

BEFORE THE ALCOHOL TOBACCO TAX AND TRADE BUREAU

Petition for Rulemaking

The Honorable John J. Manfreda  
Administrator, Alcohol Tobacco Tax and Trade Bureau  
Department of the Treasury  
Washington D.C.

In the Matter of the Repeal of the definitions of )  
“Cigar” and “Cigarette” in 27 C.F.R § 40.11, ) RM \_\_\_\_\_  
27 C.F.R. § 41.11, 27 C.F.R. § 44.11 and 27 )  
C.F.R. § 45.11 and Proposed New Rules )  
Defining “Cigar” and “Cigarette” and Proposed )  
New Procedural Rules for Cigar and )  
Cigarette Rulings )

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The States of Montana, Wisconsin, Oklahoma, Utah, Oregon, South Dakota, Vermont, California, Louisiana, Delaware, New York, Arizona, Arkansas, Nebraska, West Virginia, New Mexico, Rhode Island, Wyoming, Nevada, Pennsylvania, Kentucky, Idaho and Hawaii petition for the repeal of the definitions of “Cigar” and “Cigarette” in 27 C.F.R. § 40.11, 27 C.F.R. § 41.11, 27 C.F.R. § 44.11 and 27 C.F.R. § 45.11 and propose new rules defining “Cigar” and “Cigarette” as used in 26 U.S.C. § 5702 and new procedural rules for cigar and cigarette rulings. This petition is brought pursuant to 27 C.F.R. § 70.701(c). Petitioner States take an active role in protecting the health and safety of their citizens. These States find the tax classification of cigars and cigarettes allows products that are actually cigarettes to be taxed and sold as cigars. This growing trend endangers the integrity of our federal and state tax systems, as well as the MSA, and places the health and safety of our citizens, especially our youth, at risk.

Petitioners propose new rules that will define “Cigar” and “Cigarette” in a manner consistent with federal law and the legislative intent of Public Law 89-44. The new rules are intended to level the playing field so that cigarette-like products are taxed as cigarettes. Petitioners also seek new procedural rules to clarify and simplify the process of determining whether a product is a cigar or a cigarette. The new procedural rules no longer allow a manufacturer to decide whether their product is a cigar or a cigarette and pay the proper tax rate.

## INTRODUCTION

Petitioners seek the repeal of the definitions of “Cigar” and “Cigarette” currently found in 27 C.F.R. § 40.11, 27 C.F.R. § 41.11, 27 C.F.R. § 44.11 and 27 C.F.R. § 45.11. These rules simply reiterate the definition of cigar and cigarette found in 26 U.S.C. § 5702. New rules are needed to define “Cigar” and “Cigarette” as used in 26 U.S.C. § 5702 and new procedural rules for determinations are needed to clarify the ruling process. These new rules are necessary because of the proliferation of products that are cigarettes being taxed and sold as cigars.

Currently there are products that are really cigarettes that are being classified by the manufacturers as cigars<sup>1</sup> for tax purposes. Under current TTB rules, these products are self-classified by the manufacturer, and labeled as Little Cigars.

A manufacturer reaps many advantages from classifying its own cigarette as a cigar for tax purposes. Cigars are taxed at significantly lower rates by the federal and state governments. The tax differential allows cigars to be priced at about half the price of cigarettes. The pricing differential and the availability of even lower-priced small packs or single packs of Little Cigars makes them highly attractive and affordable to youth; most states prohibit cigarettes from being sold in small packs specifically to make them higher priced, and thus, less-affordable in order to protect our youth. In addition, many Little Cigar products are flavored to appeal specifically to youth.

The manufacturers also evade the more restrictive public health protections that apply to cigarettes and not cigars. Cigarettes must carry health-warning labels but only seven cigar manufacturers are required to place warnings on their packages.<sup>2</sup> The ingredients of cigarettes, but not cigars, must be reported to the Center for Disease Control. Escrow or Master Settlement Agreement (MSA) payments must be made on cigarettes, but not cigars. Cigars are not subject to the advertising and youth-targeting restrictions of the MSA.

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<sup>1</sup> There are products that are small or little cigars that are in actuality cigars (i.e. a roll of tobacco wrapped in a tobacco leaf.) In this petition, products that are actually cigarettes being sold as cigars will be referenced as “Little Cigars”. Products that are really little cigars will be referenced as little cigars. See Appendix A and B for pictures of Little Cigars, little cigars, and cigarettes.

<sup>2</sup> In 2000, the FTC entered into an agreement with the seven largest cigar manufacturers to place warnings on their cigars. The companies that agreed to the settlement are Swisher International Inc., Consolidated Cigar Holdings, Inc., Havatampa Inc. (Altadis USA), General Cigar Holdings, Inc., John Middleton Inc., Lane Ltd. and Swedish Match AB.

The incorrect and inaccurate classification of Little Cigars raises numerous public health and other public policy concerns for the States. Consumers incorrectly believe that Little Cigars are a safer alternative to cigarettes. Little Cigar makers often blatantly advertise their products as an alternative to cigarettes. States that tax Little Cigars as cigarettes under state law run into substantial opposition from manufacturers that complain of inconsistent tax treatment between the federal and state governments. The end result is confusion in the marketplace.

In short, the current ATF<sup>3</sup> ruling on the definitions of cigar and cigarette wreak a host of problems on the federal and state governments and our citizens. The States therefore petition the TTB to adopt new rules to stop unscrupulous manufacturers from continuing their end run around all the federal and state laws and regulations designed to tax and regulate cigarettes. In addition, the States believe procedural rules changes are necessary to revise the ruling<sup>4</sup> process and enable tobacco product manufacturers, importers, distributors, retailers, State taxing authorities, tobacco control programs, law enforcement and consumers to quickly access TTB rulings.

## **A. Public Health**

### **a. Youth Use of Little Cigars**

The States are increasingly concerned that our youth are smoking and becoming addicted to cigarettes that they believe are Little Cigars because the cigarettes have been self-classified and labeled by an unscrupulous manufacturer as Little Cigars. This consumer fraud against our children is a plausible explanation of why studies have found that cigar production, sales and consumption has increased dramatically in recent years, while cigarette production, sales and consumption has decline significantly.

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<sup>3</sup> At the time Revenue Ruling 73-22 was issued the Bureau was the ATF (Bureau of Alcohol, Tobacco, and Firearms). On November 26, 2002, President Bush signed into law the Homeland Security Act of 2002 which split the ATF into two agencies: the Alcohol Tobacco Tax and Trade Bureau (TTB) and the Bureau of Alcohol, Tobacco, Firearms and Explosives.

<sup>4</sup> A ruling is an official interpretation by the Bureau that has been published in the Bulletin for the information and guidance of the taxpayers, Bureau officers, and others concerned. Rulings are the conclusions of the Bureau on the application of the law to an entire state of facts. 27 C.F.R. § 70.701(d)(2).

While most studies do not differentiate between small cigars and large cigars, the U.S. Department of Agriculture (USDA) does report on the taxable sales of small cigars specifically in its annual Tobacco Yearbook. In the recently released USDA Tobacco Yearbook for 2005, whereas taxable removal/sales of cigarettes decreased by 13% between 2000 and 2004, taxable removals/sales of little cigars increased by 51% during the same period.<sup>5</sup> Whereas cigarette production decreased by 18.9% from 2000 to 2005, production of small cigars increased by 71.8%.<sup>6</sup> This may well be due the pricing differences between cigars and cigarettes.

A study of freshman at a historically black university supports the existence of this trend. Among the students who reported ever using tobacco, students were more likely to smoke little cigars (74.13%) than either cigarettes (68.90%) or other cigars (33.43%). Likewise, among students who had smoked within the past 30 days, more students reported using little cigars (73.56%) than cigarettes (43.68%).<sup>7</sup>

Another recent survey conducted by Case Western University and the Cuyahoga County Board of Health similarly found that more Cleveland area high school students reported using cigar products (26%) than cigarettes (16%).<sup>8</sup> The study concluded that cigars are a major component of teen tobacco use that should be addressed in prevention efforts. Anti-smoking activists say that the change is due to state taxes that have driven up the price of cigarettes while leaving the price of cigars unchanged.<sup>9</sup> The States believe that much of the reported increase in cigar smoking by high school students is, in fact, increased smoking of cigarettes that they had been misled to believe were Little Cigars.

In New Jersey, cigarette taxes were raised 3 times between 2002 and 2004. At the same time, taxes on cigars were decreased from 48% to 30%. A 2004 New Jersey Youth Tobacco Survey found that increasingly youth are turning to cigars instead of cigarettes. Current cigarette use declined by 29% among high school

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<sup>5</sup> U.S. DEP'T AGRICULTURE, TOBACCO SITUATION AND OUTLOOK YEARBOOK. WASH., D.C.: U.S. DEP'T OF AGRIC., ECON. RES. SERV., 2004, TABLES 1 AND 5. The Charts from the USDA Yearbook are available at the USDA website:

<http://www.ers.usda.gov/Data/SDP/view.asp?f=specialty/92015/>

<sup>6</sup> Id., TABLES 1 AND 4.

<sup>7</sup> David Jolly, Laura Fish, Isaac Lipkus & Pauline Lyna, *Little Cigars: The preferred tobacco products among freshman at an HBCU* (Am. Pub. Health Ass'n, 133rd Annual Meeting and Exposition, Abstract #118066, Dec. 10-14, 2005).

<sup>8</sup> THE CENTER FOR ADOLESCENT HEALTH, CASE WESTERN RESERVE UNIVERSITY, 2004 CUYAHOGA COUNTY CLEVELAND MUNICIPAL SCHOOL DISTRICT YOUTH RISK BEHAVIOR SURVEY, p. 39 -45

<sup>9</sup> Teenage Smoking, Cigars and Cigarettes (WorldNow WXIX Fox 19, Sept. 26, 2005) (TV broadcast).

students between 2001 and 2004. However, for the first time ever, more high school boys reported smoking cigars than cigarettes, and 10.4% of high school girls reported smoking cigars.<sup>10</sup> In addition to the tax and resulting price differential between cigarettes and cigars, the States believe that a significant part of the reported increase in cigar smoking by New Jersey high school boys is, in fact, increased smoking of cigarettes that they had been misled to believe were Little Cigars.

While public health organizations and States have been successful in lowering cigarette smoking rates among teens, Little Cigar and cigar use is threatening to reverse these gains and plunge another generation into tobacco addiction.

#### **b. Youth Access to Little Cigars**

One of the most distressing aspects of cigarettes being sold as Little Cigars is that the products are allowed to circumvent the laws intended to protect public health. Most states have laws that require cigarettes to be sold in packages of at least 20 sticks. This is intended to keep less expensive “kiddie packs” of 5 or 8 cigarettes out of the hands of children. Numerous studies have established that increasing cigarette prices reduces smoking among children.<sup>11</sup>

Since Little Cigars are not regulated as cigarettes, they can be sold in packs of 5 or 8 or even individually. Little Cigar products are often sweetened and with added flavors that appeal to children. A quick survey of Little Cigars on the internet shows that they are being sold in the following flavors: Chocolate, Chocolate Mint, Raspberry, Cherry, Vanilla, Strawberry, Wild Berry, Peach, Rum, Cinnamon and Spearmint. These flavors, and the ready availability of single Little Cigars or 5 or 8 packs of Little Cigars, make the products attractive to and affordable by teenagers. Since long-term addiction to nicotine is a process that occurs almost exclusively during adolescence and young adulthood<sup>12</sup>, it is critical

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<sup>10</sup> C.D. Delnevo, J. Foulds & M. Hrywna. *Trading Tobacco: Are Youths Choosing Cigars Over Cigarettes?*, 95 Am. J. Pub. Health 12, 2123 (Dec. 2005).

<sup>11</sup> Frank Chaloupka & Kenneth Warner, *The economics of smoking*. (NBER Working Paper No. 7047, Mar. 1999); U.S. DEP’T HEALTH HUM. SERV., REDUCING TOBACCO USE: A REPORT OF THE SURGEON GENERAL. ATLANTA, GA: U.S. DEP’T HEALTH HUM. SERV., CENTERS FOR DISEASE CONTROL AND PREVENTION, NAT’L CENTER FOR CHRONIC DISEASE PREVENTION AND HEALTH PROMOTION, OFF. ON SMOKING AND HEALTH, 2000.

<sup>12</sup> U.S. DEP’T HEALTH HUM. SERV., PREVENTING TOBACCO USE AMONG YOUNG PEOPLE: A REPORT OF THE SURGEON GENERAL. ATLANTA, GA: U.S. DEP’T HEALTH HUMAN SERV., PUB. HEALTH SERV., CENTERS FOR DISEASE CONTROL AND PREVENTION, NAT’L CENTER FOR CHRONIC DISEASE PREVENTION, NAT’L CENTER FOR CHRONIC DISEASE PREVENTION AND HEALTH PROMOTION, OFF.ON SMOKING AND HEALTH, 1994.

to keep tobacco products out of the hands of our youth, especially if the product is a cigarette that has been disguised, by the manufacturer's self-classification and labeling of a cigarette, as a Little Cigar.

**c. Health Effects of Cigars**

Of further concern to State regulators is the fact that even real cigars are not a safe alternative to cigarettes and in many cases, cigars are more harmful than cigarettes. But some former cigarette smokers perceive cigars as a safer alternative to cigarettes.<sup>13</sup> One Little Cigar website reinforces that belief by advertising, "If you want to quit smoking and try something better tasting, this is a great alternative!"<sup>14</sup>

A recent New Jersey study found that after a cigarette tax increase, "a small but notable proportion" of smokers substituted cigars for cigarettes.<sup>15</sup> After a tax increase, the current use of cigarettes among adults declined from 22 % to 18%, with 1.6% of the adult population reporting they quit cigarette smoking within the last six months. However the same study found that 11% of recent quitters reported smoking cigars. Thus the study concludes that a small but notable proportion of recently quit cigarette smokers substituted cigars for cigarettes.<sup>16</sup>

For cigar smokers that do not inhale, the risk of death from lung cancer for cigar smokers is not as high as it is for cigarette smokers. But it is still significantly higher than the risk for nonsmokers. However, cigar smoking causes several types of oral cancers including cancers of the tongue, lips, oral cavity, the pharynx, esophagus and larynx. Many of these types of cancers have extremely low cure rates. Only 11% to 14% of patients with esophageal cancers survive five years after diagnosis. Cigar smokers face a risk of death from laryngeal, oral or esophageal cancer that is 4 to 10 times greater than the risk faced by nonsmokers. The risk associated with occasional cigar smoking (less than daily) is not known.

For cigar smokers who do inhale the cigar smoke, the risk of dying from oral cancer is six times greater than nonsmokers. The risk of dying from esophageal cancer is twice that of nonsmokers. The risk of dying from cancer of the larynx is 39 times greater than nonsmokers. They also double their risk of

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<sup>13</sup> C.D. Delnova, *Smokers' Choice: What Explains The Steady Growth of Cigar Use in the US?*, 121 Public Health Reports 116-119 (March-April 2006).

<sup>14</sup> TBS-Cigars.com. Advertising Prime Time Mini Cigars (2006), [www.tbs-cigars.com/cigars/PrimeTime\\_Cigars/primetime\\_cigars.html](http://www.tbs-cigars.com/cigars/PrimeTime_Cigars/primetime_cigars.html).

<sup>15</sup> C.D. Delnevo, M. Hrywna, J. Foulds & M.B. Steinberg, *Cigar use before and after a cigarette excise tax increase in New Jersey*. 29 Addictive Behaviors 1804 (2004).

<sup>16</sup> *Id.* at 1799-1807.

dying from pancreatic cancer and face three times more risk of dying from bladder cancer than nonsmokers.

Secondhand cigar smoke contains higher concentrations of toxins and cancer causing agents than cigarette smoke. There are several reasons for this. Cigar tobacco is fermented which increases the level of nitrates, a cancer-causing agent. Cigars burn longer than cigarettes and contain more tobacco than cigarettes, which increases the amount of smoke emitted. And cigars do not burn as hot as cigarettes, in part because the wrapper is not as porous as a cigarette, resulting in incomplete combustion. Some of the toxins or irritants in cigar smoke include:

- Carbon monoxide
- Nicotine
- Hydrogen cyanide
- Ammonia
- Volatile aldehydes

Carcinogens in cigar smoke include:

- Benzene
- Aromatic amines
- Vinyl chloride
- Ethylene Oxide
- Arsenic
- Chromium
- Cadmium
- Nitrosamines
- Polynuclear aromatic hydrocarbons

Second-hand cigar smoke contains more than 4,000 chemicals, including 200 poisons and carcinogens.<sup>17</sup>

#### **d. Increasing Sales of Little Cigars**

Before 1971, small cigars sales were only a tiny fraction of cigar market. In 1969, Congress passed The Public Health Cigarette Smoking Act. That Act banned cigarette advertising on radio and television. But it did not apply to cigars. Between 1971 and 1972, the sales of small cigars increased by 254% presumably because they could be advertised on television. In September 1973, Congress

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<sup>17</sup> Margaret J. Fehrenbach, *Cigar Smoking*, RDH (ADHA Ann. Sess. Feb. 2003, revised 10/26/05); AM. CANCER SOC'Y, CIGAR SMOKING, GROWING POPULARITY AMONG YOUNG ADULTS (REVISED 11/1/02); Dietrich Hoffman & Ilsa Hoffman, *Chemistry and Toxicology*, 9 Smoking and Tobacco Control Monograph 55 (1998).

passed a ban on advertising of small cigars and the sales of small cigars dropped steadily until the early 1990's.<sup>18</sup>

But in the 1990's cigar smoking surged and the increase in cigar smoking coincided with increased advertising. Cigar advertising in the 1990s includes magazines aimed at cigar smokers, cigar-tasting dinner events and celebrity endorsements. Since the mid 1990's, the number of people who started smoking cigars has exceeded the number of people who started smoking cigarettes.

From 1993 to 1998, the fastest growing segment of the cigar market was large cigars, which increased by 73%. But since 1998, little cigars have been the fastest growing segment of the market, increasing by 76%. Between 1997 and 2004 imports of little cigars grew by 500% from 34 million sticks to 215 million sticks. For the first quarter of 2005, little cigar sales were up 67%.<sup>19</sup>

The 2005 Tobacco Yearbook defines small cigars as those weighing three pounds or less per thousand. The 2005 Tobacco Yearbook states that taxable removals of small cigars increased by 1,240 million sticks from 2004 to 2005. Based on 6 months of data, small cigar output in 2005 is projected at 4,600 million, while taxable removals are expected at about 3,600 million.<sup>20</sup>

Small cigar production in 2004 was up 28 percent from 2003. Taxable removals of small cigars reached 2,578 million during 2004, an increase of 17 percent. Exports for 2004 reached 179 million cigars. Imports of small cigars reached 215.4 million during 2004.<sup>21</sup>

#### **e. Advertising of Little Cigars**

Little Cigar makers have encouraged smokers to identify Little Cigars as cigarettes through their marketing practices. A Little Cigar manufacturer ran an advertisement that read, "So much like cigarettes, it's hard to believe they are cigars!" The same Little Cigar manufacturer advertised on its website, "If you are tired of the same old everyday smoke and the excessive price of tobacco products, its your time to have a [Little Cigar]." This advertising directs the consumer to the concept that these products are cigarettes, but cheaper. One brand of Little Cigars ran an advertising campaign (which has since been discontinued) that showed a

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<sup>18</sup> Karen Gerlach, et al., *Price Trends in Cigar Consumption and Smoking Prevalence*, 9 Smoking and Tobacco Control Monograph 21-24 (1998).

<sup>19</sup> U.S. TOBACCO BAROMETER: CIGARETTES, CIGARS AND SMOKING TOBACCO, DEC. 2005.

<sup>20</sup> Economic Research Service, U.S. Department of Agriculture, 2005 Tobacco Situation and Outlook Yearbook 3, Dec. 2005.

<sup>21</sup> *Id.*

package of Little Cigars with the banner, “You’ll love the taste. You will really love the price!” “Compare us to your favorite brand!” (Emphasis in original.)

The cigar industry is well aware that consumers are substituting Little Cigars for cigarettes. Barton Laws, Chief Operating Officer of American Western Cigars stated, “Increased prices on manufactured cigarettes have caused the little cigar business to blossom. Consumers are constantly searching for lower cost alternatives to cigarettes, and they have found such an alternative in little cigars.”<sup>22</sup>

Jeffrey Wagner, Director of International Corporate Sales for Royal Blunts, Inc. says, “Little cigars are the newest phenomenon in the category—they are often filtered and packaged in packs of 20, manufactured on machines with cigar tobacco and natural leaf wrapping. When they are filtered, Wagner refers to them as ‘a smoking alternative to cigarettes and not to cigars. Lower priced than cigarettes, they are a quick, inexpensive way to fill a need.’”<sup>23</sup>

That sentiment is echoed by Harry Preston, National Accounts Manager for J.C. Newman Cigar Company, “[T]he popularity of mini cigars is at least partially due to the cost increases of cigarettes. Some cigarette consumers are clearly switching to little cigars as a more inexpensive way to enjoy a smoke.”<sup>24</sup> Wagner also encourages convenience stores to place little cigars near the register where consumers can see how much they resemble cigarettes, “This is not Bayer Aspirin; a little nudge by the clerk to suggest they try them as an alternative to cigarettes, as well as a bright and clean display near the register, can make all the difference.”<sup>25</sup>

Many smokers do, in fact, self-identify their Little Cigars as cigarettes. In a 2003 National Survey on Drug Use and Health, smokers were asked what brand of cigarettes they smoked, some reported Little Cigars such as Black & Mild, Captain Black, Phillies, Swisher Sweets, and Winchesters.<sup>26</sup>

In light of this research, the States believe that the public health consequences of cigarettes being disguised and self-classified as cigars are significant and warrant a careful re-examination of how best to define and classify tobacco products as cigars or cigarettes.

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<sup>22</sup> C.D. Delnova, *Smokers’ Choice: What Explains The Steady Growth of Cigar Use in the US?*, 121 Public Health Reports 116-119 (March-April 2006).

<sup>23</sup> Renee M. Covino, *Might of Mini’s*, 9-1 Tobacco On Line (Jan./Feb. 2006).

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 5.

<sup>26</sup> C.D. Delnova, *Smokers’ Choice: What Explains The Steady Growth of Cigar Use in the US?*, 121 Public Health Reports 116-119 (March-April 2006).

## **B. Federal Definition of Cigar and Cigarette**

26 U.S.C. § 5702(a) defines “Cigar” as: “any roll of tobacco wrapped in leaf tobacco or in any substance containing tobacco (other than any roll of tobacco which is a cigarette within the meaning of paragraph (2) of the definition of cigarette).”

26 U.S.C. § 5702(b) defines “Cigarette” as: “(1) any roll of tobacco wrapped in paper or in any substance not containing tobacco, and (2) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in paragraph (1) of this definition.”<sup>27</sup>

The federal rules that define “Cigar” and “Cigarette” reiterate the language of these two statutes.

Traditionally cigars have been wrapped in a leaf of tobacco. Cigars are made of air-cured tobacco that is aged and subjected to a multi-step fermentation process that reduces sugar content. Traditionally, cigars are also unflavored. Cigar smoke is not intended to be inhaled, so traditionally cigars do not have integrated filters. Sometimes, however, cigars have a mouthpiece made of plastic or wood that is intended to keep stray pieces of tobacco out of the mouth. In the United States, cigars come in many styles and sizes. Small cigars generally have straight bodies and weigh between 1.3 and 2.5 grams each. Large cigars vary greatly in size and shape. They can contain from 5 to 17 grams of tobacco.

Traditionally cigarettes have been wrapped in paper. Cigarettes are made of flue-cured tobaccos, not fermented tobaccos. Cigarette smoke is intended to be inhaled into the lungs, consequently some cigarettes have cellulose acetate filters or other integrated filters that are intended to filter some of the tar out of the smoke. Cigarette manufacturers often add sugar to enhance the flavor of the cigarette smoke. They generally range from 68-121 mm. in length and are generally of less than 28 ring gauge.

Prior to 1965, “Cigar” as used in 26 U.S.C. § 5702 was defined as “any roll of tobacco wrapped in tobacco” and “Cigarette” was defined as “any roll of

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<sup>27</sup> Identical definitions cigarette are found in the FCLAA (15 U.S.C. § 1332) and the Contraband Cigarette Trafficking Act (18 U.S.C. § 2341).

tobacco, wrapped in paper or any substance other than tobacco.” 26 U.S.C.S. § 5702.

With the advent of reconstituted tobacco, it became possible to machine wrap cigars in a mixture of paper and tobacco. Reconstituted tobacco is ground tobacco mixed with various adhesives and cellulose fibers. This blurred the line between a cigar and a cigarette. In 1965, Congress enacted Public Law 89-44 which amended the definitions of cigar and cigarette to those we have today. The legislative history of Public Law 89-44 describes how technology created the problem of distinguishing between cigars and cigarettes.

The introduction of reconstituted (homogenized) tobacco for use as a wrapper for rolls of tobacco had created problems regarding the existing distinction between a cigar and a cigarette. Reconstituted tobacco can be used to wrap rolls of tobacco that closely resemble cigarettes. Moreover, it possesses many of the properties of paper, including suitability for use in high-speed cigarette manufacturing machinery.

Your committee’s bill amends present law to clarify the definition of cigars and cigarettes. The effect of the present definition of a cigarette is retained in that it is defined as any roll of tobacco wrapped in paper or in any substance not containing tobacco. The definition is also expanded, however, to include a roll of tobacco wrapped in a substance containing tobacco, if, because of its appearance, the type of tobacco used in its filler, its packaging and labeling, it is likely to be sold as, or purchased as, a cigarette. The effect of the present definition of a cigar is retained in that it is defined as a roll of tobacco wrapped in leaf tobacco or in any substance containing tobacco which is not defined as a cigarette. (Emphasis added.)

Excise Tax Reduction Act of 1965 at 1744.

Clearly Congress intended that “cigarette” would include a product wrapped in something that contains tobacco if it was likely to be sold as or purchased as a cigarette. In 1969, the ATF issued Revenue Ruling<sup>28</sup> 69-198. That Ruling maintained the distinction between a cigar and a cigarette.

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<sup>28</sup> A ruling is an official interpretation by the Bureau that has been published in the Bulletin for the information and guidance of the taxpayers, Bureau officers, and others concerned. Rulings are the conclusions of the Bureau on the application of the law to an entire state of facts. 27 C.F.R. § 70.701(d)(2).

A combination of other factors must also be considered in determining whether a product wrapped in a “substance containing tobacco” is a cigar or a cigarette. Any such roll of tobacco which is not a cigar as defined in section 5702(a) of the Code is a cigarette as defined in section 5702(b). To be a cigar the filler must be substantially of tobaccos unlike those in ordinary cigarettes and must not have any added flavoring which would cause the product to have the taste or aroma generally attributed to cigarettes. The fact that a product does not resemble cigarette (such as many large cigars do not) and has a distinctive cigar taste and aroma is of considerable significance in making this determination. The package should conspicuously declare the product a cigar and all marketing materials should clearly present the product to the consumer as a cigar and not as a cigarette. There should be no words or implications on the package or in other marketing materials to negate the declaration that the product is a cigar. (Emphasis added.)

Rev. Rul. 69-198

However, in 1973, the ATF issued Rev. Rul. 73-22 which superceded Rev. Rul. 69-198.

**a. ATF Revenue Ruling 73-22**

The ATF issued Rev. Rul. 73-22 to amplify and clarify developments since Ruling 69-198 was issued. Rev. Rul. 73-22 states that in order for a wrapper to be considered a “substance containing tobacco” within the meaning of the definition of cigar, the “finished wrapped must (1) be approximately two-thirds or more tobacco which did not in the reconstitution process lose its tobacco character (e.g., taste, aroma, identifiable chemical components), and (2) be of a color consistent with that of the natural leaf tobaccos traditionally used as a wrapper for American cigars.”

The Ruling goes on to state that a variety of factors must be considered to determine if a product wrapped in a substance containing tobacco is a cigar or a cigarette. For a product to be a cigar, the filler must be cigar-type tobaccos without flavorings that would cause the product to taste or smell like a cigarette. “The inclusion of flue-cured or aromatic (Oriental) tobaccos--which traditionally have been the primary constituents of cigarette filler--can contribute significantly to making a product cigarette-like, and if the product also is of the typical cigarette size and shape, has a typical cigarette-type filter, and is in a cigarette-type

package, the inclusion of these tobaccos could cause the product to be classified as a cigarette rather than a cigar.”

The Ruling also addresses the “likely to be sold as or purchased as a cigarette” portion of the definition. The Ruling states that it is important that the package for a product to be offered as a cigar conspicuously declare it to be a cigar and that all marketing materials and advertising clearly present the product to the consumer as a cigar and not as a cigarette.

The Ruling states that cigar products that are comparable to the traditional 20-cigarette pack must have the declaration “cigars”, “small cigars”, or “little cigars” in direct conjunction with, parallel to, and in substantially the same conspicuousness of type and background as the brand name each time the brand name appears. A conspicuous “cigar” declaration must appear on the front, back, and bottom panels of such a typical cigarette-type package even if the brand name does not appear on any of these panels.

The Ruling makes manufacturers initially responsible for classifying their tobacco products as cigars or cigarettes and paying the proper rate of tax. While the Ruling allows a manufacturer to request a ruling on the taxable status of any product that the manufacturer seeks to market as a cigar, manufacturers are not required to request a ruling.

#### **b. The Difficulties Ruling 73-22 Creates**

There are several difficulties with Rev. Rul. 73-22. The Ruling assumes that products that are likely to be sold as or purchased as cigarettes will not be if they are labeled as cigars. This has led to rolls of tobacco that are filtered, appear to be cigarettes in brown wrapper and packaged in a traditional cigarette pack, are being taxed and sold to consumers as cigars because they are labeled as little cigars. But recent surveys on youth use of little cigars and the manufacturers’ own statements show that “Little Cigars” are being purchased in lieu of cigarettes. “Little Cigars” are advertised to consumers as cigarette alternatives and consumers are self-identifying “Little Cigars” as cigarettes. Consumers recognize that a product that looks like a cigarette, is filtered to be inhaled like a cigarette, and is packaged like a cigarette is, in fact, a cigarette. Unscrupulous manufacturers have exploited the loopholes in Ruling 73-22 by self-classifying cigarettes as cigars. This intentional, unscrupulous misclassification of cigarettes as cigars has resulted not only in damage to the public health but also in significant lost revenues and confusion in the marketplace.

## **C. Lost Tax Revenues**

### **a. Lost Federal Tax Revenue**

At the federal level, small cigars are taxed at the rate of 4¢ per pack or 40¢ per carton. Cigarettes are taxed at the rate of 39¢ per pack or \$3.90 per carton. This tax difference of \$3.50 per carton means that the federal government and the states are losing significant tax revenues due to cigarettes improperly taxed as cigars.

While it is not possible to calculate precisely the number of products in the marketplace that are misclassified, the growth of the "Little Cigar" market corresponds with a decrease in the sales of cigarettes. The States believe that cigarette smokers have switched to the cheaper cigarettes intentionally misclassified and mislabeled by unscrupulous manufacturers as "Little Cigars" in order to continue to smoke cigarettes, at a cheaper price.

From 1999 to 2005, the total little cigars sales (domestic, PR & imported) increased by over 1.7 billion sticks, or 79%. During this same time period cigarette sales decreased by over 20%. The States believe that consumers are buying the cigarettes that are intentionally misclassified as much cheaper "Little Cigars" in order to avoid the high cigarette prices. If we assume that this increase is all due to the improperly labeled products, the federal excise taxes lost total \$34 million, based upon the applicable tax rate of \$3.90 per carton.

Almost as much federal excise taxes are lost even if the shorter time period, from 2002 to 2005, is selected. From 2002 to 2005, "Little Cigar" sales increased over 1.6 billion sticks, or 69%. The federal excise taxes lost on this increase, at \$3.90 per carton, total \$32 million.

### **b. Lost State Tax Revenues**

At the state level as well, cigars are taxed at lower rate than cigarettes. Four states do not tax cigars at all. States that do tax cigars often assess a tax that is a percentage of the wholesale value of the product.<sup>29</sup> In Montana, for example, the tax on cigars is 50% of the wholesale value of the product. So Montana state taxes on a carton of Little Cigars that have a wholesale value of \$7.20 are \$3.60. Cigarette taxes are \$1.70 per pack or \$17.00 per carton. The difference is \$13.40

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<sup>29</sup> Attached as Appendix C is a table of state cigarette and cigar tax rates.

per carton. It is estimated that Montana lost over \$11 million in tax revenues in 2005 due to cigarette products improperly taxed as cigars.<sup>30</sup>

#### **D. Evasion of MSA Payments**

The MSA requires manufacturers that joined the MSA to pay payments to the States based on their sales of cigarettes. However, MSA payments are calculated based on the federal excise taxes paid for cigarettes. Because federal excise taxes are not paid on “Little Cigars”, they are not included in the calculation of MSA payments. This loophole creates a financial incentive for tobacco companies to shift a product from the cigarette classification to the cigar classification to avoid paying MSA payments. For 2005, the MSA payment is \$4.25 per carton.

#### **E. Evasion of State Escrow and Cigarette Directory Laws**

Pursuant to the MSA, the Settling States have enacted and diligently enforced state escrow laws that require tobacco product manufacturers that did not join the MSA (non-participating manufacturers), to place money into escrow accounts each year based on their sales of cigarettes in each state. Under many of the states’ statutes, only products stamped as cigarettes are subject to the escrow requirements. In most states, since cigars are not stamped, they are not subject to the escrow requirements. For 2005, the escrow amount per carton is \$4.16.

Thus in Montana, for example, a non-participating cigarette manufacturer pays a total of \$25.06 per carton of cigarettes, for state and federal taxes and escrow payments. A cigar manufacturer pays a total of \$4.00.<sup>31</sup> Clearly manufacturers have great financial incentive to package and sell cigarettes as cigars.<sup>32</sup>

In addition to the financial incentive created by the tax classification of a product, manufacturers have another reason to classify cigarettes as cigars. Many states have enacted Directory laws that are intended to enhance the enforcement of the escrow statutes. The Directory laws require all tobacco product manufacturers that wish to sell cigarettes in a state to certify that they are in full compliance with the MSA or the escrow statutes, whichever applies. The State publishes a Directory of Approved Tobacco Products that lists all the tobacco products that are compliant in that state. Only those tobacco products listed on the Directory may be sold in that state. If a tobacco product manufacturer is not fully compliant with the escrow statutes, they cannot be listed on the Directory and their products may not be sold in that state.

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<sup>30</sup> This assumes that the wholesale value of a carton of little cigars is \$7.20 per carton.

<sup>31</sup> This assumes that the wholesale value of a carton of little cigars is \$7.20 per carton and the tax on cigars is 50% of the wholesale value.

<sup>32</sup> See Appendix D.

Increasingly, States are experiencing a disturbing pattern. After the states obtain an award of civil penalties and an injunction against further sales by a noncompliant non-participating manufacturer for failing to make escrow deposits, the same manufacturer simply repackages their cigarettes as “Little Cigars” and continues to sell them in the state. Because “Little Cigars” are not covered by the escrow statutes, they are not required to be listed on the State Tobacco Product Directories in order to be sold in a State. The States passed Directory laws specifically to prevent repeated violations of their escrow laws, but non-compliant tobacco manufacturers are able to evade the Directory laws by simply repackaging their cigarettes as “Little Cigars” as allowed under current federal classification rules and definitions. Not surprisingly, the States now believe there is a critical need to reform the federal classification rules and definitions.

#### **F. Health Warnings and Ingredient Reporting**

The Federal Cigarette Labeling and Advertising Act (FCLAA) that requires health warning labels and ingredient reporting applies only to cigarettes. Cigars are not required by federal statute or rules to have health warning labels on them. However, in 2000 the FTC entered into an agreement with the seven largest cigar manufacturers to place warnings on their cigars.<sup>33</sup> Only those seven companies are bound by the warning label settlement. Other companies sometimes place warnings on their products, but the warnings may not comply with the terms of the settlement. The cigar warning labels are:

Cigar smoking can cause cancers of the mouth and throat, even if you do not inhale.

Cigar smoking can cause lung cancer and heart disease.

Tobacco use increases the risk of infertility, stillbirth and low birth weight.

Cigars are not a safe alternative to cigarettes.

Tobacco smoke increases the risk of lung cancer and heart disease, even in nonsmokers.

The first cigar warning label assumes that the consumer will not inhale the product. This makes perfect sense if the consumer is smoking a cigar. But if the consumer is smoking a cigarette disguised by the manufacturer as a Little Cigar (which is intended to be inhaled) the first warning is highly misleading, if not a consumer fraud.

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<sup>33</sup> The companies that agreed to the settlement are Swisher International Inc., Consolidated Cigar Holdings, Inc., Havatampa Inc. (Altadis USA), General Cigar Holdings, Inc., John Middleton Inc., Lane Ltd. and Swedish Match AB.

## **G. Confusion in the Marketplace**

Several States have looked closely at “Little Cigars” and determined they are cigarettes for state tax purposes and several other States stand ready to do so. Attached as Appendix E is a list of states tobacco tax laws definitions of cigars and cigarettes. If the States change their tax definitions without a corresponding change in the TTB regulations, the inconsistencies between the two definitions cause tremendous confusion in the marketplace. For example, if a State requires “Little Cigars” to be stamped as cigarettes, while the TTB considers them to be cigars, the stamping agents must continually monitor which Little Cigar products should be stamped as cigarettes. This requires placing cigarette stamps on products labeled as “Little Cigars” that have cigar warning labels on them.

States that have made or contemplated this change have run into the argument that the products are cigars for federal tax purposes and should be treated the same at the state level. Cigar manufacturers maintain that States should rely on the TTB testing of products to determine if the product is a cigar or a cigarette rather than adopting inconsistent regulations. However the States believe that the proper solution to the current confusion in the market place is to revise the TTB definition of cigar and cigarette so that these products can be treated consistently under both state and federal law. In order to do that, the TTB must take the lead to establish clear, objective, non-lab dependent standards that create a clear federal regulatory framework into which the states may integrate their laws. Public health, consumers, state and local government tax and tobacco control programs, as well as law abiding tobacco manufacturers, distributors, wholesalers and retailers will benefit greatly from more consistent, and perhaps even uniform definitions under state and federal law.

### **SUMMARY AND REQUEST FOR RULEMAKING**

In short, the States are increasingly alarmed by the growing trend toward sales of “Little Cigars” that are really cigarettes. This trend endangers tax revenues, public health and our youth, and allows evasion of the state statutes enacted to protect them. The states urge Alcohol Tobacco Tax and Trade Bureau to repeal 27 C.F.R. § 40.11, 27 C.F.R. § 41.11, 27 C.F.R. § 44.11 and 27 C.F.R. § 45.11 and enact the following new rules to define cigar and cigarette as used in 26 U.S.C. § 5702 and set forth procedures for a ruling of whether a product is a cigar or a cigarette.

New Rule 1 is intended to preserve the integrity of the cigar classification by requiring that cigars be either wrapped in a 100% natural tobacco leaf or in a

substance that contains 75% or more tobacco, and not be a cigarette within the meaning of New Rule 2. This rule defines cigar in a manner consistent with federal law. The federal statute defines cigar as a product wrapped in leaf tobacco or a substance containing tobacco –other than a cigarette. 26 U.S.C. § 5702(a). The intent of the rule is to make clear that a cigar is only a product wrapped in 100% natural leaf or 75% or more tobacco that does not meet the definition of cigarette.

New Rule 2 is intended to fairly define cigarettes based upon their design characteristics. This definition addresses the design characteristics of the filler and wrapper of the product as well as the appearance, the packaging and labeling, and whether the product will be likely to be offered to or purchased by consumers as a cigarette.

New Rule 3 sets forth the procedure to be use to determine if a product is a cigar or a cigarette under federal law. It requires a manufacturer to request an advance ruling from Bureau on their product, sets forth the process for such a ruling, and requires the Bureau to post a list of their rulings on their website in order to allow easy access to that information.

## Proposed New Rules

### New Rule I. Cigar.

A cigar is a roll of tobacco that:

1. is wrapped in 100% natural leaf tobacco, or
2. (a) is wrapped in any substance that contains 75% or more tobacco which did not in the reconstitution process lose its tobacco character (taste, aroma, identifiable chemical components) and is of a color consistent with that of the natural leaf tobaccos traditionally used as a wrapper for American cigars; and (b) is not a cigarette within the meaning of [New Rule II].

### New Rule II. Cigarette.

A cigarette is a roll of tobacco that:

1. is wrapped in paper or any substance not containing tobacco, or
2. is wrapped in a substance containing tobacco, and is likely to be offered to, or purchased by, consumers as a cigarette. A roll of tobacco wrapped in a substance containing tobacco (other than 100% natural tobacco leaf) shall be considered to be likely to be offered to, or purchased by, consumers as a cigarette if any of the following are true:
  - a. it has a cellulose acetate or other integrated filter;
  - b. the tobacco used in the filler contains flue-cured or unfermented tobaccos or has flavor additives;
  - c. the tobacco in the filler, binder, or wrapper contains any sucrose;
  - d. the packaging does not clearly and conspicuously declare that the product is a cigar;
  - e. the appearance, packaging and/or labeling of the product meets three or more of the following criteria:
    - i. the product is sold in packs containing twenty or twenty-five sticks,
    - ii. the product is available for sale in cartons of 10 packs,
    - iii. the product is sold in soft packs, hard packs, flip-top boxes, clam shells, or other cigarette-type boxes,
    - iv. the product weighs less than three pounds per thousand sticks,  
or
    - v. the product is the diameter and length of a commercially-manufactured cigarette;
  - f. the product is marketed or advertised to consumers as a cigarette or cigarette substitute; or

- g. it contains any other indicia that the product fits within the definition of cigarette in 26 U.S.C. 5702(b).

### New Rule III. Procedure.

1. A manufacturer shall request an advance ruling from the bureau as to any product a manufacturer or importer wishes to market as a cigar.
2. The bureau shall make an advance ruling as to whether a product is a cigar within the meaning of 26 U.S.C. 5702(a), using the criteria above and the characteristics of the tobacco product, its packaging and labeling, and the totality of the circumstances.
3. Along with a request for determination, the manufacturer shall submit the following:
  - a. The package and any larger consumer container such as the carton, or the detailed graphics for these if they have not been printed;
  - b. A statement of the merchandising theme and copies of all advertising that mentions or depicts the product and point of sale merchandising material for the product;
  - c. A statement under penalty of perjury that the merchandising and advertising materials submitted are of the exact, actual advertising that will be used in the United States;
  - d. A statement under penalty of perjury that the manufacturer will obtain a new ruling from the Bureau if any material modifications are made to the marketing or advertising of the product prior to any change in the existing marketing or advertising.
  - e. A statement of composition of the wrapper including the type, geographic origin, treatment, age, and percentage of each tobacco used;
  - f. 2,500 square inches (17 square feet) of the wrapper material;
  - g. A statement of all the materials, chemicals, and additives and proportion of each used in the binder, and the production process;
  - h. 400 sticks of the finished product (if weighing not more than 10 pounds a thousand), or 200 sticks of the finished product (if weighing more than 10 pounds a thousand);
  - i. A statement under penalty of perjury of all the materials, chemicals, and additives and proportion of each used in the filler and the production process, including, but not limited to the proportion of fermented air-cured tobacco, flue-cured tobacco and unfermented tobacco;
  - j. A statement under penalty of perjury that the samples submitted are of the exact, actual product that will be sold in the United States; and

- k. A statement under penalty of perjury that the manufacturer will obtain a new ruling from the Bureau if any modifications are made to the composition or ingredients of the product prior to sales of any modified product.
- 4. If the manufacturer requests a ruling, the manufacturer shall submit all other relevant evidence required to enable the bureau to make a ruling. Pending a ruling by the Bureau, the manufacturer may only sell its product as a cigarette and comply with all laws applicable to cigarettes; such sales may occur only after the manufacturer notifies the revenue departments of the states where the product will be sold that a ruling by the Bureau is still pending.
- 5. Not later than January 1, 2007, the Bureau shall develop and publish on its Internet Web site a directory listing of all rulings by the Bureau regarding the classification of a tobacco product as a cigar or as a cigarette, including the name and address of the manufacturer requesting the product classification, the product brand family and if the trademark for the brand family is not owned by the manufacturer, the name and address of the owner of the trademark.