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March 26, 2007

VIA EMAIL 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: Notice No. 65, Tax Classification of Cigars and Cigarettes

Dear Director:

Attached please find the comments of Alternative Brands, Inc., in response to Notice of Proposed Rulemaking No. 65, Tax Classification of Cigars and Cigarettes issued by the Alcohol and Tobacco Tax and Trade Bureau ("TTB") and published at 71 Federal Register 62,506 (2006).

Sincerely yours,

D. Randall Gibson
Counsel for Alternative Brands, Inc.

BEFORE THE ALCOHOL TOBACCO TAX AND TRADE BUREAU

In the Matter of:

Notice of Proposed Rulemaking No. 65	)	
Tax Classification of Cigars and Cigarettes in	)	
27 CFR Parts 40, 41, 44, and 45 and Notice	)	RM No. 65
of Total Reducing Sugars Analytical Method	)	

COMMENTS OF ALTERNATIVE BRANDS, INC.

Alternative Brands, Inc. ("ABI") submits these comments in response to Notice of Proposed Rulemaking No. 65, Tax Classification of Cigars and Cigarettes (the "Proposed Rule") issued by of the Alcohol and Tobacco Tax and Trade Bureau ("TTB") that is published at 71 Federal Register 62,506 (2006). ABI is located in Mocksville, North Carolina and is a manufacturer of cigars not weighing more than 3 pounds per thousand (See, 26 U.S.C. 5701(a)(1)) ("little cigars") and cigarettes.

TTB's stated goals of the Proposed Rule are to address concerns regarding the regulatory distinction between little cigars and cigarettes and to clarify existing statutory definitions to provide more objection product classification. *See* 71 Fed. Reg. 62,506 (2006). Instead, the Proposed Rule as currently written would have a devastating economic impact on the little cigar industry, would dramatically change the scope of the TTB regulations, and would place unwarranted and counterproductive emphasis on such irrelevant issues as whether the product has a filter. ABI further notes that packaging and labeling rules, while helpful in part, do nothing to establish an objective, easily-discerned physical appearance for the product itself. Accordingly, ABI hereby submits proposed

changes that will meet TTB's stated objectives but will prevent the unnecessary and unwarranted economic destruction of the little cigar industry.

INTRODUCTION

ABI agrees with the decision of TTB to develop a more objective and dependable standard by which little cigars can be distinguished from cigarettes for tax purposes. ABI also agrees with most of the regulatory changes set forth in the Proposed Rule. However, there are key provisions in the Proposed Rule that would eliminate little cigars in the marketplace and that should be changed for both legal and policy reasons, as is further explained below.

Any regulations adopted by TTB must be based on the statute adopted by Congress to regulate cigarettes and little cigars. Internal Revenue Code § 5702 sets forth the definition of cigars and cigarettes that TTB must follow in implementing any new regulation on the subject and provides as follows:

> **§ 5702. Definitions.**
>
> When used in this chapter –
>
> (a) Cigar. "Cigar" means 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 subsection (b)(2)).
>
> (b) Cigarette. "Cigarette" means –
>
> (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).

The statute specifically and clearly provides that a roll of tobacco wrapped in a substance containing tobacco cannot be a cigarette ***unless*** it is ***likely to*** be offered to, or purchased by, consumers as a cigarette. In addition, Congress identified three specific factors that could create the sort of confusion that would cause a little cigar to be falsely perceived by the public as a cigarette: [1] appearance, [2] filler or type of tobacco, and [3] packaging and labeling. This three-factor analysis, recognized by TTB in Revenue Ruling 73-72, must be the basis of any analysis of product features that could bear on whether the product is likely to be viewed by the consumer as a cigarette or a little cigar.

During the process of reviewing and possibly revising the regulations adopted by TTB to govern the taxation of cigarettes and cigars, TTB received three petitions requesting rulemaking by TTB on little cigars. The Cigar Association of America requested TTB to maintain the integrity of the little cigar class by revising the regulations, emphasizing the need to resolve the confusion concerning the definition of "little cigars," citing state attorney general concerns that some "little cigars" are actually "cigarettes in disguise," and requesting "firm guidance" from TTB so that the products can be reasonably distinguished from each other. Cigarette manufacturers, Lorillard Tobacco Company and R.J. Reynolds Tobacco Company, sought to amend the classification of little cigars to re-characterize little cigars. They cite concerns that tobacco products are now being marketed as "little cigars" rather than as "cigarettes" in order to "bypass federal and state tax burdens, reporting requirements, and MSA payments." Certain Settling States (as defined in the Master Settlement Agreement), collectively in their petition (the "States' Petition") and in furtherance of their collaborative efforts, sought new definitions for cigars and cigarettes in order to eliminate

little cigars as a separate classification, charging that some manufacturers deliberately market "cigarettes" as "little cigars" in order to offer consumers a cheaper way to continue smoking "cigarettes." A product sold as a "little cigar" is cheaper because cigar manufacturers do not need to pass on to consumers the high cigarette tax or Master Settlement Agreement ("MSA") payments. The State Petition decries the increasing difficulty in telling "little cigars" and "cigarettes" apart; notes that tax revenue is lost when "cigarettes" are marketed as "little cigars;" and complains that MSA payments are not made on products that are actually "cigarettes" but are being called "little cigars."

These petitions emphasize the difficulty in legally distinguishing little cigars from cigarettes – a difficulty largely resulting from the physically similar appearance of these products. Based on these petitions, TTB issued its Proposed Rule.

ABI urges TTB to adopt Final Rules that incorporate the following proposed changes that will avoid the economic impact to the little cigar industry of the Proposed Rule. These changes will provide an effective regulatory scheme that complies with the statutory requirements, that takes into account facts and issues relevant to the purposes of the classification scheme, and that should satisfy all legitimate and good faith concerns of the various parties.

TTB SHOULD MODIFY THE PROPOSED RULE TO MAKE THE FINAL RULE CONSISTENT WITH TTB'S STATED INTENT AND THE CODE

ABI submits the following specific changes to the Proposed Rule and an analysis supporting these changes:

1. Product Appearance – A Diagonal Wrapper

The statute focuses on the *appearance of the wrapper* as a key element in determining whether the appearance of a tobacco product is likely to be offered to or purchased by consumers as a cigarette. A roll of tobacco with a wrapper made of tobacco is a cigar. A roll of tobacco with a wrapper made of paper is a cigarette. A roll of tobacco with a wrapper made of reconstituted tobacco will be considered a little cigar unless a consumer would likely purchase it as a tobacco product with a wrapper made of paper.

One alternative to avoid confusion in the marketplace and among regulators as to whether a tobacco product with a wrapper made of reconstituted tobacco is a little cigar or a cigarette, is to make an objective, easily ascertainable, and statutorily-authorized legal distinction between little cigars and cigarettes by recognizing in the regulations a further distinction for little cigars in the appearance of the wrapper. Defining a product as a little cigar on the basis that it has a diagonal wrapper made of reconstituted tobacco would be a simple and cost effective way to ensure that a little cigar is sold as, and taxed as, a little cigar, and that a cigarette is sold as, and taxed as, a cigarette. The European Union has adopted a similar standard to distinguish little cigars.

By adding the following language to the definition of little cigars in proposed Sections 40.12(a)(1), 41.12(a)(1), and 44.12(a)(1) as new Sections 40.12(a)(1)(iii); 41.12(a)(1)(iii) and 44.12(a)(1)(iii), TTB would ensure that little cigars with wrappers made of reconstituted tobacco would be easily distinguishable from cigarettes:

> "(iii) It consists of a roll of tobacco that contains no more than 3.0 percent by weight of total reducing sugars and that is wrapped in a substance containing tobacco where the wrapper is fitted in a spiral form with an acute angle of at least 30 degrees to the longitudinal axis of the tobacco product."

It is imperative, when possible, that governmental agencies provide the regulated community with a simple and reasonable means of meeting legitimate regulatory goals. By Executive Order, every federal agency is obligated to simplify the regulatory process where possible by ensuring that the regulatory cure addresses only the regulatory problem, and that it does so in the most efficient, cost-effective manner available, "tailor[ing] its regulations to impose the least burden on society." Exec. Order No. 12,866 (1993). Adoption of a diagonal wrapper standard would solve the problems identified in the Proposed Rule and the petitions for rulemaking, and it would do so simply, in a way that would be easily and immediately understood by the regulators, manufacturers, producers, and consumers.

2. Definition of Little Cigars

Contrary to the Statute and the stated intentions of TTB, the Proposed Rule reclassifies virtually all little cigars as cigarettes even if such little cigars are not likely to be offered to, or purchased by, consumers as cigarettes. The new definition of cigarettes set forth in the Proposed Rule (PR 40.12(b)(3)(ii), 41.12(b)(3), and 44.12(b)(3)) (the "New Definition") would reclassify almost all little cigars as cigarettes by providing that a single characteristic of a tobacco product can automatically classify it as a cigarette. However, the existence of one characteristic cannot render a tobacco product a cigarette under the Statute if, on balance, the other characteristics of the product make it unlikely to be offered or purchased as a cigarette. A regulation cannot withstand judicial scrutiny if it exceeds the agency's statutory authority. 5 U.S.C. § 706 (2)(C); *See also Industrial Union Dept., AFL-CIO v. American Petroleum Institute,* 448 U.S. 607, 641-643 (1980).

Nor can a regulation survive review when the promulgating agency "has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Prometheus Radio Project v. F.C.C.,* 373 F.3d 372, 390 (3rd Cir. 2004), *cert denied sub nom F.C.C. v. Prometheus Radio Project,* 545 U.S. 1123 (2005). The New Definition does not meet these standards. As proposed, it addresses two tobacco product characteristics related to appearance: "typical cigarette size and shape" and "integrated filters." If a roll of tobacco is wrapped in reconstituted tobacco and has either one of these characteristics, the New Definition would classify the product as a cigarette. This result is not only contrary to the statute, there is absolutely no basis for it in practice or custom. For more than 50 years, little cigars and cigarettes have shared the common features of their shape and size and the presence of a filter.

By definition, cigarettes and little cigars are defined exactly the same by Congress: "a tobacco product that weighs no more than 3 pounds per thousand." 26 U.S.C. § 5701. This weight limitation virtually dictates that little cigars and cigarettes will have the same size and shape – there is no other option. In fact, the size and shape of little cigars and cigarettes have been the same since little cigars have been manufactured. To suggest that consumers are as likely to purchase a little cigar as a cigarette, based solely on the size and shape of the product, is absurd; and if this were the case, little cigars would be as prevalent in the marketplace as cigarettes. There must be a "rational connection between the facts found and the choice made" by an administrative agency.

Bowen v. American Hospital Ass'n, 476 U.S. 610, 626 (1986) (internal citation omitted). *See also Prometheus Radio Project,* 373 F.3d at 390, *quoting Burlington Truck Lines, Inc. v. United States,* 371 U.S. 156, 168 (1962) (Courts "ensure that, in reaching its decision, the agency examined the relevant data and articulated a satisfactory explanation for its action, including a 'rational connection between the facts found and the choice made.'"). The facts here preclude such a rational connection in support of the New Definition, which apparently is based on the flawed conclusion that consumers would purchase, or have purchased, little cigars as cigarettes solely on the basis of a similarity in size and shape.

Next, almost all little cigars have integrated filters. Because both little cigars and cigarettes have integrated filters, the filter by itself could not make it likely that consumers would be offered or purchase the tobacco product as a cigarette rather than a little cigar. Again, if this were the case, little cigars would be as prevalent in the marketplace as cigarettes. In fact, Congress has refused to classify little cigars as cigarettes simply because they are the same size and shape as cigarettes and have integrated filters. *See* Little Cigar Act of 1973, Pub. L. 93-109, 87 Stat. 352.

Even if TTB's proposed rule were in compliance with Congressional directives, a governmental discouragement of the placement of any "cigarette-type integrated filter" on a cigar, lest it be considered a "cigarette," is seriously flawed policy that is counter to regulatory goals. TTB, in adopting the Proposed Rule, infers, and the Settling States directly claim, that one of the reasons the changes encompassed by the Proposed Rule should be adopted is to protect the public health. If this is so, why, then, in pursuing this goal, should TTB institute a rule that would encourage manufacturers of little cigars to

make the product *less* safe by eliminating the integrated filter? Eliminating the filter would be adverse to public health. Once again the Proposed Rule runs afoul of the Supreme Court's warning to agencies in *Bowen* and *Burlington* that there must be a "rational connection" between the facts and the agency's regulatory choices. There is no rational connection whatsoever between seeking to protect the public health and discouraging the placement of a filter on a little cigar.

Rather than focus on peripheral, and ultimately counterproductive, issues, TTB should recognize that the ultimate inquiry under the statute must be whether it is *likely* that a roll of tobacco would be offered to, or purchased by, consumers as a cigarette based on the collective review of the three factors: appearance, filler and packaging. Instead, the Proposed Rule defines cigarettes (PR 40.12(b)(3)(ii) to include a roll of tobacco wrapped in a substance containing tobacco that (1) "has a typical cigarette size and shape"; ***or*** (2) "has a cellulose acetate or other cigarette-type integrated filter"; ***or*** (3) "is put up in a traditional cigarette-type package that does not bear all of the notice requirements for cigars." (Emphasis added). Since this definition is phrased with the disjunctive "or" rather than the conjunctive "and," the Proposed Rule ignores the multi-factor analysis required by the Code and would cause the destruction of the little cigar industry. In order to correct this problem, the Final Rules should replace the "or" with the word "and."

Sections 40.12(b)(3)(ii), 41.12(b)(3)(ii), and 44.12(b)(3)(i) of the Final Rule should read as follows:

> "(3) It consists of a roll of tobacco 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/ 41.74 respectively; this section omitted from §44.12];
>
> (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 § [40.214/ 41.73/44.186 or 44.253 respectively]; or
>
> (iii) It 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. (Emphasis added).

3. Recertification.

In the Proposed Rule, §§ 40.13(b), 41.13(b), 44.13(b) and 45.13(b) state that if, after submitting a certification to TTB under §§ 40.13(a), 41.13(a), 44.13(a) or 45.13(a), there is "***any change***" in the composition or presentation of the product, a recertification must be filed. The purpose of the recertification rule is to notify TTB of changes in the classification of the product. The Proposed Rule as written, though, would require the filing of constant re-certifications for changes that do not effect the classification of the product. For example, each lot of tobacco is slightly different from a prior lot and would require a new re-certification even though no change in the classification of the tobacco product occurred. Similarly, different color schemes on packaging would change the presentation and would require a re-certification by the Proposed Rule. In order to capture the intent of the recertification rule, ABI recommends that the following language replace the current language in 40.13(b), 41.13(b), 44.13(b) and 45.13(b) in the Final Rules:

> "If after the filing of a certification, there is any change in the composition or presentation of the product so that a change occurs in the classification of the product as a cigar under 20 CFR 40.12 (or 41.12, 44.12 or 45.12 respectively), the manufacturer/importer must file a new certification that (1) the product complies with the rules for classification as a cigar; or (2) the product does not comply with the rules for classification as a cigar."

4. Export labeling.

Proposed Rules §§ 44.186 and 44.253 specify how packaging of cigars intended for export must be labeled. These provisions repeat the labeling requirements set forth in proposed Section 40.214, which are applicable to cigars intended for sale in the United States market. Packaging for cigars intended for export should be allowed to conform to the labeling requirements of the country of import, not those of the United States. As currently written, the Proposed Rule would eliminate the export market for little cigars. All exports would have to comply with labeling requirements for the United States and then, before being distributed in the country of export, would have to be re-packaged with labeling requirements of the foreign country. The cost of such activity would be prohibitive and its imposition by regulation arbitrary and capricious. Thus, the labeling provisions of Sections 44.186 and 44.253 should be replaced with the requirement that packages of cigars intended for export be conspicuously labeled with the statement "for export only."

5. Cigar certifications.

The manufacturers of little cigars should be able to rely upon certifications of suppliers of tobacco products, including filler and wrappers, in making the certifications required by the Proposed Rule. The suppliers of these products are in a better position to certify to the content of these products than the manufacturer. ABI recommends that the

following language be added to proposed Sections 40.13, 41.13 and 44.13 to provide that in making certifications, manufacturers and importers may rely upon reasonable representations by suppliers and vendors that both the wrapper and tobacco comply with the requirements of proposed Section 40.12, 41.12, or 44.12, respectively:

> I _______________(name of person executing certification) of __________ (name and address of manufacturer) hereby certify under penalty of perjury that the product designated __________________ (brand and style of product) _____ complies with _________ does not comply with (check one) the rules for classification as a cigar within 27 C.F.R. 40.12.
> ____________________________ (Signature and Date)
>
> I _______________ certify that the above certification was made based upon the reasonable reliance on representations made by ________________________ (name and address of suppliers), who supply __________________ to ____________________ (name of manufacturer).
>
> I __________________ authorize the Alcohol and Tobacco Tax and Trade Bureau (TTB) to publish the information I have provided with regard to the above tax classification certification.

6. Labeling requirements.

In §§ 40.214, 41.73, 44.186, 44.253, and 45.44 of the Proposed Rule, TTB sets forth requirements for the labeling of cigars. These requirements include the directive that the packaging for little cigars must contain certain conspicuous language. However, the Proposed Rule does not provide any objective standards, but requires labeling in such subjective terms that the Rule is ambiguous. ABI recommends that the Proposed Rule be modified to provide some objective guidance for manufacturers/importers in labeling by adding the following language to §§ 40.214, 41.72, 44.186, 44.253 and 45.44:

(c) *Conspicuousness of type.*

(1) For purposes of § [40.214(b) /41.73(b) /44.186(b)/ 44.253(b)/45.44(b) respectively] "conspicuousness of type" or "conspicuous" shall appear in the following type size in relation to total surface area of the largest panel of the package:

(a) Surface area of less than 5 square inches
Type size: 9 point

(b) Surface area of 5 inches to less than 10 square inches
Type size: 10 point

(c) Surface area of 10 inches to less than 15 square inches
Type size: 11 point

(d) Surface area of 15 inches to less than 25 square inches
Type size: 12 point

(e) Surface area of 25 inches to less than 40 square inches
Type size: 14 point

(f) Surface area of 40 or more square inches
Type size: 16 points

In addition, specific objective guidance should be given as to color contrast requirements.

7. Effective Date - Transition Time.

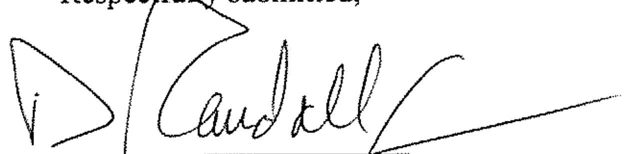
ABI requests that the Final Rules become effective no sooner than one (1) year after issuance. Manufacturers and importers will need time to adjust and transition to the new requirements or to conduct an orderly liquidation of their businesses if the little cigar industry is no longer viable after issuance of the Final Rules. New packaging may need to

be created, and existing stocks of packaging should be permitted to be used so as not to impose a significant financial burden on manufacturers/importers.

CONCLUSION

For the foregoing reasons, ABI respectfully requests that the Proposed Rule be modified and amended to incorporate the recommendations set forth above.

Respectfully submitted,



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