assembly, the Department of Revenue was asked to determine the tax liability of the Phase II grant recipients by matching a database of the Phase II grantees against 1998 income tax returns for these individuals and corporate entities (partnerships, LLCs, etc.). The Tax Research Division of the Department of Revenue estimated that the state would gain $6.7 million in individual income taxes and $500,000 in corporate income taxes from $135.1 million in Phase II payments to growers and quota holders. These tax receipts equal an effective tax rate of 5.328%. This effective tax rate is applied to future year disbursements to determine the revenue gained by the state General Fund from Phase II payments and to determine the potential revenue loss due to the passage of this bill. This fiscal note assumes that Phase II recipients will report these grants on their annual tax returns in the spring of each year and not report the income in quarterly estimated payments. This means the payments received by growers and quota holders in 2001 will be reported on returns filed in 2002 and be General Fund revenue for state fiscal year 2001-02. Revenue from Phase II funds is built into future year revenue forecasts.

PHASE I SETTLEMENT

North Carolina is sharing in the $206 billion Phase I Settlement between five major tobacco companies and the state attorneys general of 46 states, four territories, and the District of Columbia. North Carolina's share of the fund over the next twenty-five years equals approximately $4.5 billion. This figure is subject to annual adjustment based on changes in the volume of cigarette sales, inflation, and increases in federal taxes. To date, North Carolina has received $234.8 million and will receive an average of $167.2 million each year over the next five years (2002 to 2006).

The 1999 General Assembly approved Senate Bill 6 in order to divide up the state's share of the Phase I money. Fifty percent of the funds are allotted to a nonprofit corporation that has been named the Golden L.E.A.F., Inc. (Long-term Economic Advancement Foundation). The articles of incorporation for this foundation state that its purpose is to provide economic impact assistance to economically affected or tobacco dependent regions of the state. The foundation can provide education assistance, job training and employment assistance, scientific research, economic hardship assistance, public works and industrial recruitment, health and human services, and community assistance to these regions. The Foundation's current approach is to place its Phase I money in an endowment and make grant awards from the interest earned from the fund. In 2000, the Foundation awarded $5.12 million in grants to 39 tax-exempt organizations and governmental units. Individuals and corporations were not eligible for these funds. Based on the operating principles of Golden L.E.A.F., Inc., there will be no taxable income derived from this segment of Phase I.

Senate Bill 6 directed the remaining 50% of the Phase I settlement funds be divided equally between a trust fund for the benefit of health and a trust fund for the benefit of tobacco producers, tobacco allotment holders, and persons engaged in tobacco related businesses. HB 1431 was introduced in 1999 to establish a Health and Wellness Trust Fund Commission and a

Tobacco Trust Fund Commission to administer the funds. (HB 1431 was ratified on July 13, 2000.) Only the Tobacco Trust Fund has the potential to provide taxable income to individuals and businesses. GS 143-720 states that the Fund may provide direct and indirect financial assistance. The recently appointed Tobacco Trust Fund Commission may choose to compensate 1) "tobacco producers, allotment holders, and persons engaged in tobacco-related businesses for economic loss resulting from lost quota and compensate tobacco producers for the decline in value of tobacco-related personal property assets and declining market conditions resulting from the Master Settlement Agreement in this State," 2) "individuals displaced from tobacco-related employment in this State as a result of the adverse economic effects from the Master Settlement Agreement," and 3) "tobacco product component businesses that are adversely impacted by the Master Settlement Agreement and need financial assistance to retool machinery or equipment, or to retrain workers in order to convert to the production of new products or non-tobacco use of existing products, or to effect other similar changes." The Tobacco Trust Fund will receive an average of $41 million per year over the next five years. If the Tobacco Trust Fund Commission awards these funds to businesses and individuals, the state would earn approximately $2.2 million in General Fund revenue each year. Conversely, passage of HB 58 would preclude the state from collecting this revenue.

FEDERAL AID

As of February 22, 2001, there are no bills pending in the U.S. Congress that would award payments to tobacco farmers and quota owners. This was not the case in 1999 and 2000. In October 1999, Congress approved the conference report to HR 1906 (House Report 106-354) that distributed $328 million in aid to compensate tobacco producers that had suffered a reduction of tobacco quota or acreage for the 1999 crop year. North Carolina's share of the aid, approximately $99 million, was allocated in the same manner as the Phase II Settlement funds. On June 22, 2000, President Clinton signed HR 2559 (PL 106-224), the Agricultural Risk Protection Act of 2000, which distributed another $340 million to tobacco producing states. The Farm Service Agency of the U.S. Department of Agriculture distributed $100 million of this appropriation to North Carolina tobacco quota owners, tobacco quota lessees, and tobacco producers. Applying the 5.328% effective tax rate found in Phase II grants to the $199 million in federal aid awarded to North Carolina individuals and businesses in tax year 2000, the state earned $10.6 million in income tax revenue from these federal payments. HB 58 will prevent the taxation of future federal aid payments to tobacco farmers and quota owners.

FISCAL RESEARCH DIVISION 733-4910
PREPARED BY: Richard Bostic
APPROVED BY: James D. Johnson
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