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Via Electronic Mail (nprm@ttb.gov) and Hand Delivery

Francis W. Foote
Director
Regulations and Rulings Division
Alcohol and Tobacco Tax and Trade Bureau
P.O. Box 14412
Washington, D.C. 20044-4412

**Re: Notice 65 - Tax Classification of Cigars and Cigarettes,
71 Fed. Reg. No. 206, pp. 62505-62523, Oct. 25, 2006**

Dear Mr. Foote:

My name is Jeffrey Avo Uvezian, and I am the President of International Tobacco Partners, Ltd. ("ITP"). I write this letter to comment on the Alcohol and Tobacco Tax and Trade Bureau's ("TTB") proposed regulations promulgated in Notice 65, 71 Fed. Reg. No. 206, pp. 62505-62523, Oct. 25, 2006 ("proposed rule").

Our principal concern is that the proposed rule, as drafted, would eliminate the category of little cigars

The first part of this letter describes ITP. As discussed below, ITP is a small business that does a growing business in "little cigars." ITP imports the little cigars it sells, and distributes those little cigars to wholesalers around the country. The second part of this letter discusses the effect that the draft rules would have on ITP if they were implemented in their current iteration. The third part of this letter discusses the limited ways we recommend the draft proposed rules be changed. Most importantly, the "or" in the third line of proposed Sections 40.12(b)(3)(ii), 41.12(b)(3)(ii) and 42.12(b)(3)(i) should be changed to "and" after the word "filter."

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This section of the letter describes ITP's business. ITP imports cigarettes and cigars into the United States for re-sale. In 2006, ITP had gross sales of several million dollars. One-hundred percent of ITP's 2006 gross revenues were from the sale of cigarettes and cigars (including little cigars). ITP started selling little cigars for sale in 2006, and sales of our little cigars are growing. From the third to fourth quarter of 2006, sales grew over 25%. ITP sells little cigars under the tradename i80®.

ITP has five employees, and its headquarters are located in Long Island, New York. ITP maintains warehouse space in Florida. ITP's little cigars are manufactured overseas according to ITP's contract specifications, and i80s are now available in many parts of the United States.

Effect of Rule Change If Current Draft Is Implemented

This section of the letter describes some of the effects that the proposed rules, if implemented as drafted, would have on ITP's business.

Under the October 25, 2006 draft rule changes, 100% of the little cigars sold by ITP would be classified as cigarettes. The effects on ITP would be devastating for two reasons. First, ITP's i80 little cigars would be deemed contraband by most states because i80 little cigars are not certified for sale as cigarettes. Second, if ITP's little cigars were redefined as cigarettes, a \$4.29 per carton escrow deposit would have to be made for each i80 sold in the 46 Master Settlement Agreement States. Third, excise taxes would be increased from 37¹ cents to \$3.90 per carton – a thousand percent increase. ITP would have to pass through this cost to its customers, making i80s less competitive.

The Master Settlement Agreement

If the "little cigars" sold by ITP were to be reclassified as "cigarettes," then the cost to consumers of those little cigars would be drastically increased, ITP would lose sales, or probably both. These consequences would occur because, under the law prevailing in 43 states,² ITP (or the company that manufactures ITP's little cigars) would have to make an escrow deposit based on the number of little cigars sold in most States.

In 1998, 46 States and four major cigarette manufacturers, including Philip Morris ("the Majors"), executed the Master Settlement Agreement ("MSA"). Among other things, the MSA settled litigation between those 46 States and the Majors. In that litigation, the 46 States sought compensation for healthcare costs the States claimed were imposed on those States when people insured by them suffered tobacco-related illnesses.

As part of their agreement, the 46 States that signed the MSA are required to diligently enforce certain statutes that the MSA required signatory states to enact. One of those statutes requires cigarette companies who are not members of the MSA to "certify" on a state-by-state basis the brands of cigarettes those non-members intend to sell. ITP and ITP's little cigar manufacturer are not members of the MSA. Because ITP and its manufacturer are not members of the MSA, ITP must certify – on a state-by-state basis – any brand family of cigarettes it intends to sell. If ITP were to sell cigarettes into an MSA state without certifying

¹ See note 3 *infra*.

² Four states, Florida, Minnesota, Mississippi, and Texas, are not parties to the Master Settlement Agreement. Two states currently do not have in effect all of the legislation passed by the other 43 MSA states. In one state, New York, a federal court has enjoined enforcement of the New York law that would have eliminated ITP's opportunity to receive a refund of a portion of its escrow deposits. *Freedom Holdings v. Spitzer*, 447 F. Supp. 2d 230, 264-65 (S.D.N.Y. 2004). This action has not yet been finally adjudicated.

them, that would subject the cigarettes to forfeiture, and subject the manufacturer to treble penalties.

Naturally, because ITP's little cigars are not "cigarettes," they are not certified in any state. Therefore, if the definition of "cigarettes" were changed to include "little cigars," ITP would have to begin certifying its little cigars on a state-by-state basis. The certification process takes months – sometimes years – and certification is by no means guaranteed. Because uncertified cigarettes are contraband in most States, ITP would have to stop selling immediately. ITP's little cigar volume would drop to zero.

Even if ITP were to succeed in certifying its re-classified "little cigars" as "cigarettes," ITP's costs would drastically increase. Under the legislation that the MSA required its member states to pass, the manufacturer of cigarettes must make escrow deposits based on the number of cigarettes it sells. These escrow deposits remain in escrow for 25 years. The manufacturer may receive the interest on these deposits, but the deposit itself must remain in escrow. No such deposit is required for little cigars.

For sales made in 2006, manufacturers must deposit \$4.29 per carton of cigarettes. ITP is responsible for an escrow deposit of several hundred thousand dollars for its 2006 sales; when this deposit is combined with ITP's deposits for prior years, ITP will have almost two million dollars locked away in escrow for 25 years.

If ITP's little cigars become reclassified as cigarettes, then ITP will be forced to pass along its increased costs to its customers, who will either accept the price increase, thereby increasing their costs and costs to the ultimate consumer, or ITP's customers and ultimate consumers will stop buying ITP's product.

Additional Consequences

If ITP's little cigars were reclassified as cigarettes, such a reclassification would have the following additional, negative consequences:

- As a newly-classified cigarette, the excise taxes on little cigars would increase by literally one-thousand percent to \$3.90 per carton. Such costs would make ITP less competitive in the marketplace;³
- In those states, including California, Kentucky, New Hampshire, and New York, that require low ignition propensity paper (so-called "fire-safe cigarettes"), ITP would have to redesign the little cigars so as to make them "fire-safe," further increasing the costs and burdens on ITP; and

³ Federal excise taxes ("FET") on little cigars are \$1.828 per 1000 little cigars (37 cents per 200 little cigars); the FET on 1000 cigarettes is \$19.50 (\$3.90 per carton of 200 cigarettes).

- If a little cigar were reclassified as a cigarette, ITP would, at a minimum, have to change the homogenized paper we use to make the little cigars, and then certify with each State’s fire marshal or other appropriate authority that the little cigars are “fire-safe.”

Therefore, if “little cigars” were reclassified as “cigarettes,” such a reclassification would draw “little cigars” into a rubric of regulation and obligations that were never intended to include cigars and little cigars.

The Proposed Rules and Recommended Changes

This section analyzes the relevant laws and rules governing how cigars and cigarettes are defined, and then discusses ITP’s proposed changes that would alleviate ITP’s principal concern that its “little cigar” products not be wholesale recategorized as “cigarettes.”

What’s a Cigarette?

According to the United States Code, a “cigarette” is “(1) any roll of tobacco wrapped in paper or in any substance not containing tobacco” or “(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).”⁴ In contrast, the same section of United States Code defines a “cigar” as “any roll of tobacco wrapped in leaf tobacco or in any substance containing tobacco (other than a roll of tobacco which is a cigarette within the meaning of subsection (b)(2) [quoted above].”⁵ Of course, ATF Ruling 73-22 interpreted the statutory definitions of “cigars” and “cigarettes.” In that ruling, the ATF stated that a product could be classified as a “cigarette” if it contained traditional cigarette filler and:

[I]f 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 than a cigar.⁶

The little cigars sold by ITP are currently classified as “small cigars,” not “cigarettes.” ITP’s little cigars contain a “roll of tobacco” that is wrapped in a substance containing tobacco, they contain traditional cigar filler, and they are prominently labeled as “Little Cigars.” Indeed, ITP’s little cigars have been tested by the TTB and approved to be sold as “cigars.”

Although the preamble to the TTB’s proposed rules states that it “is in substantial agreement with the standards and statements contained in ATF Ruling 73-22,” the actual rule as drafted has quite the opposite effect. As drafted, the rule sweeps into the definition of “cigarette” all little cigars that are sold in the United States today, including those sold by ITP. Specifically, in language found in proposed regulations §§ 40.12(b)(3), 41.12(b)(3)(ii), 44.12(b)(3)(i), and 45.12(b)(3)(i), the conjunctive conditions of the ATF’s 73-22 ruling are made disjunctive:

⁴ 26 U.S.C. § 5702(b)(2).

⁵ 26 U.S.C. § 5702(a).

⁶ ATF Ruling 73-22 (1973).

[A product is classified as a cigarette if it] consists of a roll of tobacco wrapped in a substance containing tobacco; and –

(ii) It has a typical cigarette size and shape, has a cellulose acetate or other cigarette-type integrated filter, or is put up in a traditional cigarette-type package that does not bear all of the notice requirements for cigars specified in Sec. 40.214
.....⁷

As is clear, the proposed regulation has the opposite effect as both the draft regulation's preamble and the ATF's 73-22 ruling.

We are not aware of any evidence that would justify this administrative about-face. Of all the cigarettes and cigars sold in the United States annually, little cigars constitute about one percent of total sales.⁸ Little cigars are not new to the tobacco market; little cigars, including those with filters, have been in the United States for 40 years. The ATF's 73-22 ruling specifically considered little cigars in its interpretation of 26 U.S.C. § 5702.

Nor are we aware of any consumer confusion between little cigars and cigarettes. Our little cigars are prominently labeled as such, and the one percent market share of little cigars shows that consumers know the difference from a cigarette.

While there would appear to be absolutely no positive effect on adopting the draft regulations in their proposed form, the negative effects on small business are quite real, as discussed in the previous section. Briefly, if implemented, the draft regulations would have, among others, the following consequences:

- Reclassify virtually all little cigars as cigarettes;
- Increase consumer costs by making little cigars subject to higher federal excise taxes and MSA payments;
- Force ITP to either seek, on a state-by-state basis, certification for its little cigars and, in the interim, halt all sales prior to certification;
- Force little cigar manufacturers to wrap their little cigars in low-ignition propensity paper, which is more expensive than normal homogenized paper; and
- Force ITP and its manufacturer to change its manufacturing specifications.

Collectively, the costs of these consequences very well could force ITP and similarly situated small companies out of the little cigar market entirely.

⁷ 71 *Fed. Reg.* 62506, 62517, Oct. 25, 2006 (emphasis added).

⁸ The fact that little cigars constitute one percent of the volume of cigar and cigarette sales shows that the concerns expressed in the April 24, 2006 correspondence of various states that little cigars endangered the "integrity" of the Federal and State excise tax system is mere hyperbole.

Therefore, we propose the following: Change “or” to “and” in the third line of proposed Sections 40.12(b)(3)(ii), 41.12(b)(3)(ii), 42.12(b)(3)(ii), and 45.12(b)(3)(ii) after the word “filter.” Because the current proposed regulation is drafted in the disjunctive, the definition is overly broad. Replacing “or” with “and” accurately reflects the marketplace distinctions between little cigars and cigarettes. The revised § 40.12(b)(3)(ii) regulation, as the other draft regulations, would read:

(ii) It has a typical cigarette size and shape, has a cellulose acetate or other cigarette-type integrated filter, and is put up in a traditional cigarette-type package that does not bear all of the notice requirements for cigars specified in Sec. 40.214.

In addition, we propose four other changes:

(1) Because some importers (such as ITP) import little cigars from unaffiliated companies that are overseas, some importers do not necessarily have complete control over the manufacturing process. Therefore, proposed §§ 41.13 and 44.13 should provide that when importers are making certifications, they are allowed to rely upon reasonable representations by suppliers and vendors that the wrapper and tobacco comply with the requirements of proposed Section 41.12, and that importers not be liable for incorrect representations if the importer’s reliance thereon was reasonable.

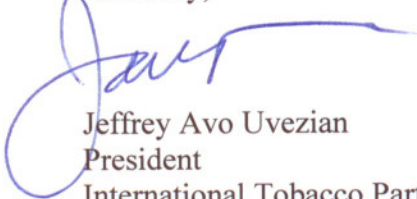
(2) The requirement for recertification concerning “any change” in the composition or presentation of tobacco products should be amended so as to only require recertification if there is a “material” change in the tobacco product.

(3) Regarding labeling to be required by §§ 40.214, 41.73, 44.186 and 44.253, the proposed rules should be modified to provide objective guidance for labeling, such as specifying the type sizes for required information.

(4) The final rules should provide for a transition time to give importers the opportunity to create new packaging, meet new reporting requirements, and sell off existing stock. We propose a transition period of 12 months from the time that the final rules are published in the *Federal Register*.

I would be pleased to discuss these issues with you in greater detail. I may be reached at 516-466-0700, or jeffreyavo@aol.com. Thank you for the opportunity to submit these comments, and for the attention you have given them.

Sincerely,



Jeffrey Avo Uvezian
President
International Tobacco Partners, Ltd.