

**Tobacco Tax and Tobacco Settlement
Revenue Collections and Distributions**

**Departments of Revenue and
Treasury**

**Performance Audit
May 2012**



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May 15, 2012

Members of the Legislative Audit Committee:

This report contains the results of an evaluation of **Department of Revenue and Treasury, Tobacco Tax and Tobacco Settlement Revenue Collections and Distributions**. The evaluation was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits and evaluations of all departments, institutions, and agencies of state government. The report presents our findings and conclusions.



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Tobacco Tax and Tobacco Settlement Collections and Distributions

Background

The State of Colorado receives revenue from two tobacco-related sources: (1) a tax on the sale of tobacco products required by Amendment 35 of the State Constitution and (2) funds received annually from tobacco manufacturers under the Tobacco Master Settlement Agreement between the tobacco industry and the majority of states, including Colorado. The State's collection, transfer, and distribution of these sources of state revenue were the focus of this performance audit. These processes and our related testwork are described in the sections below.

Amendment 35

Since 1964, all but two U.S. states have taxed cigarette and tobacco products. Colorado implemented a tax on cigarettes in 1964 (Section 39-28-103, C.R.S.) and a tax on other tobacco products in 1986 (Section 39-28.5-102, C.R.S.). As of 2004, Colorado had a tobacco tax of \$0.20 per pack of cigarettes, which was less than the taxes imposed by 42 of the 50 states. Also at that time, Colorado had a tax of 20 percent of the manufacturer's list price on all other tobacco products. In 2005, Colorado voters approved a citizen-initiated amendment to the State Constitution, Amendment 35 (art. X, sec. 21), which increased the tax on cigarettes by \$0.64 per pack and the tax on other tobacco products by an additional 20 percent of the manufacturer's list price as of January 1, 2005. The result was the current tobacco tax of \$0.84 per cigarette pack and 40 percent of the manufacturer's list price for all other tobacco products, with the additional \$0.64 per pack of cigarettes and the additional 20 percent tax on other tobacco products specifically attributable to Amendment 35.

The tax revenue generated by Amendment 35 is primarily used by the State to fund public health care programs; tobacco cessation and education programs; and the prevention and treatment of cancer, cardiovascular disease, and pulmonary disease. The State Constitution [art. X, sec. 21(5)] specifies that the tax revenue generated by Amendment 35 shall be distributed to the Tobacco Tax Cash Fund [Section 24-22-117(1)(a), C.R.S.] and appropriated annually as follows:

- Forty-six percent to the Department of Health Care Policy and Financing “to increase the number of children and pregnant women enrolled in the Children’s Basic Health Plan, enroll the parents of enrolled children, and expand eligibility of low-income adults and children who receive medical care” through the Children’s Basic Health Plan.
- Nineteen percent to the Department of Health Care Policy and Financing “to fund comprehensive primary care through Colorado qualified providers, as defined in the Colorado Medical Assistance Act...” Qualified providers are community health centers and providers that primarily serve uninsured or medically indigent patients.
- Sixteen percent to the Department of Public Health and Environment “to fund school, community-based, and statewide tobacco education programs designed to reduce initiation of tobacco use by children and youth, promote cessation of tobacco use among youth and adults, and reduce exposure to secondhand smoke.”
- Sixteen percent to the Department of Public Health and Environment “for the prevention, early detection, and treatment of cancer, cardiovascular disease, and pulmonary disease.”
- Three percent “for health-related purposes to provide revenue for the State’s General Fund, Old Age Pension Fund, and municipal and county governments to compensate proportionately for tax revenue reductions attributable to lower cigarette and tobacco product sales resulting from the implementation of this tax.”

Amendment 35 allows the General Assembly to redirect the tobacco tax revenue to any health-related purpose and to serve enrollees in the Children’s Basic Health Plan and Medicaid programs if the General Assembly adopts a joint resolution declaring a state fiscal emergency. The joint resolution must be approved by a two-thirds majority vote in both houses and be signed by the Governor. In Fiscal Years 2010 through 2012, the General Assembly declared a fiscal emergency and redirected a portion of Amendment 35 tax revenue, as allowed under the amendment. This redistribution happens after the monies are distributed from the Office of the State Treasurer, as prescribed by the percentages above; then the monies are redistributed by the affected departments.

In Fiscal Year 2011, the State collected about \$146 million in tobacco product taxes from Amendment 35. Amendment 35 tobacco tax revenue and distributions for Fiscal Years 2009 through 2011 and the first quarter of Fiscal Year 2012 are shown in the following table.

Amendment 35 Tobacco Tax Revenue and Distributions					
Fiscal Years 2009 Through 2012¹					
	2009	2010	2011	2012³	Total
Tax Revenue	\$159,334,568	\$148,454,086	\$145,575,930	\$40,848,636	\$494,213,220
Tax Distributions					
Department of Health Care Policy and Financing (Health Care Expansion Fund, Primary Care Fund, Children's Basic Health Plan, Old Age Pension Fund, Pediatric Specialty Hospital Fund)	106,435,492	99,167,330	97,244,722	27,286,889	\$330,134,433
Department of Public Health and Environment (Tobacco Education Programs Fund and Prevention, Detection & Treatment Fund)	51,465,065	47,950,670	47,021,025	13,194,109	\$159,630,869
Department of Revenue (Municipal and county governments to compensate for tax revenue reduction due to lower Amendment 35 cigarette and tobacco taxes)	1,434,011	1,336,086	1,310,183	367,638	\$4,447,918
Office of the State Treasurer²	65,816	22,282	29,300	9,477	\$126,875
TOTAL Distributions	\$159,400,384	\$148,476,368	\$145,605,230	\$40,858,113	\$494,340,095
Source: Office of the State Auditor's analysis of data obtained from the Office of the State Treasurer.					
¹ According to the Legislative Economic and Revenue Forecast, tobacco tax revenue and distributions were expected to decline between Fiscal Years 2009 and 2011. This trend is shown above.					
² The interest earned on the tobacco taxes is transferred from the Tobacco Tax Fund to the General Fund by the Office of the State Treasurer in accordance with Senate Bill 09-270.					
³ The information related to Fiscal Year 2012 includes only the first 3 months of the fiscal year.					

Tobacco Master Settlement Agreement

In 1998, Colorado, along with 45 other states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, American Samoa, the Northern Mariana Islands, and Guam entered into a Tobacco Master Settlement Agreement (Tobacco Settlement) with the four largest tobacco manufacturers. The Tobacco Settlement was established to resolve all past, present, and future tobacco-related claims at the state level. Under the Tobacco Settlement, tobacco manufacturers agreed to place restrictions on their marketing practices and pay a projected \$206 billion

over 25 years to the states, the District of Columbia, and the U.S territories to compensate them for costs arising from health problems caused by the use of cigarettes and other tobacco products.

In Fiscal Year 2011, the State received about \$89 million in Tobacco Settlement payments. According to statute (Section 24-75-1104.5, C.R.S.), Tobacco Settlement monies are to be used for the following programs, services, and funds:

- AIDS Drug Assistance Program
- Alcohol & Drug Abuse Community Prevention & Treatment Fund
- Child Mental Health Treatment Act
- Children's Basic Health Plan
- Colorado Autism Treatment Fund
- Colorado HIV and AIDS Prevention Program
- Colorado Indigent Care Program
- Colorado State Veterans Trust Fund
- Comprehensive Primary and Preventative Care Grant Program
- CU Denver Health Services – Health Education Fund
- Dental Loan Repayment Program
- Fitzsimons Trust Fund
- Nurse Home Visitor Program
- Offender Mental Health Services Fund
- Public Health Services Per Capita Support Fund
- Read to Achieve
- Ryan White AIDS Drug Assistance
- Short-Term Innovative Health Program Grant Fund
- Supplemental Account of Colorado Immunization Fund
- Supplemental Account of Pediatric Specialty Hospital Fund
- Tony Grampsas Youth Services Program

Statute provides for additional programs that can receive Tobacco Settlement funds if there are excess funds available after appropriations have been made to the programs, services, and funds listed above. Statute also allows the General Assembly to retain a portion of Tobacco Settlement funds for General Fund purposes.

In Fiscal Year 2011, the State distributed about \$95 million in Tobacco Settlement funds to state agencies and programs. State funds received from the Tobacco Settlement and distributions for Fiscal Years 2009 through 2011 are shown in the table on the following page.

Tobacco Master Settlement Agreement Funds Received and Distributions Made by the Office of the State Treasurer Fiscal Years 2009 Through 2011				
	2009	2010	2011	Total
Tobacco Settlement Funds Received	\$112,831,178	\$94,587,045	\$89,065,763	\$296,483,986
Tobacco Settlement Distributions¹	\$ 222,757,600	\$ 81,477,074	\$ 95,472,889	\$399,707,563

Source: Office of the State Auditor's analysis of data from the Office of the State Treasurer.

¹ The programs that received distributions of Tobacco Master Settlement funds are listed above this table. There are differences between the funds received and the distributions due to timing differences of when the State receives the funds and when the funds are statutorily required to be distributed. In addition, the distribution is higher than the funds received in Fiscal Year 2009 due to statutorily required transfers made from the Tobacco Litigation Settlement Cash Fund to the General Fund to cover the revenue short falls.

According to the Office of the State Treasurer, Tobacco Settlement funds received and distributions made declined between Fiscal Years 2009 and 2011 due to certain provisions in the Tobacco Settlement. Currently, the Participating Manufacturers may withhold a percentage of annual payments made to the Settling States and Territories under the Tobacco Settlement due to the Non-Participating Manufacturers (NPM) Adjustment. The 2003 NPM Adjustment and disposition of the funds withheld for that year is currently in arbitration, and the final completion of this arbitration is projected to be completed by late 2013. The Tobacco Settlement payment calculation takes into consideration numerous factors including cigarette sales, inflation, and the NPM Adjustment. The NPM Adjustment is an adjustment that reduces the annual payments of the Participating Manufacturers if it is found that all of the below are true:

- The Participating Manufacturers have lost a certain amount of market share to manufacturers that are not part of the Tobacco Settlement.
- The Tobacco Settlement was a significant factor contributing to the market share loss.
- Any or all states are found to not have been upholding certain legal obligations under the agreement.

After it is determined that the first two above bullets are true, the NPM Adjustment is calculated. Participating Manufacturers may then withhold these funds, which results in the distribution to the States being reduced by the amount of the NPM Adjustment. The funds are retained in a separate account pending the commencement and completion of arbitration. The third bullet will be decided in the arbitration.

Administration

The Department of Revenue is responsible for the administration and collection of cigarette and tobacco product taxes. On a monthly basis, once the taxes have been collected from tobacco wholesalers, the Department of Revenue determines the portion of revenue attributable to Amendment 35 and transfers that portion to the Office of the State Treasurer.

The Office of the State Treasurer is responsible for the distribution of Amendment 35 tobacco tax and Tobacco Settlement funds to various state agencies and programs. The Office of the State Treasurer receives monthly transfers of Amendment 35 tobacco tax revenue from the Department of Revenue. The Office of the State Treasurer transfers the Amendment 35 tax revenue to various state agencies and programs on a monthly basis, in accordance with Section 24-22-117, C.R.S. The Tobacco Settlement monies are transferred from the tobacco industry to the Office of the State Treasurer annually in April. The Office of the State Treasurer then distributes the Tobacco Settlement funds to various state agencies and programs, in accordance with Section 24-75-1104.5, C.R.S.

Audit Purpose and Scope

This report provides the results of our performance audit of the State's collection, transfer, and distribution of tobacco-related revenue received under Amendment 35 and the Tobacco Settlement, including the Department of Revenue's, the Office of the State Treasurer's, the Department of Health Care Policy and Financing's, and the Department of Public Health and Environment's compliance with applicable constitutional and statutory requirements for these tobacco-related funds. The audit was conducted in response to a legislative request. The objectives of this audit were as follows:

- Determine the amounts of Amendment 35 tobacco taxes collected by the Department of Revenue and Tobacco Settlement funds received by the State.
- Determine the accuracy of the amounts of Amendment 35 tobacco tax revenue and Tobacco Settlement funds distributed by the Office of the State Treasurer to the State's General Fund and other agencies and programs.
- Review the transfers and distributions of Amendment 35 tobacco tax revenue and Tobacco Settlement funds to determine whether the Department of Revenue and the Office of the State Treasurer complied with the State Constitution and statute.

- Assess whether Amendment 35 tobacco tax revenue was distributed by the Office of the State Treasurer in accordance with the State Constitution and redistributed by the affected departments in accordance with the statute following the declaration of state fiscal emergencies in Fiscal Years 2010 through 2012.

To accomplish our audit objectives, we reviewed the collection, transfer, and distribution of Amendment 35 tobacco tax and Tobacco Settlement funds from Fiscal Year 2009 through the first quarter of Fiscal Year 2012. Our audit work also included conducting interviews with Office of the State Treasurer personnel to gain a better understanding of the processes that are in place regarding the receipt and distribution of Amendment 35 tobacco taxes and Tobacco Settlement funds. The audit did not review how Amendment 35 tobacco tax and Tobacco Settlement funds are used by state agencies. In response to a legislative request, our office is in the process of conducting a performance audit of the use of Amendment 35 tobacco tax revenue by the Department of Public Health and Environment for its various grant programs.

We conducted this performance audit pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. We performed this audit work during our Fiscal Years 2011 and 2012 financial audit of the Department of Revenue and Office of the State Treasurer. We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings, if any, and conclusions based on our audit objectives. We thank the Department of Revenue and the Office of the State Treasurer for their assistance during the audit.

Audit Results

Overall, we found that the Department of Revenue and the Office of the State Treasurer complied with the requirements of the State Constitution and statutes related to the collection, transfer, and distribution of tobacco-related funds received under Amendment 35 and the Tobacco Settlement. The Department of Public Health and Environment and the Department of Health Care Policy and Financing were in compliance with the requirements of the state fiscal emergency statutes related to the redistribution of Amendment 35 tobacco tax funds. The results of our audit work are described below.

- **Collection of Amendment 35 Tobacco Tax and Tobacco Settlement Funds.** We reviewed documentation from the Department of Revenue showing the Amendment 35 tobacco tax revenue collected for 16 of the 36 months in Fiscal Years 2009, 2010, and 2011 and the first three months of Fiscal Year 2012 to determine the amount of monies collected by the State related to Amendment 35 tobacco taxes. We selected a judgmental sample of 19 months of documentation to provide adequate coverage of the Department of Revenue's processes and controls during a 39-month period. We tested \$284,063,643, or 57 percent, of the \$494,213,220 in Amendment 35 tax revenue collected and distributed in Fiscal Years 2009 through 2011 and the first quarter of Fiscal Year 2012. We reviewed the Department of Revenue Collections Report to determine the total amount of Amendment 35 tobacco taxes collected for each month reviewed. We also reviewed bank wire documentation showing funds transferred to the Office of the State Treasurer, and the Office of the State Treasurer's bank statements to determine the amount of monies collected by the State related to the Tobacco Settlement. We found that the State collected approximately \$494 million in tobacco taxes under Amendment 35 and approximately \$297 million in Tobacco Settlement funds from Fiscal Year 2009 through the first quarter of Fiscal Year 2012. The tables in the background section of this report show tobacco tax and Tobacco Settlement funds collections for Fiscal Years 2009, 2010, and 2011 and the first quarter of Fiscal Year 2012.
- **Transfer of Amendment 35 Tobacco Tax and Tobacco Settlement Funds.** We reviewed a sample of the Department of Revenue's 19 monthly transfers of Amendment 35 tobacco tax revenue to the Office of the State Treasurer during Fiscal Years 2009, 2010, and 2011 and the first three months of Fiscal Year 2012. The purpose of our review was to ensure the amount collected by the Department of Revenue agreed to the amount received by the Office of the State Treasurer. We found that the 19 sampled Amendment 35 tobacco tax transfers we reviewed were accurate.
- **Receipt and Distribution of Amendment 35 Tobacco Tax and Tobacco Settlement Funds.** For the 19 sampled months, we reviewed the distribution of Amendment 35 tobacco taxes from the Office of the State Treasurer to state agencies and programs to ensure that the distributions were made in accordance with Amendment 35 and statute. We found that the distributions we reviewed complied with Amendment 35 and statute. We also reviewed 100 percent of the Office of the State Treasurer's receipts and distributions of Tobacco Settlement funds made in Fiscal Years 2009, 2010, and 2011 to determine whether receipts were accurate and distributions were made in accordance with Section 24-75-1104.5, C.R.S. We found that the Office of the State Treasurer received and distributed Tobacco Settlement funds in accordance with statute during

Fiscal Years 2009, 2010, and 2011. It is further noted that the Office of the State Treasurer does not receive Tobacco Settlement funds until April every year. Therefore, at the time of the audit, Fiscal Year 2012 Tobacco Settlement funds had not yet been received or distributed.

- **Redistribution of Tobacco Tax Revenue During State Fiscal Emergencies.** The redistribution of funds that may occur during a state fiscal emergency should be completed by state agencies after the Office of the State Treasurer distributes tobacco tax revenue, in accordance with Amendment 35. We reviewed all applicable Senate Bills and House Bills for Fiscal Years 2010 through 2011 to determine the amounts of transfers that were to be made, as a result of the state fiscal emergencies, at the Department of Health Care Policy and Financing and the Department of Public Health and Environment. The transfers occur at the year-end; therefore, at the time of the audit, Fiscal Year 2012 transfers had not yet occurred. We compared the redistribution amounts in statute to the amounts that were actually transferred at the Departments. Based on this testwork, we determined that all redistributions and transfers were made in accordance with the statutes. We further note that there was a reduction of the General Fund appropriation when the redistributions were made, in accordance with the statutes.

See the following chart below which details the redistributions made as a result of the State Fiscal Emergency:

Amendment 35 Tobacco Tax Funds Redistributions Made in Accordance with Statutory Requirements for State Fiscal Emergencies Fiscal Years 2010 Through 2011			
	2010	2011	Total
From the Colorado Department of Public Health and Environment to the Department of Health Care Policy and Financing	\$35,000,000	\$25,691,418	\$60,691,418
From the Healthcare Expansion Fund to the General Fund within the Department of Health Care Policy and Financing	\$42,693,900	\$47,790,139	\$90,484,039
From the Primary Care Fund to the General Fund within the Department of Health Care Policy and Financing	\$18,668,765	\$24,096,888	\$42,765,653
From the Primary Care Fund to the Primary Care Distribution Fund within the Department of Health Care Policy and Financing	\$0	\$3,560,000	\$3,560,000
TOTAL Redistributions	\$96,362,665	\$101,138,445	\$197,501,110
Source: Office of the State Auditor's analysis of data from the Department of Public Health and Environment and the Department of Health Care Policy and Financing.			

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