TOBACCO TAXES
SECTION 7

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GOVERNOR'S OFFICE OF
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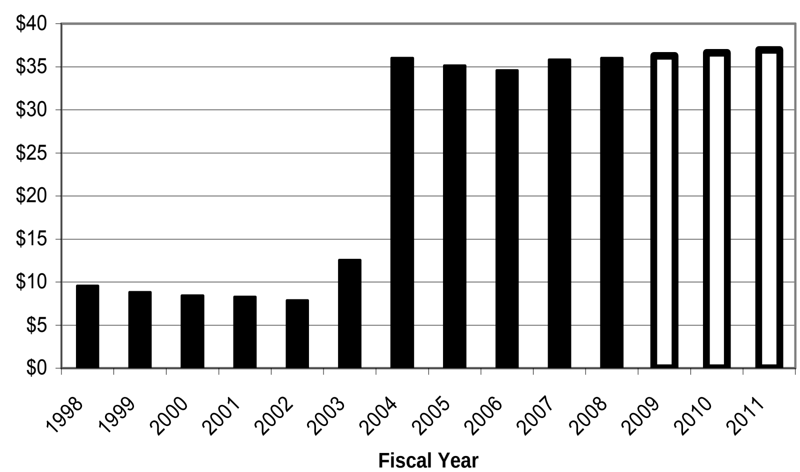
Revenue Description

According to 16-11-111, MCA, a specific tax of $1.70 is imposed on each pack of 20 cigarettes. If a pack contains more than twenty cigarettes, the tax is pro-rated by 1/20th of the $1.70 tax for each cigarette exceeding 20 cigarettes. Currently, revenue generated from the cigarette tax is distributed as follows: 45.1% to the general fund; 44.0% to the health and Medicaid initiative account; 2.6% to the long-range building account; and the greater of 8.3% or $2 million for operation of state veterans' nursing homes.

Table 1
Cigarette Tax General Fund Revenue
($ millions)

Fiscal Year	General Fund	Percent Change
A 1998	$9.544	-
A 1999	$8.823	-7.56%
A 2000	$8.418	-4.59%
A 2001	$8.285	-1.58%
A 2002	$7.887	-4.80%
A 2003	$12.576	59.46%
A 2004	$36.002	186.26%
A 2005	$35.117	-2.46%
A 2006	$34.573	-1.55%
A 2007	$35.830	3.64%
A 2008	$36.004	0.49%
F 2009	**$36.266**	**0.73%**
F 2010	**$36.631**	**1.01%**
F 2011	**$36.977**	**0.94%**



HB 166, (1997 Session) distributed cigarette tax revenue 73.04% to the general fund; 15.85% to the long-range building account; and 11.11% to the Department of Public Health and Human Services (DPHHS), as provided for in section 16-11-119, MCA. Beginning May 1, 2003, SB 407 (2003 Session) increased the tax on cigarettes from $0.18 to $0.70 per pack. SB 407 also changed the distribution of cigarette taxes, increasing the general fund portion to 87.40%, the long-range building account to 4.3%, and the DPHHS portion to the greater of 8.3% or $2.0 million. The tax increase under SB 407 explains the FY 2003 and FY 2004 increase in cigarette tax revenue shown in Table 1.

Initiative 149 (I-149) further increased the tax on each pack of cigarettes to $1.70 as of January 1, 2005. I-149 also changed the allocation of total collections as follows: 45.1% to the general fund; 44.0% to the health and Medicaid initiative account; 2.6% to the long-range building account; and the greater of 8.3% or $2 million for operation of state veterans' nursing homes.

Forecast Methodology

The general fund share of the cigarette tax is prepared in four steps:

Step 1: Estimate taxable per capita cigarette consumption.

- Montana population over age 15 has experienced an average annual increase of 1.23% between 2002 and 2008.
- Per capita consumption has experienced an average annual increase of 0.90% between 2006 and 2008.

- Montana population age 15 and over was used for this forecast because, according to statistical analysis, this demographic tracked total cigarette consumption over time better than changes in other age demographics such as total population, the population between 30 and 60 years old, etc.
- Although national trends indicate an overall downward trend for cigarette consumption, the rate at which consumption declines is also declining. According to the Center for Disease Control, the national prevalence of cigarette smoking has not declined significantly since 2004, which would imply a break in the previous seven year decline in cigarette smoking in the United States.

Step 2: Estimate cigarette tax revenue.

Step 3: Calculate tribal revenue sharing agreement payments.

- There are three types of arrangements for cigarette taxes with the seven Indian reservations in Montana:
  - The Northern Cheyenne has a tax-free quota agreement with the state.
  - The Flathead Reservation abides by the tax-free quota law with no specific agreement with the state.
  - The Blackfeet, Fort Belknap, Rocky Boy, Fort Peck, and Crow Reservations have a revenue sharing agreement with the state.
- Tribes in categories 1 and 2 receive cigarettes tax free for the enrolled tribal members residing on the reservation. Under the revenue sharing agreements, the tribe and state cigarette tax rates are the same. The tribe's share of the tax revenue is 150% of the per capita cigarette tax collected for each of the tribes' enrolled members residing on the reservation.

Step 4: Calculate state cigarette tax revenue and allocation.

Distributions

Table 2 shows the calculation and allocation of state cigarette tax revenue for FY 2009 through FY 2011. The tribes' revenue allocations are subtracted from the gross cigarette tax revenue to yield total state cigarette tax revenue. Revenue is allocated to each fund by multiplying state cigarette tax revenue by the fund's share.

Table 2
Calculation and Distribution of Cigarette Tax Revenue

Calculation	FY 2009	FY 2010	FY 2011
Gross Cigarette Tax Revenue	$84,470,433	$85,322,531	$86,128,176
Subtract Tribe Payments	($4,058,815)	($4,099,758)	($4,138,470)
Total State Cigarette Tax Revenue	**$80,411,618**	**$81,222,773**	**$81,989,706**
Allocation			
General Fund (45.1%)	**$36,265,640**	**$36,631,471**	**$36,977,358**
Long Range Building Fund (2.6%)	$2,090,702	$2,111,792	$2,131,732
State Veterans' Nursing Homes (8.3%)	$6,674,164	$6,741,490	$6,805,146
Health and Medicaid (44.0%)	$35,381,112	$35,738,020	$36,075,471
Total State Cigarette Tax Revenue	**$80,411,618**	**$81,222,773**	**$81,989,706**

Data Sources

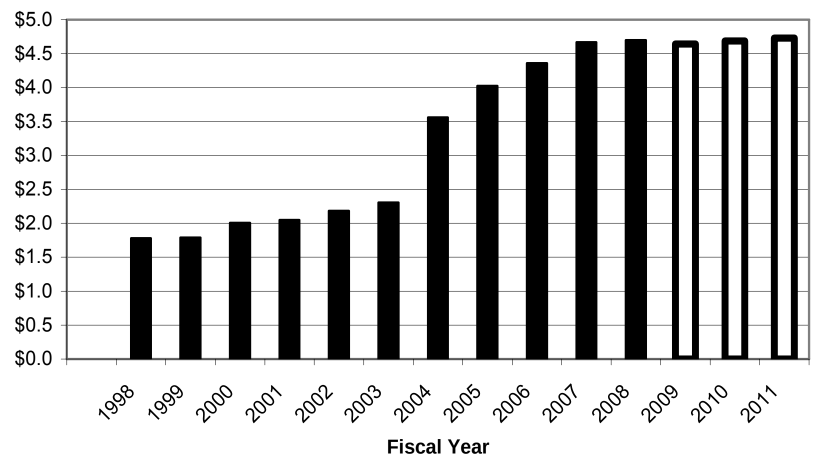
The general fund revenue data was obtained from SABRHS. Current tribal payments are provided by DOR Fiscal Year 2008 Revenue Sharing Agreement Quarterly Reports. Population data forecasts are provided by Global Insight (July, 2008).

Revenue Description

According to 16-11-111, MCA, the Department of Revenue (DOR) is directed to collect a tax of 85 cents per ounce of moist snuff and 50% of the wholesale price of all other tobacco products, excluding cigarettes. Tobacco products destined for retail sale and consumption outside Montana are not subject to this tax. The general fund and the health and Medicaid initiative account each receive 50% of the tobacco products tax revenue after payments are made as per tribal revenue sharing agreements.

Table 1
Tobacco Tax General Fund Revenue
($ millions)

Fiscal Year	General Fund	Percent Change
A 1998	$1.779	-
A 1999	$1.791	0.7%
A 2000	$2.007	12.1%
A 2001	$2.048	2.0%
A 2002	$2.183	6.6%
A 2003	$2.305	5.6%
A 2004	$3.562	54.5%
A 2005	$4.024	13.0%
A 2006	$4.360	8.3%
A 2007	$4.670	7.1%
A 2008	$4.699	0.6%
F 2009	**$4.641**	**(1.2%)**
F 2010	**$4.688**	**1.0%**
F 2011	**$4.732**	**0.9%**



In FY 2000, there was a 12.08% increase in tobacco revenue due to an unexpected increase in gross tobacco sales coupled with a modest increase in state population, therefore effectively increasing per capita consumption and general fund revenue. In FY 2004 there was a 54.52% increase in tobacco revenue due to SB 407 (2003 session). On May 1, 2003, SB 407 changed the tax on moist snuff from 12.5% of the wholesale price to 35 cents per ounce, an effective increase of 7 cents per ounce. SB 407 also increased the tax on all other tobacco from 12.5% of the wholesale price to 25% of the wholesale price.

On January 1, 2005, Initiative 149 (I-149) changed the tax on moist snuff to 85 cents per ounce and increased the tax on all other tobacco to 50% of the wholesale price. This tax increase explains the increase in total tobacco tax revenue in FY 2005 and FY 2006. Revenue increased 7.10% in FY 2007 as a result of a larger proportion of refunds for unsalable tobacco product than usual being credited back to sellers for sales in FY 2006.

Forecast Methodology

The tobacco tax revenue is comprised of two taxes: (1) the moist snuff tax of 85¢ per ounce; and (2) the other tobacco tax of 50% of the wholesale price.

The six steps in estimating tobacco tax revenues are:

Step 1: Estimate per capita tobacco consumption;

- Montana population over age 15 has experienced an average annual increase of 1.23% between 2002 and 2008.

- Moist snuff per capita consumption has experienced an increase of 5.30% from 2005 to 2008.
- Montana population age 15 and over was used for this forecast because, according to statistical analysis, this demographic tracked total tobacco consumption over time better than changes in other age demographics such as total population, the population between 30 and 60 years old, etc.

Step 2: Estimate projected gross tobacco tax revenue;

- Moist Snuff
  - Multiply the estimated per capita consumption of moist snuff by Montana's population over 15 years of age to determine total moist snuff consumption.
  - Multiply total moist snuff consumption by the moist snuff tax rate to determine gross moist snuff tax revenue.
- Other Tobacco Products
  - Multiply the estimated per capita consumption of other tobacco products by Montana's population over 15 years of age to determine total other tobacco product consumption.
  - Multiply total other tobacco product consumption by the other tobacco product tax rate to determine gross other tobacco product tax revenue.

Step 3: Calculate wholesaler discounts. The excise tax on tobacco products is imposed on retail consumers, but the tax is collected by wholesalers. In accordance with 16-11-112, MCA, wholesalers are allowed a discount equal to 1.5% of total tax collections to defray collection and administrative costs.

Step 4: Calculate refunds for unsalable product. Tobacco product sellers can obtain a refund credit for tobacco products that could not be sold due to defect. The average percentage of defective product credits of total collections in FY 2005 through FY 2008 (2.05%) is used to forecast refund credits for FY 2009 through FY 2011.

Step 5: Calculate tribes' revenue allocation. Five Indian reservations in Montana have a tobacco revenue sharing agreement with the state: Blackfeet, Fort Belknap, Rocky Boy, Fort Peck, and Crow Reservations. Under the revenue sharing agreements, the tribe tobacco tax and the state tobacco tax are the same. The tribe's share of the tax revenue is 150% of the per capita state tobacco tax collected for each of the tribes' enrolled members residing on the reservation.

Step 6: Calculate state tobacco tax revenue and allocation.

Distributions

Wholesaler discounts and refund credits are subtracted from total tobacco tax revenue and tribal allocation payments are subtracted from net revenue to determine total state other tobacco tax revenue. Fifty percent of the state tobacco tax revenue goes to the general fund and 50% goes to the health and Medicaid fund. Please see Table 2 on the following page.

Table 2 Calculation and Distribution of Tobacco Tax Revenue			
Calculate Tobacco Tax Revenue	**FY 2009**	**FY 2010**	**FY 2011**
Total Tobacco Tax Revenue	$10,130,893	$10,233,161	$10,329,897
Subtract Wholesaler Discounts	($151,963)	($153,497)	($154,948)
Subtract Refund Credits	($207,318)	($209,411)	($211,390)
Net Revenue	$9,771,611	$9,870,253	$9,963,558
Subtract Tribal Payments	($489,677)	($494,620)	($499,296)
Total State Tobacco Tax Revenue	$9,281,934	$9,375,632	$9,464,262
Allocate State Tobacco Tax Revenue			
Total to General Fund (50%)	**$4,640,967**	**$4,687,816**	**$4,732,131**
Total to Health and Medicaid (50%)	$4,640,967	$4,687,816	$4,732,131
Total State Tobacco Tax Revenue	$9,281,934	$9,375,632	$9,464,262

Data Sources

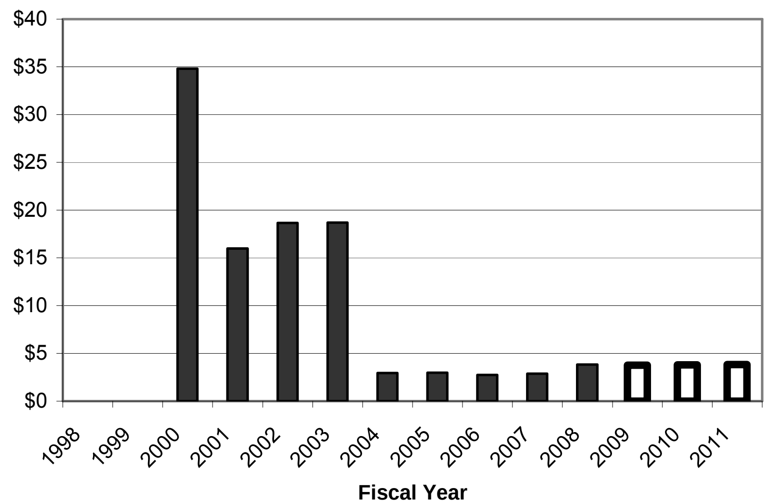
Table 1 general fund revenue data is from SABHRS. Moist snuff and other tobacco product collections, and current tribe revenue allocation payments are provided by DOR monthly total sales reports and quarterly revenue sharing agreement reports. Other data provided by DOR includes the amount of discounts and credits applied to distributors of other tobacco products. Population data is provided by Global Insight, Inc (July, 2008).

Revenue Description

In 1998, Montana, along with 45 other states, signed a settlement agreement with major tobacco companies. Pursuant to the agreement Montana will receive approximately $832 million by the year 2025. Payments are made annually beginning in FY 2000. The schedule of payments provided for under the settlement agreement is subject to change depending on adjustment criteria specified in the agreement.

Table 1
Tobacco Settlement General Fund Revenue
($ millions)

Fiscal Year	General Fund	Percent Change
A 1998	-	-
A 1999	-	-
A 2000	$ 34.804	-
A 2001	$ 15.989	-54.1%
A 2002	$ 18.647	16.6%
A 2003	$ 18.700	0.3%
A 2004	$ 2.934	-84.3%
A 2005	$ 2.978	1.5%
A 2006	$ 2.734	-8.2%
A 2007	$ 2.861	4.7%
A 2008	$ 3.808	33.1%
F 2009	**$ 3.768**	**-1.1%**
F 2010	**$ 3.804**	**1.0%**
F 2011	**$ 3.837**	**1.8%**



In FY 2008 the Base Payment paid to states increased from $8 billion to $9 billion. This accounts for the large percentage increase from FY 2007 to FY 2008. However, the forecast payments, when adjusted for inflation, are decreasing or flat because cigarette consumption per capita (nationwide) has slightly decreased. Further, additional adjustments to the annual payments have been made since FY 2005 to compensate for changes in market share among the participating and non-participating manufacturers. These market share adjustments are forecast to continue through FY 2011.

Two major arrangements in the allocation of the tobacco settlement revenue have existed since the first payment was received in FY 2000. First, in November 2000, Montana's electorate passed Constitutional Amendment 35. The amendment required no less than 40% of tobacco settlement revenue to be deposited in a trust fund, with the remaining money deposited in the state general fund. The trust fund was established to provide a permanent source of revenue to fund the costs associated with programs for tobacco disease prevention and healthcare benefits, services, or coverage. The amendment further stated that 90% of the interest income from the trust fund could be appropriated; with 10% of the interest income from the trust fund to be deposited in the trust fund on or after January 1, 2001. The principal of the trust fund and 10% of the interest income was to be deposited in the trust fund and remain forever inviolate unless appropriated by a vote of two-thirds of the members of each house of the Legislature.

Second, in the November 2002 election, Initiative 146 (I-146) was passed. I-146 required the tobacco settlement payments received after June 30, 2003 be deposited as follows: 32% in a state special revenue account for tobacco prevention; 17% in a state special revenue account for health insurance benefits; 40% in the trust fund; and 11% in the state general fund. Table 3 shows the estimated payment distributions through FY 2011.

Risks

If Original Participating Manufacturer's (OPMs) and Subsequent Participating Manufacturer's (SPMs) lose market share to Non-Participating Manufacturer's (NPMs), OPMs and SPMs may be entitled to pay less. The NPM adjustment is conditional upon two factors: (1) whether there has been a loss in market share by participating manufacturers to NPMs; and (2) whether that loss is attributable to disadvantages resultant from the tobacco settlement.

A specific provision of the MSA, referred to as the safe harbor provision, is relevant to this adjustment. Under the safe harbor provision, a state can avoid a payment reduction due to the NPM adjustment if a qualifying statute is enacted and "diligently enforced". The qualifying statute provides for an amount to be paid into an escrow account for each cigarette sold by NPMs in the state that is equivalent to the amount that would have been paid had the NPMs participated in the settlement.

Currently, all participating states (including Montana) have enacted qualifying statutes under the safe harbor provision. Because every state enacted these statutes, NPM adjustments were set to zero in the past. However, with the increasing market loss to NPMs, the meaning of "diligent enforcement" is now in question. "Diligent enforcement" is not defined in the MSA. Consequently, there is uncertainty as to how, or who, will determine the meaning of "diligent enforcement". States contend the decision should be made in state court, tobacco companies would rather the decision be made in arbitration. "Diligent enforcement" likely includes some combination of legislation and enforcement actions. An independent auditor determined that, beginning in 2003, participating manufacturers started losing market share to NPMs. Pursuant to this finding, OPMs and SPMs can pay a portion of their tobacco settlement payments into a dispute account. Withheld disputed amounts are not to be distributed to the states until the dispute is resolved.

There are numerous possible outcomes to the dispute over the NPM adjustment. The following is a short list of possible outcomes over this disputed money.

1. If it is found that the loss in market share for participating manufacturers was not due to disadvantages resulting from the tobacco settlement, then the monies withheld will likely be distributed to the states immediately.

2. If a settlement is reached between the states and the participating manufacturers, payments could be reduced by some amount, the safe harbor statute could be revised, or some combination of the two. The fiscal impacts of such a settlement are unknown because the terms of such a settlement are uncertain.

3. Litigation may extend beyond FY 2011. If this is the case, then OPMs and SPMs will continue to place the disputed money in the separate dispute account.

4. It may be found that the loss in market share is due to disadvantages as a result of the tobacco settlement and that every state did not "diligently enforce" their safe harbor statutes. This finding would mean that states would have to face an undetermined reduction to the settlement fund they receive.

Many possible outcomes exist and it is unknown at this time which scenarios are more likely. However, for purposes of this estimate, it is assumed that the dispute over the NPM adjustment will not be resolved prior to the FY 2011 payment, and that for FY 2009 through FY 2011 the participating manufacturers will withhold NPM adjustment amounts proportional to what OPMs and SPMs withheld in FY 2006 through FY 2008.

Forecast Methodology

The Master Settlement Agreement (MSA) provides for complex methods and formulas to calculate annual payments made by the settling tobacco companies to each state. Several clauses in the tobacco settlement set forth the precise calculations for the adjustments to the payments due from the two categories of settling companies: (1) OPMs and (2) SPMs.

Seven major calculations are used to calculate the annual amount due to Montana from tobacco companies which are parties to the MSA. These calculations are summarized in Table 2 and include:

Step 1: The inflation adjustment;

Step 2: The volume adjustment to the base payment;

- The base payment increased from $8 billion in 2007 to $9 billion 2008.
- OPM shipment volume has decreased due to a decrease in overall cigarette consumption and a loss in market share to other manufacturers. OPM volume has decreased 34.3% between 1998 and 2007.

Step 3: The volume adjustment to the base operating income;

Step 4: Previously settled states reduction;

Step 5: SPM payments. Pursuant to the finding of an independent auditor, OPMs and SPMs can pay a portion of their tobacco settlement payments into a dispute account. Withheld disputed amounts are not to be distributed to the states until the dispute is resolved.

Step 6: The NPM Adjustment;

The largest NPM, General Tobacco, signed the tobacco settlement agreement in August 2004 and became a SPM beginning in FY 2005. Along with making normal MSA payments, General Tobacco will also make payments on a separate ten-year schedule for prior obligations. The prior obligation payments are based on the amount they would have paid under the MSA, had General Tobacco participated since the agreement's inception in 1998. These additional payments to Montana are estimated to be $79,363 in FY 2009, $83,869 in FY 2010, and $88,027 in FY 2011.

Step 7: Montana's share of the total payment.

Table 2
Summary Calculation of Tobacco Settlement Revenue

Description	FY 2009	FY 2010	FY 2011
Base Payment	$9,000,000,000	$9,000,000,000	$9,000,000,000
Plus:			
Inflation Adjustment	$4,057,443,205	$4,449,166,501	$4,852,641,496
Net Volume Adjustment	($4,653,680,292)	($4,986,839,062)	($5,330,977,757)
Previously Settled States Reduction	($981,859,594)	($987,630,142)	($993,453,249)
Adjusted OPM Base Payment	**$7,421,903,319**	**$7,474,697,297**	**$7,528,210,491**
Adjusted SPM Base Payment	**$422,220,697**	**$444,530,861**	**$459,075,792**
Sub-total Adjusted Base Payment	$7,844,124,016	$7,919,228,159	$7,987,286,283
Less (NPM) Adjustment/Withholding (≈ 10%)	($784,412,402)	($791,922,816)	($798,728,628)
Total Adjusted Base Payment	**$7,059,711,615**	**$7,127,305,343**	**$7,188,557,655**
Strategic Con. Of Adj. Base Pay (≈ 9.5667%)	$675,379,078	$681,845,544	$687,705,349
Remainder of Adj. Base Payment (≈ 90.4333%)	$6,384,332,537	$6,445,459,798	$6,500,852,306
Total Adjusted Base Payment	**$7,059,711,615**	**$7,127,305,343**	**$7,188,557,655**
Strategic Contribution Share	$675,379,078	$681,845,544	$687,705,349
Multiplied by MT Share of Strategic Contribution	0.010447501	0.010447501	0.010447501
MT's Strategic Contribution Share	**$7,056,024**	**$7,123,582**	**$7,184,802**
Base Payment w/out Strategic Cont. Share	$6,384,332,537	$6,445,459,798	$6,500,852,306
Multiplied by MT Share of Adj. Base Contribution	0.004247591	0.004247591	0.004247591
MT's non-Strategic Adj. Base Pay. Share	**$27,118,033**	**$27,377,677**	**$27,612,962**
MT Share of Adjusted Base Payment	$34,174,057	$34,501,259	$34,797,764
Plus Additional 'New' SPM Prior Obligation	$79,363	$83,869	$88,027
Total MT Payment	**$34,253,420**	**$34,585,128**	**$34,885,791**

Distributions

Table 3 shows the calculation and distribution of Montana's share of the Tobacco Master Settlement Agreement for FY 2009 through FY 2011.

Table 3
Tobacco Settlement Payment Distributions
FY 2009 Through FY 2011

Fiscal Year 2009

Payment	Fund	Distribution	Amount
	General Fund	11%	$3.768
Forecast	Tobacco Trust Fund	40%	$13.701
$34.253	Tobacco Prevention Account	32%	$10.961
	Health Insurance Benefits Acc.	17%	$5.823
	Total	**100%**	**$34.253**

Fiscal Year 2010

Payment	Fund	Distribution	Amount
	General Fund	11%	$3.804
Forecast	Tobacco Trust Fund	40%	$13.834
$34.585	Tobacco Prevention Account	32%	$11.067
	Health Insurance Benefits Acc.	17%	$5.879
	Total	**100%**	**$34.585**

Fiscal Year 2011

Payment	Fund	Distribution	Amount
	General Fund	11%	$3.837
Forecast	Tobacco Trust Fund	40%	$13.954
$34.886	Tobacco Prevention Account	32%	$11.163
	Health Insurance Benefits Acc.	17%	$5.931
	Total	**100%**	**$34.886**

Data Sources

Tobacco Settlement data was obtained from SABHRS Data Mine, Price Waterhouse Coopers Tobacco Master Litigation Master Settlement website, and the Tobacco Master Settlement Agreement (MSA). Historical inflation data was obtained from the Bureau of Labor Statistics, and forecasted inflation was derived from Global Insights CPI estimates.