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March 22, 2007

Mr. Francis W. Foote, Director
Regulations and Rulings Division
Alcohol and Tobacco Tax and Trade Bureau
1310 G Street NW, Room 200E
Washington, D.C. 20220

Attn: Notice No. 65

Re: Notice No. 65/Tax Classification of Cigars and Cigarettes

Dear Mr. Foote:

On behalf of Philip Morris USA Inc. ("PM USA"), we submit PM USA's comments to the Alcohol and Tobacco Tax and Trade Bureau ("TTB") regarding Notice of Proposed Rulemaking No. 65, Tax Classification of Cigars and Cigarettes, which proposes certain amendments to 27 CFR Parts 40, 41, 44 and 45.

I. CLARIFICATION OF THE REGULATIONS IS ESSENTIAL FOR PROTECTING EXCISE TAX REVENUE AND PREVENTING MISCLASSIFICATION OF CIGARETTES AS LITTLE CIGARS

PM USA commends TTB for undertaking this effort to examine the proper tax classification of cigarettes and little cigars. As TTB points out, clarification is needed to ensure that revenue is not lost because cigarettes are misclassified as little cigars. The tax rate on little cigars is significantly lower than the tax rate on cigarettes. Because the current classifications do not provide a sufficiently objective test for delineating between these two products, manufacturers have been able to take advantage of the tax differential by marketing products that are cigarettes as little cigars. The market data support this conclusion.

II. MARKET DATA INDICATE THAT PRODUCTS THAT ARE CURRENTLY LABELED AND TAXED AS LITTLE CIGARS ARE CIGARETTES

Market data indicate that TTB is losing substantial cigarette tax revenue as manufacturers market and sell more products as "little cigars" that are cigarettes. During the period from 1998 to 2006, the little cigar category has grown 167%¹. Conversely, the cigarette category has declined 17% over the same period. Little cigar volume has grown 52% over the period of 2004 to 2006. At least five states -- California, Connecticut, Florida, Iowa and Tennessee -- have

¹ The little cigar and cigarette volume numbers have been obtained from ttb.gov.

already eliminated the difference in tax treatment between little cigars and cigarettes. Additionally, legislation has been proposed in Maine that seeks to classify little cigars as cigarettes, subjecting little cigars to the state's cigarette excise tax. Montana has also adopted regulations, effective July 1, 2007, that are aimed at addressing the classification problem.

III. GOVERNING PROVISIONS OF THE INTERNAL REVENUE CODE

The Internal Revenue Code of 1986, as amended (the "Code"), provides for separate rates of tax on cigarettes and cigars. The rate of tax on cigars is further divided, with one rate applicable to "small cigars" -- those weighing not more than three pounds per thousand, and another rate applicable "large cigars" -- those weighing more than three pounds per thousand. Code § 5701(a). The rate of tax for cigarettes is similarly bifurcated. Code § 5701(b).

The Code defines a cigar as any roll of tobacco wrapped in leaf tobacco or in any substance containing tobacco, other than any roll of tobacco which falls within the Code's cigarette classification. Code § 5702(a). The Code in turn defines a 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)." Code § 5702(b).

IV. SUGGESTED MODIFICATIONS TO THE PROPOSED REGULATIONS

PM USA supports TTB's goal of creating an objective test to distinguish between cigarettes and little cigars. PM USA believes that the best way to achieve this goal is with simplified regulations that contain only the essential, objective criteria needed for delineating between cigarettes and little cigars. Under the regulations proposed by PM USA below, a roll of tobacco wrapped in a substance containing tobacco would be classified as a cigarette if (1) it is sold in a package that is labeled as cigarettes or bears the cigarette tax classification or (2) it contains a cellulose acetate or other cigarette-type integrated filter and does not weigh more than three pounds per thousand.

PM USA's proposed approach would appropriately implement the definitional language of Code § 5702, which instructs TTB to examine, among other things, the appearance of products to determine whether such products are "likely to be offered to, or purchased by, consumers as a cigarette" Code § 5702(b). Any roll of tobacco that (1) is wrapped in any substance containing tobacco, (2) weighs not more than three pounds per thousand and (3) includes a cellulose acetate or other cigarette-type integrated filter is "likely to be offered to, or purchased by, consumers as a cigarette"

PM USA proposes that subsection (b) of 27 CFR § 40.12² be amended to include the following regulations for classifying cigarettes:

- (b) *Classification of cigarettes.* A tobacco product is classified as a cigarette if:
 - (1) It consists of a roll of tobacco wrapped in paper or in any substance not containing tobacco; or
 - (2) It consists of a roll of tobacco that is wrapped in a substance containing tobacco, and
 - (i) it is put up in a package that bears a product designation or tax classification specified in § 40.215; or
 - (ii) it has a cellulose acetate or other cigarette-type integrated filter³ and weighs not more than three pounds per thousand.

PM USA believes that these proposed regulations provide reliable, objective criteria for determining whether a product is a cigarette or little cigar for federal tax purposes. Under the current regulations and rulings and TTB's proposed regulations, TTB would have to determine what varieties of tobaccos are in the filler of a particular product, whether a fermentation process was used during manufacture, and make highly subjective determinations about smoking characteristics of tobaccos. Additionally, these rules and regulations do not provide for the possibility that manufacturers may create products in the future that are not easily classified based on filler types or smoking characteristics. By contrast, the regulations proposed by PM USA would not require complex laboratory analysis or subjective analysis and they provide objective criteria that should withstand product evolution. These proposed regulations would also be easier and less costly to administer. Finally, PM USA's proposal is based on product characteristics that are fundamental to the question of whether a product is "likely to be offered to, or purchased by consumers as a cigarette" For these reasons, PM USA urges TTB to adopt the regulations proposed above.

² Conforming changes would also need to be made to subsection (b) of 27 CFR §§ 41.12, 44.12 and 45.12.

³ Tips or holders should not be considered to be "cigarette-type integrated filters."


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V. CONCLUSION

PM USA agrees that the regulations classifying cigarettes and little cigars should be clarified. PM USA's proposal would protect the revenue and also prevent the unintended consequences that flow from the current incentive for manufacturers to market cigarettes as little cigars. PM USA urges TTB to issue an amendment to the Notice modifying the proposed regulations as set forth in IV above.

If you have any questions or if PM USA can provide any further information, please contact me at 336-378-5285 or at the address listed above.

Respectfully submitted,

A handwritten signature in cursive script that reads "Harold N. Bynum".

Harold N. Bynum, Esq.
Counsel for Philip Morris USA Inc.

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