



March 23, 2007

VIA ELECTRONIC MAIL AND FACSIMILE

Director, Regulations and Rulings Division
Alcohol and Tobacco Tax and Trade Bureau
(Attn: Notice No. 65)
P.O. Box 14412
Washington, DC 20044-4412

Re: Tax Classification of Cigars and Cigarettes (2006R-276P), 71 Fed. Reg. 62500
(October 25, 2006)

The Office of Advocacy offers the following comment in response to the above-referenced notice of proposed rulemaking (NPRM) entitled Tax Classification of Cigars and Cigarettes, published by the Department of Treasury (Treasury) and Alcohol and Tobacco Tax and Trade Bureau (TTB). The NPRM will affect taxpayers that manufacture, import or export cigars and cigarettes.

Office of Advocacy

Congress established the Office of Advocacy (Advocacy) under Pub. L. 94-305 to represent the views of small business before Federal agencies and Congress. The Regulatory Flexibility Act (RFA) as amended by the Small Business Regulatory Enforcement Fairness Act (SBREFA)¹ enhances small businesses participation in the Federal rulemaking process. Advocacy is an independent entity within the SBA, so the views expressed herein by Advocacy do not necessarily reflect the views of the SBA or the Administration. Section 612 of the RFA requires Advocacy to monitor agency compliance with the RFA. On August 13, 2002, President Bush underscored the importance of agency compliance with the RFA and Advocacy's role in giving a voice to small businesses in the rulemaking process when he signed Executive Order 13272 (E.O. 13272), titled "Proper Consideration of Small Entities in Agency Rulemaking."

Advocacy regularly disseminates information to, and solicits comments from, small businesses regarding proposed Federal rules affecting them. Advocacy takes its direction from small businesses. In order to understand the effect a particular proposal will have on small businesses within an industry Advocacy holds roundtables as one means of gathering information. On January 11, 2007, Advocacy met with small businesses that produce, import and export little

¹ Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. § 601 et seq).

cigars, to listen to their comments and concerns about the NPRM. The concerns raised during the meeting and from subsequent meetings are the basis of this comment.

Background

Section 5702(a) of the Internal Revenue Code of 1986 (IRC) defines a cigar as any roll of tobacco wrapped in leaf tobacco or in a substance containing tobacco (other than any roll of tobacco which is a cigarette within the meaning of section 5702(b)(2)). Sections 5723(a) and (b) of the IRC permit the Secretary of the Treasury to prescribe regulations providing standards for packaging, marks, labels and notices on every package of tobacco products.

Alcohol, Tobacco and Firearms (ATF), the predecessor agency to TTB, published a 1973 ATF Ruling (ATF-Rul. 73-22)² which established the current standards for the classification of cigars and cigarettes. Under ATF-Rul. 73-22 the elements of IRC section 5702(a) were refined to provide parameters for distinguishing cigars and cigarettes. The elements clarified by ATF-Rul. 73-22 are the wrapper, filler and packaging.

Wrapper

Wrapper material is considered “a substance containing tobacco” under ATF-Rul. 73-22 if the wrapper contains two-thirds or more tobacco and is a color consistent with natural leaf tobacco traditionally used as wrapper for American cigars.

Filler

The filler of a cigar must contain tobacco that is not cigarette tobacco and must not have the taste or aroma of a cigarette. If the filler is of the type that is typically used for a cigarette and the product has the typical shape and size of a cigarette then the product will be classified as a cigarette.

Packaging

If the product is in a typical cigarette package then the package must be clearly labeled “small cigars” or “little cigars” each time the brand appears.

Manufacturers and importers have the responsibility to determine if their product meets the definition of a cigar or cigarette. Upon request TTB issues an advance ruling on whether a product is a cigar or cigarette for tax purposes.

Under ATF-Procedures 73-5 (ATF-Proc. 73-5)³ and 76-2 (ATF-Proc. 76-2)⁴ basic analytical methods were published for use by ATF (now TTB) to determine whether the wrapper material is acceptable as a cigar wrapper and if the filler material is a cigar or cigarette for tax purposes. In general, the process described in the ATF Procedures allowed for visual inspection and microscopic testing of the components of the product to determine if the product was consistent with a cigar or cigarette for tax purposes.

² 1973-12 A.T.F.B. 1 (December 1973).

³ 1973-8 A.T.F.B. 14 (August 1975).

⁴ 1976-5 A.T.F.B. 7 (May 1976).

The Cigar Association of America has estimated that the gross retail sales of little cigars totaled \$312 million in 2005. While three large companies produce slightly over 50 percent of total sales, there are over 20 small firms that produce the remaining amount. While most small companies manufacturing little cigars also produce other tobacco products, many have invested substantially in producing little cigars for the U.S. and foreign markets. These small companies that produce, import or export little cigars have contacted Advocacy regarding this rule.

Companies that have contacted Advocacy typically derive as much as 40 to 80 percent of sales revenue from little cigars, although some derive as little as three to 20 percent. All of these companies expect little cigar sales revenue to increase in the future. However, the NPRM puts this future growth in doubt.

Tax Classification of Cigars and Cigarettes

The preamble of the NPRM indicates that the purpose of the proposed rule is to clarify the application of existing statutory definitions and to update and codify administrative policy in order to provide clearer and more objective product classification criteria.⁵ In NPRM section 40.12(a)(1) a tobacco product is classified as a cigar if:

- (i) It consists of a roll of tobacco wrapped in leaf tobacco; or (ii) It consists of a roll of tobacco that contains 3.0 percent by weight of total reducing sugars and that is wrapped in a substance containing tobacco, and it is not classified as a cigarette under paragraph (a)(2) of this section.

Section 40.12(a)(2) *cigarette classification precedence* provides as follows:

A tobacco product consisting of a roll of tobacco wrapped in a substance containing tobacco is classified as a cigarette rather than as a cigar if it is described in paragraph (b)(2) or (b)(3) of this section:

Section 40.12(b) *classification of cigarettes* – [a] tobacco product is classified as a cigarette if: (1) [i]t consists of a roll of tobacco wrapped in paper or in any substance not containing tobacco; (2) [i]t consists of a roll of tobacco that contains more than 3.0 percent by weight of total reducing sugars and that is wrapped in a substance containing tobacco; or (3) [i]t consists of a roll of tobacco wrapped in a substance containing tobacco; and (i) [i]t is put up in a package that bears a product designation or tax classification specified in section 40.215; (ii) [i]t 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 section 40.214 or (iii) [i]t has a filler primarily consisting of flue-cured, burley, oriental, or unfermented tobaccos or has a filler material yielding the smoking characteristics of any of those tobaccos.

The NPRM requires that a certification be filed with TTB by the manufacturer, if a tobacco product is classified as a cigar under section 40.12(a)(1)(ii) and before the product receives its tax stamp. Certification requires a statement signed under penalty of perjury that the product is a

⁵ 71 Fed. Reg. 62500, 62519 (October 25, 2006).

cigar. Additionally, if there is any change to the product including a change in packaging then a new certification is required.

All of the requirements above are applied equally to imported and exported cigars and cigarettes.

Regulatory Flexibility Act Certification

When an agency is developing a regulation and determines that the RFA applies then the agency must determine whether a certification of the rule is appropriate or whether an initial regulatory flexibility analysis (IRFA) is required. When an agency certifies under the RFA the agency states that the proposed rule will not have a significant economic impact on a substantial number of small entities. Under section 605(b) of the RFA an agency must provide a factual basis in support of the certification. At a minimum the factual basis must include: (1) identification of the regulated small entities based on the North American Industry Classification System (NAICS); (2) the estimated number of regulated small entities; (3) a description of the economic impact of the rule on small entities; and (4) an explanation of why either the number of small entities is not substantial and/or the economic impact is not significant under the RFA.

The factual basis provided by the NPRM's certification did not include the required elements listed above. Treasury and TTB support the certification by noting only that "[t]he proposed regulations primarily codify and clarify existing administrative tax classification principles and practices."⁶ The NPRM in its current form should not be certified under the RFA. Small entities in the little cigar industry have provided information that indicates the NPRM as proposed may have a significant economic impact on a substantial number of small entities.

The small entities that have contacted Advocacy will lose up to 80 percent of their sales revenue as a result of little cigars with cigarette type filters being reclassified as cigarettes. An 80 percent loss of sales revenue is a significant economic impact. All (i.e. a substantial number) of the small little cigar producers, exporters and importers will be affected by the changes in the NPRM. Consequently, the NPRM can not be properly certified under the RFA.

Industry Concerns

Small firms that have been in contact with Advocacy believe that little cigar reclassification as outlined in the NPRM will effectively end their ability to market little cigars in both domestic and foreign markets. Those small firms insist that the rule if finalized will make it impossible to sell little cigars as they have been produced and sold since the 1973 ATF ruling. The change in product definition will cause many of their products to be classified as cigarettes; this will trigger significant regulatory barriers at the state level and will inhibit their ability to export them.

Filters

Little cigars made by the small companies that have contacted Advocacy comply with the ATF-Rul. 73-22. However, they all contain a cellulose acetate or other cigarette type filter. These

⁶ Id. at 62500.

filters have been permitted as a component of little cigars since 1966.⁷ The NPRM would classify little cigars with filters as a cigarette which is a change from ATF-Rul. 73-22. Advocacy believes this is a significant deviation from existing administrative tax classification principles and practices.

State Regulations

Little cigar inclusion in the Master Settlement Agreement (MSA) is another significant change from existing administrative tax classification principles and practices. The NPRM has the potential to bring little cigars within the ambit of the MSA when prior law did not have that effect. Some states already have indicated that if the NPRM is finalized in its current form little cigars will be reclassified as cigarettes for state purposes and become subject to the MSA. There are 46 states that have signed the MSA. Under the MSA producers of little cigars would be required to have their product certified for sale in the states that are under the MSA. During the time that it takes to have the product certified the product would have to be removed from the market. Advocacy has been told that MSA certification can take up to several years.

Wrapper

Additionally, if little cigars are reclassified as cigarettes, special wrapper paper will be required in some states. Advocacy has learned that six states and Canada either currently have this requirement or will have the requirement by January 1, 2008. These states require cigarettes to be wrapped in low ignition propensity paper (LIPP). Current producers of little cigars are not certain that there would be a market for their product if it is required to be wrapped in LIPP. Reclassification of little cigars as cigarettes will significantly change the little cigar product. The NPRM does not address this potential economic impact in the regulatory analysis.

Exporters

The companies that export little cigars have explained that the countries to which they export have different labeling standards that are in conflict with the NPRM. This inconsistent treatment will prohibit future exportation of domestically produced little cigars; this economic impact has not been addressed in the NPRM.

Importers

Small importers have similar concerns. Some importers contract with unaffiliated suppliers that may or may not comply with the NPRM. Thus, the importer may not have total control over the final product. The lack of product control makes it difficult to comply with the certification process. This economic impact should also be addressed in the NPRM.

Certification

Advocacy believes that the certification requirement for little cigars as outlined in the NPRM is not consistent with existing administrative tax classification principles and practices. This new procedure requires additional information reporting. The NPRM suggests that any change to a product defined by the NPRM would necessitate a new certification. The small businesses that have had contact with Advocacy have suggested that recertification only be required when there

⁷ Rev. Rul. 66-123, 1966-1 C.B. 337 (a band of paper is permitted to be used to attach a tip to a cigar without reclassification of the cigar as a cigarette).

is a material change in the product. The economic impact of this provision has not been addressed in the NPRM.

Recommendations

TTB can do one of two things to come into compliance with the RFA. TTB can modify the rule so that the NPRM does not have a significant economic impact on a substantial number of small entities and then certify the rule with a factual basis. Alternatively, if TTB cannot properly certify the NPRM then an IRFA must be developed and published in the *Federal Register* with a period for notice and comment.

An IRFA must contain: (1) a description of the reasons why the regulatory action is being taken; (2) the objectives and legal basis for the proposed regulation; (3) a description and estimated number of regulated small entities; (4) a description and estimate of compliance requirements including any differential if any for different categories of small entities; (5) identification of duplication, overlap and conflict with other rules and regulations; and (6) a description of significant alternatives to the rule. Additionally, E.O. 13272 requires agencies to provide a copy of their draft IRFA to Advocacy at the same time it is provided to the Office of Management and Budget (OMB) under Executive Order 12866. However, if submission to OMB is not required, then the IRFA should be provided to Advocacy at a reasonable time prior to publication in the *Federal Register*.

Conclusion

Advocacy encourages the Treasury and TTB to review the comments of affected little cigar producers carefully, and recommends that Treasury and TTB either publish data supporting their certification under the RFA prior to moving forward with a final rule, or publish an IRFA with a period for comment. Advocacy stands ready to assist Treasury and TTB in the completion of the factual basis for the certification or for completion of an IRFA. If you have any questions or require additional information please contact Assistant Chief Counsel for Tax Candace Ewell at (202) 401-9787 or by email at Candace.Ewell@sba.gov. Thank you for this opportunity to contribute to the record.

Sincerely,

/s/
Thomas M. Sullivan
Chief Counsel for Advocacy

/s/
Candace B. Ewell
Assistant Chief Counsel for Tax

cc: Steven D. Aitken, Acting Administrator, Office of Information and Regulatory Affairs, OMB