



March 26, 2007

Director, Regulations and Rulings Division
Alcohol and Tobacco Tax and Trade Bureau
P.O. Box 14412
Washington, DC 20044-4412

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

Dear Director:

McLane Company, Inc. is the nation's largest wholesaler of consumer packaged goods, including cigarettes and tobacco, to the convenience store, mass merchant, drug, and other retail channels. McLane is licensed to distribute cigars and cigarettes in all 50 states and the District of Columbia, supplying regularly more than 34,000 customer locations nationwide. We appreciate this opportunity to offer comments on the Proposed Rulemaking on Tax Classification of Cigars and Cigarettes.

The Proposed Rule largely represents a solution in search of a problem as well as the imposition of a new tax created entirely administratively, *ultra vires* of Congress' authorization and intent. The Proposed Rule would dramatically change, rather than clarify, the criteria that distinguish cigars from cigarettes, and change, rather than codify, longstanding administrative practice.

Contrary to many petitioners' contentions, we perceive no widespread disparity or problem in which manufacturers of little cigars are fraudulently marketing little cigar products as cigarettes in order to avoid taxes and MSA obligations. Were that the case, given the fact that little cigars are priced lower than cigarettes, we would have expected to see a dramatic spike in little cigar sales. We have not seen that. While other tobacco products may provide alternatives to smoking cigarettes, we see no indication that little cigars are being accepted as substitutes for cigarettes.

Little cigars are a substantially distinct product from cigarettes. While they have always had a superficial resemblance to cigarettes, they differ fundamentally in composition. Little cigars are made of cigar – not cigarette – tobacco, they are wrapped in leaf tobacco or in reconstituted tobacco, and they are clearly labeled and promoted as little cigars. Merely because they comprise a roll of tobacco, wrapped in a substance containing tobacco, and have an integrated filter tip, does not make them cigarettes; yet under the Proposed Rule they would be treated as such. TTB’s final rule should eliminate the disjunctive test for “cigarette” set forth in proposed section 40.12(b).

Additionally, there are important marketing distinctions between cigarettes and little cigars. Our retail customers typically do not display little cigars alongside cigarettes, but rather with cigars and other non-cigarette products. Indeed, many little cigar products are simply line extensions of large cigar brands. If the Proposed Rule is finalized in its current form, little cigar brands can expect something of a “double whammy”: In addition to the increased tax burden, their marketing efforts are likely to experience difficulties in breaking into retailers’ cigarette displays because of the cigarette incumbents’ influence on those areas through contract and slotting allowances.

We are also concerned with the Proposed Rule’s inclusion of the 3% sugar reduction test. Pipe tobaccos typically are infused with substances high in sugar; and today, numerous products exist that consist of such pipe tobaccos rolled in cigar paper to form a large cigar. Because these products cannot meet the 3% sugar reduction test, they would be treated under the Proposed Rule the same as cigarettes. But they are far from cigarettes, and far more akin to conventional cigars. They take the form of large cigars, with a much larger diameter than cigarettes or little cigars, are packaged like other large cigars, are displayed alongside cigars, and are perceived by consumers as cigars and not cigarettes. Subjecting these pipe-tobacco cigars to the same taxation requirements as cigarettes would be functionally to create the new category of “large cigarettes,” a product not marketed in the United States today. This fact is important because wholesalers, whose responsibility it is to affix tax indicia in the various state and local jurisdictions, do not currently have stamping machines that are equipped to handle these products’ unconventionally-sized (relative to cigarette packs)



packaging. It is likely that few if any wholesalers could justify dedicating an entire separate stamping operation for these unique products, and thus could be forced to make the economic decision to discontinue carrying the products rather than incur these additional costs – a decision that would be detrimental to wholesalers and devastating to these products' manufacturers, such as John Middleton, Inc.

In sum, the Proposed Rule if adopted would threaten the very viability of a substantial segment of the cigar industry. Particularly when it comes to fashioning new taxes as the Proposed Rule would do, we believe such drastic action should be taken only at the clear direction of Congress, not administratively through new and creative applications of regulatory action.

Respectfully yours,

McLANE COMPANY, INC.

A handwritten signature in black ink, appearing to read "Bart McKay", with a stylized flourish at the end.

Bart McKay
Associate General Counsel

