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March 26, 2007

Mr. Frank W. Foote, Director
Regulations and Rulings Division
Alcohol and Tobacco Tax and Trade Bureau
Attn: Notice No. 65
P.O. Box 14412
Washington, D.C. 20044

Re: Proposed Tax Classification Rules for Cigars and Cigarettes

Dear Mr. Foote:

Reynolds American Inc. (RAI) respectfully submits these comments on the Bureau's proposed changes to the rules governing the classification of cigars and cigarettes for federal excise tax purposes. 71 Fed. Reg. 62,506 (Oct. 25, 2006). RAI is the parent of R.J. Reynolds Tobacco Company (RJR) and Santa Fe Natural Tobacco Company, which manufacture cigarette brands accounting for about 30 percent of U.S. cigarette sales, and Lane Limited (Lane), which manufactures two little cigar brands (Winchester and Captain Black) accounting for about 20 percent of U.S. little cigar sales.

RAI applauds the Bureau's effort to identify an analytic method that will yield "a clear and objective line of distinction" between cigarettes and cigars. 71 Fed. Reg. at 62,509. RAI also agrees with the Bureau that comparing the sugar content in the filler tobacco used in cigars to the sugar content in the filler tobacco used in cigarettes might yield such a line of distinction. *See id.* Lane's little cigar brands would remain classified as little cigars under the 3.0 percent line drawn in the proposed rules. Nevertheless, RAI believes that more sampling is required on a much broader range of products before the Bureau can establish sound sugar content criteria.

At the same time, RAI respectfully submits that proposed § 40.12(b)(3)(ii) and its counterparts in Parts 41, 44 and 45 are contrary to law. In addition, proposed §§ 40.214, 44.186 and 44.253 could cause significant legal and practical problems for exports. RAI has suggested below a way in which the Bureau might avoid those problems.

1. The Little Cigar Act of 1973 precludes the definition of "cigarette" proposed in § 40.12(b)(3)(ii).

Under proposed § 40.12(b)(3)(ii), a tobacco product would be classified as a cigarette if the product (1) "consists of a roll of tobacco wrapped in a substance containing tobacco" and (2) has "a typical cigarette size and shape" or "a cellulose acetate or other cigarette-type integrated filter." Under this definition, Winchester and Captain Black –

20 percent of the U.S. little cigar market – would be reclassified as cigarettes. Federal law does not allow the Bureau to classify tobacco products as cigarettes on this basis.[1]

Proposed § 40.12(b)(3)(ii) purports to interpret IRC § 5702(b)(2). IRC § 5702(b)(1) defines "cigarette" as "any roll of tobacco wrapped in paper or in any substance not containing tobacco." IRC § 5702(b)(2) further defines "cigarette" as "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 Bureau has not set out any reasons for classifying as a cigarette a roll of tobacco wrapped in any substance containing tobacco if the roll has "a typical cigarette size and shape" or "a cellulose acetate or other cigarette-type integrated filter." This omission is fatal to proposed § 40.12(b)(3)(ii). *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 41 (1983).

The only statutory language on which the Bureau *might* rest proposed § 40.12(b)(3)(ii) is the language of IRC § 5702(b)(2) classifying as a cigarette a roll of tobacco wrapped in any substance containing tobacco which, because of its "*appearance*," is likely to be offered to, or purchased by, consumers as a "cigarette" described in IRC § 5702(b)(1). In light of the Little Cigar Act of 1973, however, the fact that a roll of tobacco wrapped in any substance containing tobacco has "a typical cigarette size and shape" or "a cellulose acetate or other cigarette-type integrated filter" does *not* make the roll one that, "because of its appearance," is likely to be offered to, or purchased by, consumers as a "cigarette" described in IRC § 5702(b)(1).

The Little Cigar Act of 1973 was an amendment to the Federal Cigarette Labeling and Advertising Act (FCLAA), 15 U.S.C. § 1331 *et seq.* As enacted in 1965, FCLAA required a Surgeon General's warning on packages of cigarettes manufactured, packaged, or imported for sale or distribution in the United States.[2] FCLAA's definition of "cigarette" is the definition set forth in IRC § 5702(b). *See* 15 U.S.C. § 1332(1).[3]

In 1970, Congress amended FCLAA to ban cigarette advertising on any medium of electronic communication subject to the jurisdiction of the Federal Communications Commission; the ban took effect on January 1, 1971.[4] Thereafter, in September 1971, RJR began test-marketing Winchester, a little cigar, a product that had been in devel-

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[1] RAI's comments on proposed § 40.12(b)(3)(ii) also apply to proposed §§ 41.12(b)(3)(ii), 44.12(b)(3)(ii), and 45.12(b)(3)(ii).

[2] Pub. L. No. 89-92, § 4, 79 Stat. 282, 283 (1965) (codified as amended at 15 U.S.C. § 1333).

[3] *See* Federal Cigarette Labeling and Advertising Act, H.R. Conf. Rep. No. 586, 89th Cong. 5 (1965) (noting that FCLAA uses IRC definition of "cigarette").

[4] Public Health Cigarette Smoking Act of 1969, Pub. L. No. 91-222, § 2, 84 Stat. 88, 89 (1970) (enacting FCLAA § 6 (codified as 15 U.S.C. § 1335)).

opment since 1968,[5] advertising the product in the broadcast media.[6] According to the Federal Trade Commission:

> Winchester cigars are the same size as king size cigarettes (85 millimeters long), have filter tips, and are sold in packages of 20. However, the wrapper is made from reconstituted tobacco rather than paper and is brown in color; the tobacco in the inner roll resembles that used in cigars rather than cigarettes; and the packaging identifies the product as a cigar and not a cigarette.[7]

Products like Winchester without a filter apparently had been on the market since the late 1950s; products like Winchester with a filter apparently had been on the market since the mid-1960s.[8]

Applying the definitions in IRC § 5702, which were the same as those in FCLAA, the IRS classified Winchester as a "little cigar." Because FCLAA's advertising ban applied only to "cigarettes," and "the product was determined not to be a cigarette," "there was no legal prohibition on the advertising of Winchester in the broadcast media."[9] Indeed, the Department of Justice told Congress that the FCLAA and IRC "cigarette" definition "cannot be stretched" to cover little cigars and that "new legislation will be necessary."[10] P. Lorillard, another cigarette manufacturer, began to advertise Omega, its little cigar brand, in the broadcast media.[11]

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[5] *Public Health Cigarette Amendments of 1971: Hearings on S. 1454 before the Consumer Subcomm. of the Senate Comm. on Commerce*, 92nd Cong. 123 (1972) ("Senate Hearings") (testimony of James F. Hind, Product Manager, R.J. Reynolds Tobacco Co.).

[6] Little Cigar Act of 1973, S. Rep. No. 93-103, at 3 (1973). *See also* Senate Hearings, *supra* note 5, at 220-21 (testimony of Bruce B. Wilson, Deputy Assistant Attorney General, Antitrust Division, Dep't of Justice).

[7] Excerpt of Federal Trade Commission, *Report to Congress Pursuant to the Public Health Cigarette Smoking Act*, Dec. 31, 1972, *reprinted in* Little Cigar Act of 1973, H.R. Rep. No. 93-323, at 7-8 (1973); *see also* Senate Hearings, *supra* note 5, at 124, 126 (testimony of James F. Hind, Product Manager, R.J. Reynolds Tobacco Co.) (describing Winchester); *id.* at 159 (photograph comparing large cigars, cigarettes, and small or little cigars); *id.* at 593 (reproduction of Winchester print advertisement).

[8] *Id.* at 157 (testimony of Paul W. Garbo, Scientific Consultant and Director, General Cigar Co.); *see also* H.R. Rep. No. 93-323, at 9 ("[M]ore than two dozen varieties of domestic small cigars are marketed in this country. Most varieties have filters; all are sold in packages of 20 and resemble cigarettes in size and shape.").

[9] S. Rep. No. 93-103, at 4.

[10] Senate Hearings, *supra* note 5, at 220 (testimony of Bruce B. Wilson, Deputy Assistant Attorney General, Antitrust Division, Dep't of Justice).

[11] *See* S. Rep. No. 93-103, at 5-6. *See also Little Cigars: Hearings on H.R. 7482, S. 1165, and H.R. 3828 before the House Comm. on Interstate and Foreign Commerce*, 93d Cong.

(continued…)

Citing health concerns about little cigars expressed by the Surgeon General, the Federal Trade Commission recommended that Congress amend FCLAA's definition of "cigarette" to include "'all rolls of tobacco weighing not more than 3 pounds per thousand, without regard to the kind of tobacco in the inner roll of the substance in which the roll is wrapped.' Such a change would classify as 'cigarettes' all products now designated 'small cigars' for purposes of the prohibition against broadcast advertising."[12] Senator Lehman introduced a bill to amend FCLAA's definition of "cigarette" to include little cigars as the Commission recommended. *See* H.R. 3828, 93d Cong. (1973).

In the Little Cigar Act of 1973, Congress rejected this approach. Instead of banning the electronic advertising of little cigars like Winchester – *i.e.*, little cigars with a typical cigarette size and shape and or a cigarette-type integrated filter – by amending FCLAA's definition of "cigarette" to include such little cigars, Congress amended FCLAA to ban the electronic advertising of cigarettes *and* little cigars, Pub. L. No. 93-109, 87 Stat. 352 (1973). First, Congress recognized a "little cigar" category distinct from cigarettes, defining the term to mean –

> any roll of tobacco wrapped in leaf tobacco or any substance containing tobacco (other than any roll of tobacco which is a cigarette within the meaning of subsection (1)) and as to which one thousand units weigh not more than three pounds.

Id. § 2, 87 Stat. at 352 (codified at 15 U.S.C. § 1332(7)). Then, Congress inserted the words "and little cigars" after the word "cigarettes" in the FCLAA's ban on electronic advertising. *Id.* § 3, 87 Stat. at 352 (codified at 15 U.S.C. § 1335). By this means, Congress extended the ban on electronic advertising to include little cigars like Winchester, with a typical cigarette size and shape and or a cigarette-type integrated filter, while retaining the distinction between little cigars and cigarettes. In so doing, Congress explained that the definition of "little cigars" "would encompass all rolls of tobacco, other than cigarettes, which are the same size as cigarettes."[13]

In short, in enacting FCLAA in 1965, Congress used the definition of "cigarette" set forth in IRC § 5702. In amending FCLAA in 1973, Congress relied on the IRS' interpretation of the IRC definition of "cigarette." Rejecting calls to ban electronic advertising of little cigars like Winchester by amending FCLAA's definition of "cigarette" to include such little cigars – which would have resulted in a nonuniform definition of "cigarette" under FCLAA and the IRC – Congress banned electronic advertising of little cigars like Winchester, treating such little cigars as *not* coming within the FCLAA/IRC definition of "cigarette."

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60 (1973) (testimony of Senator Cook (attaching partial listing of little cigar manufacturers)).

[12] S. Rep. No. 93-103, at 4.

[13] *Id.* at 6. *See also* Comments of the Cigar Association of America, Inc., at 9-12.

For the Bureau to reclassify little cigars like Winchester as cigarettes under IRC § 5702(b), as proposed § 40.12(b)(3)(ii) would do, would be contrary to Congress' aim of maintaining a uniform definition of "cigarette" under FCLAA and the IRC, contrary to Congress' conclusion that little cigars like Winchester should *not* be classified as cigarettes under that definition, and render the amendments made by the Little Cigar Act of 1973 superfluous.

2. The Bureau Should Allow Exemptions From The Proposed Labeling Requirements For Cigars For Export.

Proposed § 40.214(a) would require cigar packages to be labeled as "cigars," to state the quantity of cigars contained in the package, and to provide notice of the cigar's classification as a "small" or "little" cigar, if the cigars are so classified for federal excise tax purposes. Proposed § 40.214(b) specifies the placement of the "small" or "little" cigar notices on packages that are "comparable to traditional cigarette packages." In the case of cigars for exports, these requirements could collide with labeling requirements for the countries of destination, thereby creating legal and practical problems for the manufacturer. The Bureau has not set forth any reason for applying these requirements to cigars for export. *See State Farm Mut. Auto. Ins. Co.*, 463 U.S. at 41.[14]

As the Bureau recognizes, "tax administration under the IRC is the only appropriate basis for the regulatory changes proposed in the new rules." 71 Fed. Reg. at 62,516. Little cigars for export, however, are not subject to federal excise taxes. *See United States v. IBM Corp.*, 517 U.S. 843 (1996). The Bureau has not identified any reason why placing labeling requirements on little cigars for export would further the tax administration goals of the proposed rules.

Second, Congress generally does not require tobacco products for export to meet domestic labeling requirements. For example, FCLAA generally exempts from its warning label requirements "cigarettes manufactured, imported, or packaged (1) for export from the United States or (2) for delivery to a vessel or aircraft, as supplies, for consumption beyond the jurisdiction of the internal revenue laws of the United States." 15 U.S.C. § 1340.

Third, the proposed rules could place the labeling of cigars for export legally at odds with the labeling requirements of the importing country or create practical problems in light of such requirements. Many countries have their own labeling requirements and the proposed rules could directly conflict with those requirements, thus preventing little cigar manufacturers from accessing those foreign markets. Even where the labeling requirements do not directly contradict foreign law, there may be practical problems with complying with both the proposed rules and foreign labeling laws given the limited space available on little cigar packaging. The Bureau can avoid these prob-

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[14] These comments also apply to proposed §§ 44.186 and 44.253.

lems by providing a procedure for obtaining an exemption from the proposed labeling requirements upon an appropriate showing.

* * *

For the reasons stated, the Bureau should not adopt proposed § 40.12(b)(3)(ii) or its counterparts in Parts 41, 44 and 45. The Bureau should also provide a procedure for obtaining exemptions from the requirements of §§ 40.214, 44.186 and 44.253 for cigars for export.

Sincerely,

/s/

David H. Remes
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Reynolds American Inc.