GUIDELINES GOVERNING INCENTIVE PAYMENTS TO SMALL TOBACCO PRODUCT MANUFACTURERS PURSUANT TO SENATE BILL 1332 (2005)

January 19, 2006

These guidelines are published by the Department of Taxation ("TAX") to provide guidance to small tobacco product manufacturers regarding the incentive payment program provided for by Senate Bill 1332 (Chapter 901, Acts of Assembly, 2005 Regular Session). The Commonwealth will make annual payments to qualifying manufacturers in calendar years 2007 through 2012 based on their use of domestic tobacco in manufacturing cigarettes in the preceding calendar year.

Senate Bill 1332 provides that the development and publication of these guidelines is exempt from the provisions of the Administrative Process Act (Va. Code § 2.2-4000 et seq.). TAX has worked with small tobacco product manufacturers to develop these guidelines. As necessary, additional guidelines will be published and posted on TAX’s web page at www.tax.virginia.gov.

Assignment of Escrowed Funds by Nonparticipating Manufacturers

The Virginia Tobacco Escrow Statute, Va. Code §§ 3.1-336.1 and 3.1-336.2, requires any tobacco product manufacturer that is not a party to the Master Settlement Agreement ("Non-Participating Manufacturer" or "NPM") to deposit funds into a qualified escrow fund each year. Code of Virginia § 3.1-336.2:1 allows an NPM to make an irrevocable assignment to the Commonwealth of its interests in any funds held in its qualified escrow account. Such assignment shall be permanent, and shall apply to all funds held in the qualified escrow account at the time of the assignment and any funds that may subsequently come into such account after the assignment is executed. For the procedures to make an assignment of escrowed funds, an NPM should contact the Office of the Attorney General ("OAG"): Tobacco Unit
Office of the Attorney General
900 East Main Street
Richmond, Virginia 23219
(804) 225-3195
(804) 225-3716 (fax)
tobacco@oag.state.va.us

Incentive Payments to Small Tobacco Product Manufacturers

The Commonwealth is authorized to withdraw the assigned funds from the escrow accounts. A portion of the withdrawn funds is to be used to make incentive payments to qualifying small tobacco product manufacturers in calendar years 2007 through 2012 for their use of domestic tobacco in manufacturing cigarettes in the preceding calendar year.
year. Any funds remaining in the escrow accounts after the incentive payments are made will be deposited into the Virginia Health Care Fund.

Small Tobacco Product Manufacturers

In order to be a “small tobacco product manufacturer” eligible to receive incentive payments, an applicant must satisfy all of the following requirements:


2. The applicant must directly (and not exclusively through any affiliate) manufacture fewer than 5 billion cigarettes in the calendar year in which the assignment was made. This requirement is satisfied if the applicant directly manufactures some, but fewer than 5 billion, cigarettes in the calendar year. For purposes of this requirement, "affiliate" means any one of two or more entities whose relationship to each other is such that (i) one entity owns at least 80 percent of the voting stock of the other or others or (ii) at least 80 percent of the voting stock of two or more entities is owned by the same interests. For entities that are not corporations, ownership interests that are eligible to vote will be considered voting stock. For purposes of this requirement, “entity” means a corporation, general partnership, limited partnership, limited liability partnership or limited liability company.

3. The cigarettes manufactured by the applicant during the preceding calendar year must contain, by weight, a minimum of 75 percent domestic tobacco. "Domestic tobacco" means tobacco grown, produced and processed entirely within the United States. As long as 75 percent of the tobacco contained in the aggregate of cigarettes manufactured by the applicant during the preceding calendar year is domestic tobacco, an applicant will not be disqualified if one or more of its brands contain less than 75 percent domestic tobacco. In the event that an applicant cannot specifically identify the tobacco used in its manufacturing during the year, it shall establish the percentage by using the inventory accounting method required for federal income tax purposes for the year.

4. The applicant must be a NPM in full compliance with all obligations imposed pursuant to Article 5 (§ 3.1-336.1 et seq.) and Article 6 (§ 3.1-336.3 et seq.) of Chapter 18 of Title 3.1 of the Va. Code.

Applying for Incentive Payments

Starting in 2007, each manufacturer seeking an incentive payment must apply to TAX by January 31. Applications must be made on a form issued by TAX and comply with the instructions for that form. Each applicant will be required to certify such information as TAX may require to establish that the applicant is a small tobacco product manufacturer and the following:
1. The percentage of domestic tobacco contained in the aggregate of cigarettes it manufactures; and

2. The amount paid for domestic tobacco on or after January 1, 2005 that was not grown by an agent or director of the applicant that was used by the applicant in manufacturing cigarettes in the immediately preceding calendar year.

Forms and instructions will be mailed to manufacturers that have made an escrow assignment and will also be available in the Download Forms section of TAX's web site, located at www.tax.virginia.gov.

Role of the Office of the Attorney General

Each applicant must contact the OAG and comply with any requirements mandated by the OAG for the OAG to release the following information to TAX:

1. For the initial application, verification that the applicant has made an irrevocable assignment to the Commonwealth pursuant to Va. Code § 3.1-336.2:1.

2. For an application for a 2007 incentive payment, verification of the amount that the applicant deposited into its qualified escrow account in calendar year 2006 and any applicable prior years, and of the amount of any escrowed funds attributable to deposits made in calendar year 2006 and any applicable prior years that were released and reverted to the applicant pursuant to Va. Code § 3.1-336.2 B 2 as it was in effect on June 30, 2005. Code of Virginia § 3.1-336.2 A 2 provides that escrow payments are due by April 15 of the year following the year in which cigarettes are sold.

3. For applications for 2008 through 2012 incentive payments, verification of the amount that the applicant deposited into its qualified escrow account during the prior year. Code of Virginia § 3.1-336.2 A 2 provides that escrow payments are due by April 15 of the year following the year in which cigarettes are sold.

4. Whether or not the applicant was removed from the Virginia Tobacco Directory at any time during the current or immediately preceding calendar year.

Calculation of Incentive Payments

The incentive payment made to each applicant will be based on the price of the domestic tobacco purchased by the applicant on or after January 1, 2005 used in manufacturing cigarettes in the immediately preceding calendar year. An applicant is not eligible for any incentive payment regarding the purchase of tobacco grown by an agent or director.

In 2007, the incentive payment for calendar year 2006 manufacturing is limited to 25 percent of the amount that the applicant deposited into its qualified escrow account in
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calendar year 2006 and prior years, less the amount of any escrowed funds attributable to calendar year 2006 and any applicable prior years that were released and reverted to the applicant pursuant to Va. Code § 3.1-336.2 B 2. In 2008 through 2012, incentive payments are limited to the following percentage of the amount that the applicant deposited into its qualified escrow account:

<table>
<thead>
<tr>
<th>Incentive Payment Year</th>
<th>Manufacturing Year</th>
<th>Escrow Payment Year</th>
<th>Percentage Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>2007</td>
<td>2007</td>
<td>20</td>
</tr>
<tr>
<td>2009</td>
<td>2008</td>
<td>2008</td>
<td>15</td>
</tr>
<tr>
<td>2010</td>
<td>2009</td>
<td>2009</td>
<td>10</td>
</tr>
<tr>
<td>2011</td>
<td>2010</td>
<td>2010</td>
<td>5</td>
</tr>
<tr>
<td>2012</td>
<td>2011</td>
<td>2011</td>
<td>5</td>
</tr>
</tbody>
</table>

In addition, the aggregate amount of incentive payments to all applicants in 2007 is capped at $9 million. In subsequent years, the aggregate amount of the incentive payments to all applicants is capped at the following amounts:

<table>
<thead>
<tr>
<th>Incentive Payment Year</th>
<th>Total Incentive Payments Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>$8 million</td>
</tr>
<tr>
<td>2009</td>
<td>$6 million</td>
</tr>
<tr>
<td>2010</td>
<td>$4 million</td>
</tr>
<tr>
<td>2011</td>
<td>$3 million</td>
</tr>
<tr>
<td>2012</td>
<td>$3 million</td>
</tr>
</tbody>
</table>

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

Payment of Incentive Payments

TAX shall certify to the Comptroller the amount of the incentive payment to be made to each applicant within 30 days after the January 31 deadline for manufacturers to apply for incentive payments. This will allow TAX sufficient time to review all filed applications in order to determine whether payments will need to be prorated because of the limitations on total incentive payments. Within 15 days after receipt of TAX’s certification, the Comptroller will draw his warrant from funds in the applicant’s escrow account on the state Treasurer in the amount of the payment.

Recordkeeping

Applicants must maintain records and documents substantiating all information contained on each incentive payment application, including records of purchases,
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receipts, inventories, storage, shipping, delivery, manufacturing and sales of tobacco and cigarettes for a period of five years from the required date for filing each return. Such records and documents must be available during regular business hours for inspection by TAX and the OAG. Applicants unable to document the percentage of domestic tobacco contained in their cigarettes and the amount paid for domestic tobacco purchased by the applicant on or after January 1, 2005 used in manufacturing cigarettes in the prior calendar year will not be eligible to receive an incentive payment.

Appeals and Recapture of Erroneous Payments

The incentive payment program appeals will be administered in the same manner as state taxes are administered by TAX, mutatis mutandis, under Va. Code § 58.1-1820 et seq. For example, applicants may appeal incentive payment issues to TAX using the administrative appeals process applicable to state taxes. Likewise, TAX may recapture erroneous payments in the same manner that it collects delinquent taxes.

Additional Information

For additional information about the incentive payments program, please contact the Office of Customer Services, Department of Taxation, P.O. Box 715, Richmond, Virginia 23218-0715 or call (804) 786-2809.

These guidelines, along with other reference documents, are available on-line in the Tax Policy Library section of TAX’s web site, located at www.tax.virginia.gov.

Approved:

s/s

Kenneth W. Thorson
Tax Commissioner

January 19, 2006