Before the Alcohol and Tobacco Tax and Trade Bureau
U.S. Department of the Treasury

Notice No. 65

COMMENTS ON NOTICE OF PROPOSED RULEMAKING ON CLASSIFICATION OF CIGARS AND CIGARETTES

On Behalf of the
Cigar Association of America, Inc.

March 26, 2007

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The Cigar Association of America, Inc. and its members ("CAA") submit these Comments in response to the Notice of Proposed Rulemaking, issued by the Alcohol and Tobacco Tax and Trade Bureau ("TTB"), published at 71 Fed. Reg. 62,506 (Oct. 25, 2006). CAA is a national trade association comprised of cigar manufacturers, importers, distributors and major suppliers to the domestic cigar industry. CAA's members include companies that manufacture, distribute, import and sell the vast majority of cigars sold in the United States today. In these comments, CAA identifies serious flaws in the Proposed Rules – including TTB's failure to adhere to Chapter 52 of the Internal Revenue Code[1] and unwarranted departures from long-standing rules regarding classification of cigars and cigarettes – that would have a devastating impact on the cigar industry. Accordingly, CAA recommends changes to the Proposed Rules that would satisfy TTB's stated objectives in this rulemaking, comply with the statutory mandate, and prevent the Final Rules from causing unwarranted, arbitrary, and irreparable harm to the cigar industry.[2]

I. INTRODUCTION

Chapter 52 of the Internal Revenue Code sets forth the definitions that TTB must follow while implementing new regulations to further distinguish between cigars and cigarettes. 26 U.S.C. § 5702(a) and (b) (2000) define "Cigar" and "Cigarette" 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

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1 Chapter 52 of the Internal Revenue Code sets forth the Federal excise tax and related provisions that apply to tobacco products manufactured in or imported into the United States.

2 In the Summary of Notice of Proposed Rulemaking, TTB lists the following objectives: (i) to address TTB's concerns "regarding the adequacy of current regulatory standards for distinguishing between cigars and cigarettes"; (ii) to address concerns regarding the distinction between little cigars and cigarettes raised by three petitions; (iii) to "clarify the application of existing statutory definitions . . . to provide clearer and more objective product classification criteria;" and (iv) to "reduce possible revenue losses through the misclassification of cigarettes as little cigars." 71 Fed. Reg. at 62,506.

(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).

Because the statute plainly states that a tobacco roll wrapped in paper is a cigarette, and a tobacco roll wrapped in leaf tobacco is a cigar, TTB can and should simply restate the statutory definitions for these products in its regulations. With respect to other products – tobacco rolls wrapped in a "substance containing tobacco" – TTB should adopt a clarifying construction true to the statutory definitions of cigars and cigarettes.

The controlling statute limits TTB's options in determining whether a tobacco roll wrapped in a "substance containing tobacco" is a cigar or a cigarette. In particular, the statute commands that a tobacco roll, 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." *Id.* § 5072(b)(2). The Proposed Rules conflict with this statutory mandate, by reclassifying (as "cigarettes") many cigars that are not likely to be offered to, or purchased by, consumers as a cigarette.

We respectfully submit that the Proposed Rules deviate from the statutory mandate in two fundamental ways. *First*, the Proposed Rules would reclassify virtually all little cigars as cigarettes, even if they are not likely to be offered to, or purchased by, consumers as a cigarette. TTB's proposed definition of "cigarette" takes two features that little cigars and cigarettes have long shared – their size/shape and the presence of a filter tip – and turns either one of them into a feature that, by itself, would classify the product as a cigarette. Under the definition of "cigarette" set forth in TTB's proposed section 40.12(b)(3)(ii), a roll of tobacco is classified as a cigarette if it is wrapped in a substance containing tobacco and (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 specified in § 40.214." Because proposed section 40.12(b)(3)(ii) is phrased in the disjunctive, a roll of tobacco (wrapped in a substance containing tobacco) that incorporates a filter tip would be classified as a cigarette *for that reason alone*. Similarly, under proposed section 40.12(b)(3)(ii), a roll of tobacco (wrapped in a substance containing tobacco) would be classified as a cigarette *solely* because it has the same size and shape as a typical cigarette. Approximately 97% of little cigars sold in the United States are filter-tipped and have, for decades, had the same size and shape as a cigarette (typically 85 or 100 mm in size and cylindrical in shape).[3] As a result, proposed section 40.12(b)(3)(ii) would reclassify virtually all little cigars as cigarettes, even though little cigars are a federally created and recognized product class wholly distinct from cigarettes. This reclassification would occur regardless of whether, based on other features, a particular little cigar is likely to be offered to, or purchased by, consumers as a cigarette, as the statute requires.

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[3] Declaration of Norman F. Sharp, President and Executive Director of Cigar Association of America, Inc. ("Sharp Decl.") ¶¶ 6-8, 11.

Second, the definition of "cigarette" in TTB's Proposed Rules would cause an utterly irrational reclassification of large cigars filled with pipe tobacco as cigarettes. The Proposed Rules would reclassify large cigars filled with pipe tobacco even though they are not likely to be offered to, or purchased by, consumers as a cigarette because their appearance and size readily distinguish them from typical cigarettes.

Two provisions in the Proposed Rules would effectuate this reclassification of large cigars filled with pipe tobacco. The first is proposed section 40.12(b)(2), which defines a roll of tobacco as a cigarette if it is wrapped in a substance containing tobacco and has a filler that "contains more than 3.0 percent by weight of total reducing sugars[.]" Large pipe tobacco cigars would be reclassified as cigarettes under this test solely because the reducing sugar content of their filler typically exceeds 3.0 percent.[4] There may be other cigar products impacted by the total reducing sugars test.[5]

The second provision is proposed section 40.12(b)(3)(iii), which defines a roll of tobacco as a cigarette if it is wrapped in a substance containing tobacco and has a "filler primarily consisting of" (among other things) burley or unfermented tobaccos. Even though ATF and TTB have long recognized large cigars filled with pipe tobacco as cigars,[6] such products would be reclassified as cigarettes under this test, because burley (an unfermented tobacco) is the dominant tobacco type in the filler in most large pipe tobacco cigars. The Proposed Rules would result in this drastic reclassification even though their stated objective is to "incorporate the substance of ATF Ruling 73-22" (71 Fed. Reg. at 62,517) – which does not even mention burley or unfermented tobacco as tobacco types used in cigarettes. *See* ATF Ruling 73-22.

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[4] The primary reason is that sugar is added (through a "casing" process) to most pipe tobacco blends. The tobacco leaf used in making pipe tobacco generally is burley which, after the curing process, has very little sugar content. Flue-cured tobaccos have far more sugar content after the curing process. The manufacture of pipe tobacco, however, requires the addition of casing sauce, a primary component of which is sugar. Sharp Decl. ¶¶ 16, 18, 19. The addition of casing sauce to pipe tobacco filler is recognized by ATF Procedure 90-2.

[5] On January 3, 2007, CAA submitted a request to TTB under the Freedom of Information Act (FOIA) asking for certain information relating to this Notice of Proposed Rulemaking. The March 15 response from TTB (received on March 20, 2006 following CAA's grant of a thirty day extension to TTB to respond) asked for clarification of two categories of requested documents and denied our request for three others due to an exemption. CAA received approximately one-hundred and fifty pages of materials on the afternoon of March 23, 2007 (less than one full business day before the deadline for submitting comments in this Rulemaking) in response to nine of the sixteen categories of requested documents. CAA may supplement these comments as a result of the timing of the arrival of responsive documents.

[6] *See* letters from ATF and TTB to John Middleton, Inc. dated June 27, 1968, December 27, 1979, September 11, 1991, and October 27, 2004. Ex. 1.

Unless the TTB corrects these serious problems with the Proposed Rules, the resulting wholesale reclassification of little cigars and of large pipe tobacco cigars (which make up approximately 25.0% of the large cigar market)[7] would cause a tectonic restructuring of the cigar industry, and with it, substantial irreparable economic harm. As we describe in Section IV below, little cigars and large cigars filled with pipe tobacco would not be able to be competitive in the cigarette market. In addition, price increases in the products due to assessment of federal and state cigarette excise taxes and possible application of MSA charges applied to cigarettes will cause a decrease in sales. The result would be a significant decrease in jobs and economic activity. Because TTB intends this rulemaking to "incorporate the substance of" longstanding prior classification rules (*see* 71 Fed. Reg. at 62,517), CAA believes that TTB could not have intended the dramatic sea change in the cigar industry that the Proposed Rules would in fact effectuate.

CAA respectfully requests that TTB modify the Proposed Rules in the form recommended by CAA in Section VIII of these Comments, for the reasons discussed below.

II. BACKGROUND

Although the exact date of the entrance of the cigar into the United States is unknown, its arrival can be traced to at least 1762, when Israel Putnam, later an American general in the American War of Independence (1774-1778), returned from Cuba, where he had served in the British army. Cigar smoking became widespread in the United States around the time of the Civil War in the 1860s.

Large cigars with pipe tobacco filler have been sold in the United States for over 40 years and, as noted above, account for at least 25.0% of all large cigars sold in the United States. Little cigars have been on the market in the United States for many decades, and little cigars wrapped in reconstituted tobacco have been sold for almost 40 years.[8] Because both little cigars and cigarettes must comply with the statutory requirement to weigh no more than 3 pounds per thousand, they always have had a superficial resemblance to each other. But they have always differed fundamentally from cigarettes, in both composition and marketing.[9]

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[7] A January 18, 2007 letter from Robert G. Kalik, Esq. to Mr. Frank Foote at TTB on behalf of John Middleton, Inc. lists Middleton's contribution to the large pipe tobacco filled cigar market as approximately 23% of total unit sales of the product. Ex. 2. The other manufacturers of large cigars filled with pipe tobacco constitute approximately 2% of the large cigar market. Sharp. Decl. ¶ 17.

[8] Sharp Decl. ¶ 4. TTB's regulations state that the terms "little cigar" and "small cigar" can be used to refer to cigars weighing not more than 3 pounds per thousand. 27 C.F.R. §§ 40.11, 40.214(c) (2006). We use the terms "little cigar" and "small cigar" interchangeably in these Comments.

[9] Sharp. Decl. ¶ 5.

In 1973, ATF published Ruling 73-22, which identifies the criteria for determining whether a tobacco product wrapped in a "substance containing tobacco" is a cigar or a cigarette. Consequently, for over 30 years, manufacturers of little cigars and manufacturers of pipe tobacco filled large cigars have, at significant cost, developed new products and tailored existing products to be compliant with Ruling 73-22. In addition, ATF, and subsequently TTB, have relied on these rules to audit and approve little cigar products. Although TTB stated that the new regulations should incorporate the substance of the requirements set out in Ruling 73-22 (71 Fed. Reg. at 62,517), the TTB's Proposed Rules instead would substantially deviate from Ruling 73-22 and would reclassify as cigarettes both little cigars and large pipe tobacco cigars as explained above.

In a letter to TTB dated March 5, 2004, CAA noted that several states were considering classifying little cigars as cigarettes, due to the states' inability to determine whether certain products were little cigars or cigarettes. CAA, by letter dated December 19, 2005, asked TTB to expeditiously issue guidance to clarify the differences between the two product categories. In addition, Lorillard Tobacco Company and R.J. Reynolds Tobacco Company (collectively "Lorillard") in a petition to the TTB dated January 9, 2006, asked TTB to amend its regulations regarding the classification of little cigars. Six months later, Reynolds America Inc. ("Reynolds") filed comments with TTB.[10] Finally, thirty-nine states and one territory (collectively, the "States") expressed concern about products inappropriately labeled as cigars entering into the United States market.[11]

CAA, Lorillard, Reynolds and the States expressed different rationales for their concern over the existing definitions.[12] Notwithstanding the differing opinions expressed by each of the

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[10] June 8, 2006 letter to Mr. Frank Foote, Alcohol and Tobacco Tax and Trade Bureau. Ex. 3. Reynolds is the parent company of R.J. Reynolds Tobacco, Santa Fe Natural Tobacco and Lane Limited.

[11] Petition dated April 24, 2006 from twenty-three (23) states, as amended May 18, 2006 to add sixteen (16) additional states and one territory.

[12] For example, Lorillard, Reynolds and the States each claim that the failure to clarify the definitions of cigarettes and little cigars has led to a reduction in payments under the Master Settlement Agreement, dated November 23, 1998, between Attorney Generals from 46 states and representatives of five territories and the District of Columbia, and five cigarette manufacturers ("MSA"), and claim that consumers of cigarettes have switched to purchasing small cigars, due to the tax and MSA charges applied to cigarettes. CAA believes the data on removals of little cigars and cigarettes since the MSA does not support a claim that consumers of cigarettes are switching to little cigars at any significant level. For instance, in 2006 a total of 380.3 billion cigarettes were sold in the U.S. as compared to 4.5 billion little cigars. More cigarettes were sold in five days than little cigars in the entire year. Since 2000, cigarette sales have declined by 52.1 billion units, while little cigar sales have increased by only 2.2 billion units. According to United States Department of Agriculture estimates, consumers spent $82 billion on cigarettes in 2005 versus the $312 million CAA estimates that consumers spent on little cigars. Thus, in 2005, consumers spent more on cigarettes in two days than they spent on little cigars during the

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four groups, however, each asked TTB to amend its regulations to clarify the differences between little cigars and cigarettes. None of the petitioners expressed a concern about large cigars filled with pipe tobacco.

CAA urges TTB to adopt Final Rules to reflect the recommendations of CAA set forth in Section VIII of these Comments. CAA believes that Final Rules incorporating these recommendations would provide an effective regulatory scheme that would achieve the following four objectives and satisfy the concerns of all interested parties:

- adhere to the statutory mandate that rolls of tobacco wrapped in a substance containing tobacco are only classified as cigarettes if they are likely to be offered to, or purchased by, consumers as cigarettes;
- address the discrete problem of certain unscrupulous operators that sell cigarettes fraudulently labeled as little cigars in order to avoid cigarette taxes and state MSA escrow payments applicable to cigarette manufacturers;
- clarify, preserve and reinforce the integrity of the cigar and cigarette tax classifications in accordance with law and consistent with past administrative practice; and
- promote the efficiency of the tobacco tax regime for administrators and taxpayers by establishing an objective product classification to ensure uniformity and consistency within the marketplace.

III. TTB SHOULD MODIFY THE PROPOSED RULES TO MAKE THE FINAL RULES CONSISTENT WITH THE STATUTE

TTB should modify the Proposed Rules to make them consistent with the controlling statute.

A. The Statute That Governs the Scope of the Definitions of "Cigar" and "Cigarette" Focuses on the Nature of the Wrapper

The current statutory definitions of "cigar" and "cigarette" evolved from definitions in the 1954 version of the Internal Revenue Code, which distinguished between cigars and cigarettes based solely on their wrappers. The 1954 Code defined a "cigar" as "any roll of tobacco wrapped in tobacco" and defined a "cigarette" as "any roll of tobacco, wrapped in paper or any substance other than tobacco." 26 U.S.C. § 5702(c), (d) (1954). By 1965, Congress

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entire year. Sharp Decl. ¶¶ 13-15. Economic Research Service, U.S. Dep't of Agriculture, Tobacco Data Table 21, *Expenditures for tobacco products and disposable personal income* (2006), *available at* http://www.ers.usda.gov/briefing/tobacco/Data/table21.pdf.

became concerned that these definitions did not adequately account for a new wrapping material that had developed – reconstituted tobacco – that Congress felt could be confused with paper:

> The introduction of reconstituted (homogenized) tobacco for use as a wrapper for rolls of tobacco has created problems regarding the existing distinction between a cigar and a cigarette. Reconstituted tobacco can be used to wrap rolls of tobacco that closely resemble cigarettes. Moreover, it possesses many of the properties of paper, including suitability for use in high-speed cigarette manufacturing machinery.

S. Rep. No. 89-324, at 54 (1965), *reprinted in* 1965 U.S.C.C.A.N. 1690, 1744. Accordingly, in the Excise Tax Reduction Act of 1965, Pub. L. 89-44 (79 Stat. 136), Congress amended the definitions of "cigar" and "cigarette" to address reconstituted wrappers. These are the same definitions that are still in the statute today.

Congress enacted the current definitions of "cigar" and "cigarette" in a section of the 1965 Act entitled "Use of Reconstituted Tobacco as a Wrapper." 79 Stat. at 164. As reflected in that section title, the current definitions focus on the wrapper, just like the original definitions in the 1954 statute.

The 1965 Act set forth two definitions of "cigarette." The first definition is based solely on the wrapper:

> "Cigarette" means – (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco[.]

26 U.S.C. § 5702(b)(1). This definition essentially restates the predecessor (1954) definition. *See* S. Rep. No. 89-324, at 54 ("The effect of the present definition of a cigarette is retained . . . .)

The second definition of "cigarette" also is based on the wrapper and goes to the heart of the congressional concern about reconstituted tobacco wrappers masquerading as paper. Under the second definition, a tobacco roll wrapped in reconstituted tobacco is a cigarette if it is likely, based on certain listed features, to be offered to, or purchased by, a consumer as a product described in the first "cigarette" definition (*i.e.*, as a tobacco roll wrapped in paper or any substance not containing tobacco):

> "Cigarette" means – . . . (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).*

26 U.S.C. § 5702(b)(2) (emphasis added). If the product is not likely to be offered to, or purchased by, a consumer as one wrapped in paper or any substance not containing tobacco, the product is defined as 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)).

26 U.S.C. § 5702(a).

B. Under the Statute, Products Wrapped in a Substance Containing Tobacco Can be Classified as Cigarettes Only if They Are Likely, Based on the Three Statutory Features, to be Offered to, or Purchased by, Consumers as Cigarettes

The statutory text quoted above requires TTB to ask the following question in addressing the distinction between cigarettes wrapped in a "substance containing tobacco," on the one hand, and cigars wrapped in a "substance containing tobacco," on the other:

> Is there something about the product's appearance, filler, and/or packaging and labeling that will likely cause it to be offered to or purchased by, a consumer as a cigarette (i.e., a roll of tobacco wrapped in paper or any substance not containing tobacco)?

To answer that question, the ultimate inquiry is whether it is *likely*, *i.e.*, *probable*, that a roll of tobacco would be offered to, or purchased by, consumers as a cigarette. *See Nippon Steel Corp. v. United States*, 26 C.I.T. 1416, 1419-20, 1420 n.3 (Ct. Int'l Trade 2002) (defining "likely" as "probable"). This agency determination must be grounded in evidence, and there must be a "'rational connection between the facts found and the choice made.'" *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962)); *see also Cabo Distribution Co. v. Brady*, 821 F. Supp. 582, 595-97 (N.D. Cal. 1992) (determination by ATF that a vodka label would likely mislead consumers had no rational factual basis and therefore was arbitrary and capricious).

In determining such likelihood, the three product features identified in the statute as relevant – appearance, filler, and packaging and labeling – cannot be assessed in isolation. By naming three features to be considered, the statute indicates they should be weighed in relation to one another to determine whether the product is likely to be offered or purchased as a cigarette. For example, if a product is packaged with a label that conspicuously identifies it as a little cigar, there is still the possibility in theory that one or both of the other features are distinctive to cigarettes (*e.g.*, a wrapper with the appearance of paper) such that consumers are likely to perceive it as a cigarette. The statute therefore requires consideration of all of a product's statutory features that could have a bearing on its similarity to cigarettes, to elucidate whether appearance, filler, or packaging and labeling would be likely to dictate consumer perception that the product is a cigarette.

TTB and ATF appear to have recognized this requirement of a multi-factor analysis in Revenue Ruling 73-22, as well as in earlier explanations of its classification methods both before and after the 1965 statutory amendments. *See* Rev. Rul. 69-198; Rev. Circ. 59-8. Although TTB

stated its intent to "incorporate the substance of ATF Ruling 73-22 in the regulations" (71 Fed. Reg. at 62,517), the Proposed Rules do not do so.

Section 40.12(b) of the Proposed Rules conflicts with the statute and ATF Ruling 73-22 by providing that a single characteristic of a tobacco product (*i.e.*, filler, typical cigarette size and shape, or integrated filter) can automatically classify it as a cigarette, regardless of whether, overall, it is likely to be offered or purchased as a cigarette. The Proposed Rules make a fundamental mistake: the existence of one characteristic cannot, under the statute, render a product a cigarette if, on balance, the other characteristics of the product make it unlikely to be offered or purchased as a cigarette.

1. Product Appearance

a. A Product is Not Likely to be Offered to, or Purchased by, Consumers as a Cigarette if the Product's Wrapper Contains Two Thirds or More Tobacco

In identifying product appearance as a factor relevant to determining "likelihood," the statute focuses specifically on the appearance of the wrapper. The statutory definition of "cigarette" is based on the wrapper, as explained above. In particular, under 26 U.S.C § 5702(b)(2), a tobacco roll with a reconstituted tobacco wrapper is a cigarette if a consumer would likely purchase it as a tobacco roll with a wrapper made of paper or any substance not containing tobacco. The most obvious reason a consumer would purchase a reconstituted tobacco-wrapped product as one wrapped in paper (or any substance not containing tobacco) is if the wrapper had the appearance of paper (or any substance not containing tobacco). This is the critical appearance feature that goes to the heart of the concern, expressed by Congress, that reconstituted wrapper might cause confusion between cigarettes and cigars, because "[r]econstituted tobacco can be used to wrap rolls of tobacco that closely resemble cigarettes." S. Rep. No. 89-324, at 54.

The typical cigarette is wrapped in white paper. By contrast, a reconstituted tobacco wrapper typically has a dark color and does not have the appearance of paper.[13] The more tobacco content the wrapper has, the more the wrapper resembles leaf tobacco and, therefore, the

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[13] The appearance of the typical little cigar wrapper is described in the legislative history of the Little Cigar Act of 1973, Publ. L. No. 93-109, 87 Stat. 352 (codified as amended at 15 U.S.C. §§ 1331, 1332, 1335). The House Report on the Little Cigar Act noted that the appearance of "Winchester" little cigars differed from the appearance of cigarettes because "the wrapper is made from reconstituted tobacco rather than paper and is brown in color." H.R. Rep. No. 93-323, at 8 (1973) (footnote omitted); *see also Public Health Cigarette Amendments of 1971: Hearings on S. 1454 Before the Consumer Subcomm. of the S. Comm. on Commerce,* No. 92-82, 92d Cong. 223 (1972) (statement of Bruce Wilson, Deputy Ass't Atty. General for the Antitrust Division of the Dept. of Justice) (a Winchester "in its appearance, as you know, . . . is a brown cigar . . . and most cigarette smokers, the consumers who are going to smoke anyhow, are not going to mistake that thing for a cigarette because of its appearance").

more cigar-like it is. Conversely, the less tobacco content the wrapper has, the more the wrapper resembles a "substance not containing tobacco" and, therefore, the more cigarette-like it is. Accordingly, the quantity of tobacco in the wrapper is a key factor in the "appearance" of the product. It is also a key factor in the application of the "likelihood" requirement. Stated another way, the less the tobacco content in the wrapper, the more "likely" the product would be offered or purchased as a cigarette, based on its appearance.

As reflected in ATF Ruling 73-22, a reconstituted wrapper containing at least two thirds tobacco does not have the appearance of a white paper cigarette wrapper. A product with a wrapper containing at least two thirds tobacco has an appearance that is so cigar-like that it is *unlikely* that consumers would regard the product as a cigarette. CAA therefore urges TTB to issue Final Rules providing that a product with such a wrapper is not a cigarette. TTB also should issue Final Rules providing that a product with a wrapper with less than two thirds tobacco is a cigarette if the wrapper has the appearance of a white paper cigarette wrapper.[14]

b. A Product is Not Likely to be Offered to, or Purchased by, Consumers as a Cigarette Based on its Appearance Merely Because of Features Long Common in Both Cigarettes and Little Cigars, *i.e.*, Size/Shape and Integrated Filter

TTB's proposed section 40.12(b)(3)(ii) addresses two product characteristics related to appearance – "typical cigarette size and shape" and "integrated filter[s]." If a tobacco roll wrapped in a substance containing tobacco has either one of these characteristics, section 40.12(b)(3)(ii) would classify it as a cigarette. This provision of the Proposed Rules is arbitrary and capricious.

There is absolutely no factual basis for TTB to conclude that a tobacco roll is likely to be offered or purchased as a cigarette, rather than a cigar, solely because it has a "typical cigarette size and shape." By "typical" cigarettes, we understand TTB to mean "small cigarettes," defined

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[14] TTB also should revise two other proposed provisions relating to the wrapper – the definitions of "substance containing tobacco" and "substance not containing tobacco" in proposed section 40.11(2) – to conform to the language of the statute. Proposed section 40.11(2) defines the statutory term "substance containing tobacco" to require at least two thirds, by weight, of tobacco, even though the plain meaning of the term encompasses substances containing *any* tobacco. The definition should be changed to make it consistent with the statutory text. Similarly, proposed section 40.11(2) defines the statutory term "substance not containing tobacco" as a substance containing tobacco, up to two thirds by weight, even though the plain meaning of the term is a substance *not* containing *any* tobacco. *See* S. Rep. No. 89-324, at 54 (indicating that Congress intended to "retain[ ]" the "effect" of the definition of "cigarette" from the prior (1954) version of the statute, which defined "cigarette" as "any roll of tobacco, wrapped in paper or any substance *other than tobacco,*" 26 U.S.C. § 5702(d) (1954) (emphasis added)). The definition should be revised to make it consistent with the statutory language.

as those that weigh no more than 3 pounds per thousand. 26 U.S.C. § 5701(b)(1).[15] Small cigars are defined by statute in the exact same manner, as those that weigh no more than 3 pounds per thousand. 26 U.S.C. § 5701(a)(1). In addition, small cigars have the same cylinder shape as all tobacco rolls, and their size generally is the same as cigarettes, typically 85 or 100 mm long. Therefore, because small cigars and typical cigarettes have essentially the same size and shape, it would be wholly erroneous to conclude that size and shape alone would make a consumer likely to purchase a product as a typical cigarette rather than a small cigar.

Indeed, the size and shape of little cigars and typical cigarettes have been the same for as long as little cigars have been manufactured. The statutory weight limitation applicable to little cigars and typical cigarettes virtually dictates that the size and shape of both products must be what they have been for fifty years – cylindrical rolls typically 85 or 100 mm in length. If a little cigar or typical cigarette must weigh not more than 3 pounds per thousand (as required under 26 U.S.C. § 5701), there is no other practical option as to size and shape. *See, e.g.*, *Public Health Cigarette Amendments of 1971*: *Hearings Before the Consumer Subcomm. of the S. Comm. on Commerce*, No. 92-82, 92d Cong. 124 (1972) (statement of James Hind, product manager, R.J. Reynolds Tobacco Co.) ("The size of . . . little cigars, is dictated by the requirement that they must be about this size and shape in order to meet the Internal Revenue Code definition for tax purposes. . . . Thus, in order to be classified within this category, a product must approximate the size and shape of standard cigarettes, which have a circumference of 25 mm. and lengths which vary from 70 to 101 mm.").

Congress understood this when it enacted the 1965 Act. The Senate Finance Committee noted the "suitability" of reconstituted tobacco "for use in high-speed cigarette manufacturing machinery" – which would necessarily result in the manufacture of little cigars in the size and shape of cigarettes – without any hint that these characteristics would, by themselves, convert the product into a cigarette. S. Rep. No. 89-324, at 54.

Similarly, there also is absolutely no factual basis for TTB to conclude that a tobacco roll is likely to be offered or purchased as a cigarette, rather than a cigar, solely because it has an integrated filter. Currently the vast majority of little cigars have integrated filters that are also common to cigarettes, but are characteristic of neither.[16] This is not a recent development; manufacturers began adding integrated filters to little cigars 40 years ago. Because both little cigars and typical cigarettes have integrated filters, the filter could not, by itself, make it likely that the product would be offered or purchased as a cigarette rather than a cigar. In fact, there are some large cigars sold with an integrated filter and this filter does not, by itself, make consumers likely to purchase the product as a cigarette rather than a cigar. The existence of an

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[15] To the best of our knowledge, "large cigarettes" (weighing more than 3 pounds per thousand) have not been sold in the United States for at least twelve years. *See* TTB, *Tax Paid on Removals of Cigarettes and Little Cigars* (2006); TTB, *Tobacco Statistics* (2006), http://www.ttb.gov/tobacco/tobacco_stats.shtml.

[16] Sharp Decl. ¶ 12.

integrated filter on a product simply has no probative value in differentiating one product from another.

Congress itself has recognized that there is no basis for distinguishing between little cigars and cigarettes based on similar product size and shape or integrated filter tips. In 1973, Congress enacted the Little Cigar Act, which extended, to little cigars, the television advertising ban that previously had applied only to cigarettes. *See* Little Cigar Act of 1973, Pub. L. 93-109, 87 Stat. 352. In the course of doing so, Congress rejected a proposal of the Federal Trade Commission that would have extended the advertising ban by changing the definition of cigarettes to include little cigars. Congress instead adopted a separate definition of little cigar which clearly permitted the use of a reconstituted wrapper for a little cigar and applied the advertising ban to both product classes. Congress thereby expressly recognized that little cigars and cigarettes are distinct products, even though they both have filters and also have essentially the same size and shape. Indeed, Congress observed that "more 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." H.R. Rep. No. 93-323, at 9. Congress also specifically noted that "Winchester" little cigars were "the same size as king size cigarettes (85 millimeters long), have filter tips, and are sold in packages of 20." *Id.* at 7. Congress decided to subject "Winchesters" and other little cigars to the advertising ban 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*." S. Rep. No. 93-103, at 6 (1973), *reprinted in* 1973 U.S.C.C.A.N. 2040, 2044 (emphasis added).

Thus, Congress refused to classify little cigars as cigarettes merely because they are the same size and shape as cigarettes and have similar integrated filter tips. TTB cannot do by regulation what Congress specifically chose not to do by statute. TTB therefore should modify its Final Rules, in accordance with CAA's recommendations in Section VII, so that a product is not classified as a cigarette based only on typical cigarette size and shape or integrated filter tip.

2. Product Filler

TTB's Proposed Rules also conflict with the statute by classifying a roll of tobacco as a cigarette based solely on its filler, without regard to whether it is likely to be offered to, or purchased by, consumers as a cigarette.[17]

a. A Product is Not Likely to be Offered to, or Purchased by, Consumers as a Cigarette Based on the Sugar Content of its Filler if it is a Large Cigar

[17] John Middleton, Inc., a CAA member, has filed separate comments with TTB regarding the Proposed Rules and separately addresses, among other things, the proposed sugar reduction test. *See* Ex. 2.

The filler alone should not determine classification of large cigars. The size of a large cigar (weighing more than 3 pounds per thousand), standing alone, should serve as a basis for distinguishing it from cigarettes. That is because the size of a large cigar makes it so fundamentally different from a cigarette that it is not likely be offered to, or purchased by, consumers as a cigarette.[18]

The history of the distinct treatment of large and small tobacco products by TTB's predecessors prior to the 1965 Act confirms this common sense determination. For example, in 1964, the IRS altered its procedures for distinguishing between cigars and cigarettes based on the weight of the product. For rolls of tobacco that weighed more than 3 pounds per thousand wrapped in reconstituted tobacco, the IRS required the manufacturer to submit only a sample of the reconstituted tobacco wrapper in order to determine its status as a large cigar. *See* Rev. Circ. 64-10; Rev. Proc. 64-34. For lighter weight products, the IRS continued to require submission of not only the wrapper, but also a sample of the finished product, and the package. Rev. Circ. 64-10; Rev. Proc. 64-34. It is obvious that the IRS recognized that, because large cigars do not resemble cigarettes, there was no need to examine anything other than the wrapper to confirm that the product was a cigar and not a cigarette. In the years immediately following the 1965 statutory amendment, the IRS continued this distinction between large and small tobacco products, *see* Rev. Proc. 65-23, based on the general view that the statutory amendments did not alter its prior tax determinations, *see* Rev. Circ. 65-15; *see also* Charles S. Mouhtouris, Chief, Tobacco Tax Branch, IRS, *Federal Developments in the Tobacco Tax Field,* Proceedings of the 39th Annual Meeting of the National Tobacco Tax Association (Oct. 1965) (1965 statutory amendment "constitutes a congressional endorsement of the Service's position").

These administrative determinations support the conclusion that it would be arbitrary and capricious for TTB to adopt any rule that would deem large cigars to be cigarettes purely because of their filler, despite the fact that by virtue of their size they are extraordinarily *unlikely* to be offered or purchased as cigarettes.

CAA's recommended changes in the Rules would classify a product as a cigarette based on its filler (through the sugar reduction test) *only* if the appearance of the product is similar to a cigarette because the product has the size and shape of a cigarette (*i.e.*, 85 or 100 mm and cylindrical). We note that applying the sugar reduction test in this manner would be fully consistent with the intent of Congress in enacting the 1965 Act. The legislative history of the 1965 Act indicates that the sole purpose of enacting the current definitions of "cigarette" and "cigar" was to prevent misclassification of *little* cigars and *small* cigarettes. S. Rep. No. 89-324, at 54. In particular, Congress was concerned about the potential revenue consequences of such a misclassification, given the tax rate differential between little cigars and small cigarettes:

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[18] The only cigarettes on the market are "small" cigarettes (weighing less than 3 pounds per thousand). *See supra* note 14. There obviously is no likelihood that a large cigar would be offered to, or purchased by, consumers as a large cigarette, because large cigarettes do not exist.

> ***Ordinary cigarettes*** **are currently taxed at the rate of $4 per thousand, while** ***cigars of the same weight*** **are taxed at the rate of 75 cents per thousand.**

Id. (emphasis added).[19] There is no suggestion whatsoever in the legislative history that Congress was concerned with the misclassification of *large* cigars.

Similarly, CAA's proposal would be wholly consistent with one of the stated purposes of this rulemaking proceeding, which is to prevent confusion between *little* cigars and cigarettes by clearly delineating the differences between those product categories. That was the focus of the petitions by CAA, the States, Lorillard, and Reynolds. TTB reiterated that purpose in its website announcement that addressed the scope of this rulemaking:

> **Little cigars**. Over the past several years, TTB has seen an increase in the importation and marketing of tobacco products labeled 'Little Cigars.' Due to this increase, Federal and State agencies as well as tobacco manufacturers and importers have asked TTB for clarification on the regulations that pertain to these products. Therefore, we are presently reviewing our regulations to determine how best to approach this issue.

No statement by TTB or any of the petitioners has even remotely suggested that there has been any confusion between large cigars and cigarettes. Because it would never be likely that large cigars would be offered to, or purchased by consumers as cigarettes, they should not be subject to reclassification as cigarettes through the sugar reduction test.

b. A Product is Not Likely to be Offered to, or Purchased by, Consumers as a Cigarette Based on Filler (Such as Burley) That is Not Distinctive to Cigarettes

If a consumer were likely to purchase a tobacco product as a cigarette based on its filler, it would likely be because the filler was a type of tobacco distinctive to cigarettes. The Proposed Rules conflict with the statute by authorizing product classification based solely on types of tobacco used in the filler that are not distinctive to cigarettes. In so doing, the Proposed Rules would improperly reclassify pipe tobacco-filled cigars as cigarettes.

The statutory scheme recognizes that pipe tobacco is different from cigarette tobacco. In the same section of the statute where it defined the terms "cigar" and "cigarette," Congress defined cigarette tobacco as a specific tobacco type, under the name "roll-your-own":

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[19] The Committee's reference to "ordinary cigarettes" means "small cigarettes," which were subject to the tax rate of $4 per thousand. The Committee's reference to "cigars of the same weight" obviously refers to "small cigars," not only because of the weight limitation, but also because little cigars were taxed at a rate of $.75 per thousand.

> The term "roll-your-own tobacco" means any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes.

26 U.S.C. § 5702(o); *see also* 27 C.F.R. § 40.11 (setting forth parallel TTB definition). Such cigarette tobacco is different than pipe tobacco, which Congress defined in a separate subsection of the statute:

> The term "pipe tobacco" means any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco to be smoked in a pipe.

26 U.S.C. § 5702(n); *see also* 27 C.F.R. § 40.11 (setting forth parallel TTB definition). TTB's regulations reflect that the two types of tobacco are mutually exclusive, by requiring different labeling for pipe tobacco than for cigarette tobacco. *Compare* 27 C.F.R. § 40.216a (pipe tobacco requirements) *with id.* § 40.216b (roll-your-own/cigarette tobacco requirements).

Given this distinction between pipe tobacco and cigarette tobacco, the statute does not permit classifying a product as a cigarette on the grounds that a product has a pipe tobacco filler. Yet section 40.12(b)(3)(iii) of the Proposed Rules would do just that, by classifying a tobacco roll as a cigarette solely because it has a "filler primarily consisting of . . . burley" or an unspecified type of unfermented tobacco. Pipe tobacco blends used as cigar filler are the only blends in which burley is the primary tobacco; although burley (an unfermented tobacco) is present in most cigarette blends, it does not predominate.[20] Thus the statute does not support, and TTB's Proposed Rules provide no justification for, classifying a product as a cigarette because it has a burley or other unfermented filler.

In addition, the "total reducing sugars" test imposed in proposed section 40.12(b)(2) sweeps too broadly to be a proper basis for classification. Section 40.12(b)(2) would irrationally reclassify cigars filled with pipe tobacco as cigarettes, even though no cigarette tobacco fillers were used.[21] The Proposed Rule assumes that cigarettes are the only smoking products that have

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[20] Sharp Decl. ¶ 16.

[21] As discussed in the comments filed by John Middleton, Inc. on January 18, 2007, (*see* Ex. 2) serious questions exist regarding the method used by TTB to select tobacco products for testing because important swaths of the market were apparently overlooked. Those concerns were corroborated in a letter from TTB to John Middleton dated March 5, 2007. *See* Ex. 4. In that letter, TTB stated that John Middleton's pipe tobacco large cigars were never tested as part of the sugar reducing test samples in TTB's analysis. Basing a rule on inaccurate statistics, in addition to being arbitrary and capricious, violates agency guidelines issued pursuant to Section 515 of the Treasury and General Government Appropriations Act for Fiscal Year 2001, which requires each federal agency to "issue guidelines ensuring and maximizing the quality, objectivity, utility, and integrity of information (including statistical information) disseminated

(footnote continued on next page)

sugar added to the filler tobaccos. As stated in John Middleton, Inc.'s January 18, 2007 submission, however, the manufacture of pipe tobacco traditionally requires the addition of casing sauce to achieve various flavors, smoothness and aroma. The primary component of these casing sauces is sugar. *See* Section I *supra*. Thus, large cigars filled with pipe tobacco generally will not meet the total reducing sugar level for cigars, despite the fact that they are filled with pipe tobacco rather than cigarette tobacco.

CAA has no objection to utilizing the sugar reduction test as the basis for identifying *some* fillers that *are not* cigarette fillers (*i.e.,* those with sugar content too low to be cigarette tobacco). However, CAA does object to using the sugar reduction test as the sole basis for identifying fillers that *are* cigarette fillers, because the test fails to distinguish between cigarette tobacco filler and pipe tobacco filler used in cigars. CAA strongly recommends that TTB investigate and develop a valid and workable test or other objective standard to distinguish between cigarette tobaccos and pipe tobaccos used as fillers for cigars.[22] This second test would be applied to any filler that exceeds the established total reducing sugars cutoff, such that TTB would determine that a filler is a cigarette filler only if both tests so indicate.[23]

Furthermore, because the sugar reduction test would identify both the oriental and flue-cured tobaccos commonly found in cigarette fillers and the burley and other unfermented tobaccos commonly found in pipe tobacco cigar fillers, CAA recommends deleting the references to all of these fillers in the Final Rules.

3. CAA Supports TTB's Proposed Rules as to Packaging and Labeling

Under the statute, "packaging and labeling" is the third product feature that must be considered when determining whether a product would likely be offered or purchased as a cigarette. 26 U.S.C. § 5702(b)(2). CAA believes that a product with a package containing required cigarette markings should be classified as a cigarette, based on the predominance of those markings and the resulting likelihood that a consumer would consider it to be a cigarette.

(footnote continued from previous page)

by the agency." Pub. L. No. 106-554 (codified at 44 U.S.C. § 3516 Note). Department of the Treasury guidelines require that, in the context of scientific or statistical information, the agency must use "sound statistical and research methods" in order to meet the "objectivity" requirement. Dep't of the Treasury, *Information Technology (IT) Manual* § 14.4.2 (2002). The TTB's apparent failure to select a sufficiently representative cross-section of tobacco products is contrary to sound statistical methods and thus the result of its study cannot be relied upon in this rulemaking.

[22] To the best of our knowledge, the only prior test used to distinguish cigarette tobacco from pipe tobacco is ATF Procedure 90-2, which is no longer used by either TTB or the industry.

[23] As explained above, the product should be classified as a cigarette based on its filler only if it has the size and shape of a typical cigarette (85 or 100 mm and cylindrical).

CAA accordingly supports TTB's proposal that a product should be classified as a cigarette for that reason alone.

CAA also believes that a product with a cigarette-type package that lacks required cigar markings should be classified as a cigarette, based on the predominance of those features and the resulting likelihood that a consumer would consider it to be a cigarette. CAA therefore supports TTB's proposal that a product should be classified as a cigarette for that reason alone.

Although ATF Ruling 73-22 considered advertising and marketing as a factor relevant to product classification, TTB's Proposed Rules do not address the issue. In deference to TTB, CAA has not included an advertising and marketing provision in its proposed revisions to the Rules but would support any reasonable steps TTB may wish to take to curtail unscrupulous marketing and advertising practices.

CAA further submits that to strengthen and clarify the packaging/labeling notice requirement for little cigars, TTB should consider further enhancing the "conspicuousness" requirement. TTB could do so by prescribing minimum letter size for the product identification or tax classification notice, in a similar manner to the warning mandate by the Federal Trade Commission's consent decree to which seven cigar manufacturers, representing the vast majority of the U.S. cigar market, are parties.[24] Those requirements are included within the proposed regulatory language set forth in Section VIII below.

IV. THE PROPOSED RULES WOULD CAUSE SUBSTANTIAL IRREPARABLE ECONOMIC HARM

If adopted in their current form, the Proposed Rules would cause substantial irreparable economic harm due to the wholesale reclassification of little cigars and pipe tobacco large cigars as cigarettes.

Significant economic harm would flow from the fact that reclassification of little cigars and pipe tobacco large cigars as cigarettes would require these products to compete in the cigarette market, even though they are not cigarettes. CAA believes that a large percentage of little cigar and large pipe tobacco cigar companies would cease doing business entirely rather than pursue the costly changes required to sell their products as something they are not.

The economic impact caused by having to market cigars as cigarettes, is just one part of the overall irreparable harm the Proposed Rules would cause. Because the federal excise tax for cigarettes is higher than that for little cigars, and state excise taxes on average also are higher, there can be no question that reclassification of little cigars as cigarettes would cause the prices of the products to increase. The prices of little cigars may further increase, as may the price of

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[24] The seven manufacturers were Swisher International, Inc., Consolidated Cigar Corporation, Havatampa, Inc., General Cigar Holdings, Inc., John Middleton, Inc., Lane Limited, Inc. and Swedish Match North America, Inc. Due to acquisitions and consolidations among the seven, the companies today are called Altadis U.S.A., Inc., Swisher International, Inc., John Middleton, Inc., Lane Limited, Inc. and Swedish Match North America, Inc.

large cigars filled with pipe tobacco, because of the possible application of MSA escrow assessments. These increases in sales prices would cause a sharp reduction in demand for little cigars and pipe tobacco large cigars. As discussed below, the economic losses from this price-induced demand reduction would be substantial, and these losses would be irreparable, because they could never be recouped.[25]

It is imperative that TTB avoid the economic destruction that would flow from reclassification of little cigars, and large pipe tobacco cigars, as cigarettes. Based on that economic impact alone, TTB should modify its Proposed Rules so that they do not reclassify little cigars and large pipe tobacco cigars as cigarettes.

A. The Cigar Industry Makes a Significant Contribution to the U.S. Economy

The cigar industry in the United States is comprised of companies that manufacture, import, distribute, and sell cigars and those companies that manufacture, import, distribute, and sell supplies to the domestic manufacturers. In 2005, consumers spent approximately $3,184,000,000[26] to purchase cigars. Of these sales, little cigars accounted for approximately $312,000,000 and large cigars filled with pipe tobacco accounted for approximately $525,000,000.[27] Manufacturers of little cigars and large pipe tobacco filled cigars contributed $67,000,000 in excise taxes to the federal government[28] and $79,000,000 in state excise tax in 2005.[29] Manufacturers, importers, wholesalers and retailers of little cigars and large cigars filled with pipe tobacco currently employ an estimated 8,734 individuals in the United States. In addition, suppliers to these industries and the respending by employees create an additional

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25 CAA has retained an experienced tobacco economist, John Dunham, who developed economic models for the little cigar market and the pipe tobacco large cigar market and performed a quantitative analysis of the Proposed Rules' economic impact on each. That analysis is attached to these Comments (hereinafter "Dunham Report"). The Dunham Report explains the methodology followed to develop the models (*see* Dunham Report at 11-15), attaches the data inputs used in the models (*see* Appendices 1-7 to Dunham Report), and explains the conclusions regarding economic impact, including the conclusions regarding price-induced demand reduction described above (*see* Dunham Report at 3-11).

26 *See* Economic Research Service, U.S. Dep't of Agriculture, Tobacco Data Table 21, *Expenditures for tobacco products and disposable personal income* (2006), *available at* http://www.ers.usda.gov/briefing/tobacco/Data/table21.pdf.

27 Sharp Decl. ¶ 14.

28 Calculated by multiplying the number of removals of each product by the federal tax rate for each product. For information regarding the number of removals in 2005 see http://www.ttb.gov/tobacco/tobacco_stats.shtml. The federal excise tax rates for cigars can be found at 26 U.S.C. § 5701 (2000).

29 Dunham Report at 3, 10-11.

68,822 jobs. Each lost job or dollar of sales of little cigars and large cigars filled with pipe tobacco would greatly impact a wide range of other parts of the economy.[30]

As shown in the charts set forth below, reclassification of little cigars, and large cigars filled with pipe tobacco, as cigarettes would cause a sizeable loss in sales, resulting in loss of jobs, economic activity and a reduction in federal and state business and excise taxes.

B. TTB's Proposed Rules Would Require Cigars to be Sold as Cigarettes

1. Little Cigars and Large Cigars Filled With Pipe Tobacco are not Cigarettes

Cigars and cigarettes are not interchangeable products. Cigars are separate and distinct from cigarettes, beginning with the raw material used in their filler.[31] The difference between a cigar and a cigarette is not merely a difference in nomenclature. Cigars are different from cigarettes in how they are smoked.[32] There are significant differences between cigarettes and cigars in taste, aroma, and draw. In addition, most cigarette smokers smoke every day. In contrast, as many as three-quarters of cigar smokers smoke only occasionally. Some may only smoke a few cigars annually.[33]

Reclassifying little cigars and large pipe tobacco cigars as cigarettes by TTB does not mean that the products can be sold as cigarettes even if the manufacturers of these products wish to try to compete in an industry in which they have no experience. The driving force of competition in the cigar market is product differentiation based on branding and the tobacco blend associated with each brand. Customer loyalty to a brand is paramount. It requires heavy investment over a long time to establish and maintain product identification by brand in order to attract a following.[34] Little cigars are often extensions of established large cigar brands. As a result, if sales of little cigars decrease, sales of large cigars of the same brand are also likely to decrease.[35] Thus, a blanket reclassification of little cigars and large cigars filled with pipe

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30 *Id.* at 1-2.

31 *See supra* Section 3.

32 Cigarette smokers inhale the smoke of cigarettes in contrast to cigar smokers who generally puff, but do not inhale, cigar smoke. It is the mouth feel, the taste and aroma of a cigar, rather than inhalation of smoke, that attracts the typical cigar smoker. Sharp. Decl. ¶ 23.

33 U.S. National Institutes of Health, Smoking and Tobacco Control Monograph No. 9, *Cigars: Health Effects and Trends* iii (1998).

34 Sharp Decl. ¶ 20.

35 *Id.*

tobacco as cigarettes, resulting from TTB's application of the Proposed Rules, would cause a massive loss of sales that are dependent on product identification in the marketplace.

The chances of successfully introducing a new product into the cigarette market today are extremely poor, particularly for a company not currently in the cigarette business, in part because of the decline in cigarette consumption, prohibition on cigarette advertising via electronic media, and inability to acquire shelf space in retail outlets. This would happen regardless of the enormous cost that would be imposed on cigar manufacturers due to increased taxes and possible MSA escrow payments.[36] It would be impossible for little cigar manufacturers and manufacturers of large cigars filled with pipe tobacco to transition their products to the cigarette market.[37] The barriers to acceptance of their products among cigarette smokers would be virtually insurmountable because of the paramount importance of brand loyalty. The entry costs are simply too high in a market dominated by mammoth cigarette companies. Cigar manufacturers, with long-established brands and brand-loyal customers, would not succeed in gaining a foothold in a declining cigarette market.[38]

Finally, the difference in the marketing of cigarettes and cigars is significant. Planograms used by the large chain stores separate the cigar products from cigarettes in shelving and display areas. Other merchants follow their lead in separating cigarette and cigar products. Cigar manufacturers forced to sell their products as cigarettes would be shut out of shelf space for their products.[39] Major cigarette manufacturers, notably R.J. Reynolds Company ("RJR") and Philip Morris USA, Inc. ("PM"), which make up approximately 70% of the cigarette market, offer significant price incentives to distributors. The distributors, in turn, place product in retail spaces throughout the United States. Cigar companies entering the cigarette market could not compete with the likes of RJR and PM, which have spent considerable time and financial resources locking up the prime sales spots in retail establishments.[40]

2. Inability to Compete in the Cigarette Market Would Cause Substantial Economic Harm

Because of the insurmountable barriers to entry into a well established cigarette industry, we believe the decreased sales and resulting loss of jobs would occur almost immediately and

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36 *Id.* ¶ 24.

37 *Id.* ¶ 25. This assumes that little cigar manufacturers and manufacturers of large cigars filled with pipe tobacco would even want to be in the cigarette market.

38 *Id.*.

39 *Id.* ¶ 26.

40 *See Smith Wholesale Co. v. R.J. Reynolds Tobacco Co.*, No. 05-6053, ___ F.3d ___, 2007 WL 581660, at *1-*3 (6th Cir. Feb. 27, 2007); *Smith Wholesale Co. v. Philip Morris USA, Inc.*, No. 05-6481, 2007 WL 614237, at *1-*2 (6th Cir. Feb. 27, 2007).

certainly within one year of reclassification. We also believe that the decrease in sales could reach 90% and would be at least a 75% reduction in current sales levels.

The graph below shows the economic consequences of these decreased sales of little cigars due to the Proposed Rules.[41]

Decrease in Total Sales	Loss of Jobs	Loss of Economic Activity	Loss of Federal and State Tax Revenue
50%	25,823	$5.726 billion	$471 million
75%	39,192	$8.671 billion	$714 million
90%	46,810	$10.3 billion	$852.9 million

In addition, we believe there would be no market for large cigars filled with pipe tobacco classified as large cigarettes, causing at least a 90% reduction in sales of this product. Under such circumstances, there would be a loss of 22,615 jobs, $4.39 billion less in economic activity, and a resultant loss of state and federal tax revenues of $143.6 million.[42]

C. At a Minimum, Reclassification Due to the Proposed Rules Would Increase Price and Decrease Sales

1. Increased Prices Would Decrease Sales of Little Cigars

Even if the insurmountable barriers to entry described above were not considered, reclassification of little cigars as cigarettes would unquestionably lead to increased prices of the products, and reduced sales, for those products. Federal excise taxes on little cigars are currently $.04 per pack of 20. If TTB's Proposed Rules were adopted, federal excise tax on little cigars would increase to $.39 per pack of the same size.[43] Reclassification of little cigars as cigarettes also could well lead to higher taxes at the state level.[44] Finally, although we are uncertain as to

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41 Dunham Report at 5-7.

42 *Id.* at 10-11.

43 *Id.* at 4.

44 *See Id.* at n.3 (citing William Orzechowski & Robert Walker, *The Tax Burden on Tobacco*, vol. 41 (2007)). For an accounting of state pipe cigar and little cigar excise tax rates, *see* John Dunham, Bill Orzechowski & Rob Walker, *The Tax Burden on OTP* (2004).

the application of the MSA to cigars classified as cigarettes for tax purposes, reclassification of little cigars as cigarettes pursuant to the Proposed Rules could cause additional price increases due to the assessment of state MSA escrow payments.[45]

The graph below shows the loss of sales, loss of jobs, decrease in total economic activity and resultant loss of state and federal tax revenue due to the assessment of higher federal and state excise and MSA escrow payments on little cigars.[46]

Tax/Assessment	Decrease in Volume of Sales	Loss of Jobs	Decrease in Total Economic Activity	Loss of State and Federal Tax Revenue
Increase in Federal Excise Tax	12.4%	6,320	$1.43 billion	$117.1 million
Increase in Federal Excise Tax and State Taxes	32%	16,160	$3.6 billion	$297.1 million
Increase in Federal and State Excise Taxes and Possible MSA Escrow Payments	43.7%	21,670	$4.82 billion	$397.7 million

45 Pursuant to the MSA (*see supra* note 11), every participating manufacturer is required each year to make payments into an escrow fund. The MSA was initially entered into by the four largest cigarette manufacturers; however, numerous additional cigarette companies have since signed the agreement. Cigarette manufacturers who have elected not to become a party to the MSA are called Non-Participating Manufacturers ("NPMs"). NPMs are not exempt from monetary payments, however, because the 46 states, the District of Columbia, and the various U.S. territories have all enacted statutes that give the NPMs the option of either signing onto the MSA or making annual payments into a special escrow account on par with the amount they would pay the state each year if they did sign onto the MSA.

46 Dunham Report at 3-5.

2. Increased Prices Would Decrease Sales of Large Cigars Filled with Pipe Tobacco

If the insurmountable barriers to entry were not considered, the large pipe tobacco cigar market also would suffer a reduction in sales if the MSA escrow payments were assessed.[47]

The graph below shows the loss of sales, loss of jobs, decrease in total economic activity and resultant loss of state and federal tax revenue due to the assessment of MSA escrow payments on large cigars filled with pipe tobacco.[48]

Tax/Assessment	Decrease in Volume of Sales	Loss of Jobs	Decrease in Total Economic Activity	Loss of State and Federal Tax Revenue
Increase in Federal and State Excise Taxes and Possible MSA Escrow Payments	2.4%	418	$81.2 million	$2.5 million

3. Other Costs Due to Re-Classification of Products Would Further Decrease Sales

The price increases described above underestimate the actual increases (and resulting economic harm) that reclassification of little cigars and large cigars filled with pipe tobacco as cigarettes would cause, due to possible application of regulations that were never intended to apply to cigars. For example, manufacturers may be required to (i) file an annual ingredient disclosure report to the U.S. Office on Smoking & Health and to the Texas Department of Health;[49] (ii) comply with low ignition propensity ("LIP") laws related to cigarette paper design in six states (California, Illinois, Massachusetts, New Hampshire, New York and Vermont);[50]

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47 *Id.* at 9.

48 *Id.* at 9-10.

49 Tex. Health & Safety Code Ann. §§ 161.351–.352 (West 2006). It would be impossible for manufacturers of little cigar and large cigars filled with pipe tobacco to comply with this requirement because there is no viable means to identify the ingredients.

50 Cal. Health & Safety Code §§ 14951–14960 (West 2006); 425 Ill. Comp. Stat. Ann. 8/1 *et seq.* (West 2006); Mass. Gen. Laws Ann. ch. 64C, §§ 2B-F (West 2006); N.H. Rev. Stat. Ann. § 339-F:1–:11 (2006); N.Y. Exec. Law § 156-c (McKinney 2006); Vt. Stat. Ann. tit. 20, § 2757 (2006).

(iii) report annual nicotine yield ratings to the state of Texas;[51] (iv) file an Annual Surgeon General cigarette warning display rotation plan with Federal Trade Commission;[52] (v) file annual tobacco product manufacturer certifications and cigarette brand directory listings with all MSA states;[53] and (vi) file periodic reports (monthly, quarterly, annually) of cigarette sales in various states.[54]

The reclassification of little cigars and large cigars filled with pipe tobacco under the Proposed Rules may also cause manufacturers of these products to acquire and maintain state licenses and permits imposed on sellers of cigarettes and to comply with state minimum cigarette pricing laws,[55] even though the products have always been considered cigars. In addition, manufacturers of cigar products classified as cigarettes due to the Proposed Rules would be required to verify that all direct-buying customers possess state or local licenses required to purchase, distribute and stamp cigarettes.[56] Finally, most states require the application of cigarette tax stamps. Such stamps are applied by machines specifically designed for use on uniform size cigarette packs. Because cigar packaging is not uniform, stamps would have to be applied by hand, which would be a laborious and costly process. The likely result is that distributors would forego sales of many, if not all, cigar products in lieu of actual cigarettes.

The administrative and operational costs identified above are not easily quantifiable, but would undoubtedly further decrease sales, resulting in the loss of additional jobs, further decrease in economic activity and loss of federal and state business and excise taxes.

D. TTB Must Consider the Irreparable Economic Impact of the Proposed Rules

We respectfully submit that TTB is bound to consider the irreparable economic impact of the Proposed Rules, including the impact quantified in the economic analysis submitted with these Comments, as a fundamentally significant factor in this rulemaking proceeding. *See, e.g.*, *PPL Wallingford Energy LLC v. F.E.R.C.*, 419 F.3d 1194, 1198 (D.C. Cir. 2005) ("An agency's 'failure to respond meaningfully' to objections raised by a party renders its decision arbitrary and capricious.") (quoting *Canadian Ass'n of Petroleum Producers v. F.E.R.C.*, 254 F.3d 289, 299 (D.C. Cir. 2001)). Among other things, TTB must consider that these economic harms would be

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51 Tex. Health & Safety Code Ann. §§ 161.351–.353. It would be impossible for manufacturers of little cigars and large cigar filled with pipe tobacco to comply with this requirement because there is no recognized mechanism to measure nicotine in cigars.

52 15 U.S.C. § 1333.

53 Conn. Gen. Stat. §§ 4-281 (2007); Md. Code Ann., Bus. Reg. §§ 16-503 (West 2006).

54 Cal. Rev. & Tax. Code § 30165.1 (2007); Ala Code 1975§ 6-12A-3 (West 2003).

55 Alaska Stat. § 43.50.010 (2006); La. Rev. Stat. Ann. § 47:844 (2006); La Rev. Stat. Ann. § 26:924 (2006).

56 Cal. Rev. & Tax. Code § 30165.1.

particularly egregious, because the Proposed Rules would completely restructure an industry that has developed in reliance on prior agency guidance – ATF Ruling 73-22, which interpreted the very same statutory text that the Proposed Rules would now radically reinterpret with a wholly different set of classification rules. The cigar industry's substantial investment in reliance on ATF Ruling 73-22 is a sufficient ground for rejecting the Proposed Rules in their current form. *See Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 219-20 (1988) (Scalia, J. concurring) (a rule is arbitrary or capricious, on grounds of unreasonable "secondary retroactivity," if it is amended "in a manner that makes worthless substantial past investment incurred in reliance upon [a] prior rule"); *Indep. Petroleum Ass'n of Am. v. DeWitt*, 279 F.3d 1036, 1039 (D.C. Cir. 2002) (stating that a secondarily retroactive regulation may be arbitrary or capricious).[57]

V. TTB SHOULD MODIFY THE PROPOSED CERTIFICATION RULE

CAA supports the proposed certification requirement for manufacturers but believes that the certification should be limited. We recommend three changes in the certification procedure; these changes are incorporated in our recommendations set forth in Section VIII below.

The first proposed change relates to TTB's disclosure of the certified product classification to the states. The important goal of nationwide uniformity, and the concerns of the states raised in this rulemaking, would be furthered if the states classify tobacco products in accordance with TTB's classification. In order for the states to follow TTB's classification of a product, they must be aware of that federal classification determination. We recommend changing the certification form to permit manufacturers to waive any legal restrictions on TTB's disclosure of a product's classification to the states. We further recommend that TTB post, on its website, such product classifications subject to the waiver described, in order to facilitate state access to them.

The second proposed change establishes that manufacturers may properly rely on information provided by their suppliers in making tax classification certifications.

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[57] In addition, TTB incorrectly certified pursuant to the Regulatory Flexibility Act, 5 U.S.C. §§ 601-612 (2000), that the Proposed Rules would not have a significant economic impact on a substantial number of small entities. That statute requires TTB to determine the effect the Proposed Rules would have on small businesses. TTB certified in Notice 65 that an analysis was not required because the proposed regulations primarily codified and clarified existing administrative tax classification principles and practices. As set forth herein, however, the Proposed Rules instead failed to adhere to Chapter 52 of the Internal Revenue Code and significantly departed from long-standing rules regarding little cigars and large cigars filled with pipe tobacco. Many companies in the cigar industry qualify as small businesses. It would be arbitrary and capricious for TTB to issue Final Rules without assessing their economic impact on small businesses. *See N.C. Fisheries Ass'n, Inc. v. Daley*, 16 F. Supp. 2d 647, 651-53, 658 (E.D. Va. 1997).

The third proposed change is to provide that recertification would be necessary only if there is a change in the composition or presentation of a product that would change its tax classification.

VI. THE PROPOSED RULES SHOULD NOT APPLY TO CIGARS DEDICATED FOR EXPORT

Sections 44.186 and 44.253 of the Proposed Rules covering notice requirements on cigars removed from a factory (section 44.186) and withdrawn from a customs warehouse (section 44.253) require additional and specific labeling of cigars dedicated for export. Requiring such additional labeling fails to advance any internal revenue objective and serves to further injure the U.S. cigar industry.

Proposed sections 44.186(b) and 44.253(b) do not meet the primary objective of this rulemaking, which is to reduce possible revenue losses through misclassification of cigarettes as little cigars. 71 Fed. Reg. at 62,506. Proposed sections 44.186 and 44.253 apply to cigars dedicated for export, which are exempt from taxation. *See United States v. Int'l Bus. Machs. Corp.*, 517 U.S. 843 (1996) (holding that the Export Clause of the Constitution categorically bars any tax on exports). Accordingly, these proposed sections would not reduce any revenue losses.

In addition, the highly specific packaging and labeling requirements in Proposed Rule sections 44.186(b) and 44.253(b) could conflict with the labeling and packaging requirements of destination countries, thus potentially excluding American cigars from importation into, and sale in, those countries. For example, the Canadian Tobacco Act requires that a typical pack of little cigars, which is approximately 51.6 cm^2, must have a label affixed to it that is at least 20 cm^2 and no less than 4 cm wide. *See* Tobacco Products Information Regulations (Tobacco Act) § 6 SOR/2000-272 (Can.). Furthermore, the label must be displayed entirely on one side of the package in such a way that the label is not severed when the package is opened. *Id.* As the label will encompass almost half of the available package area, it may be difficult for cigar manufacturers to imprint upon the package all the requirements stated in sections 44.186 and 44.253 as well as the requirements in the Canadian Consumer Packaging and Labelling Act, C.R.C., c. 417 (Can.), thus potentially excluding American cigars from the Canadian market. The exclusion of American cigars from foreign markets such as Canada would further compound the already devastating economic impact of the Proposed Rules on U.S. cigar manufacturers. In addition, the non-tariff trade barrier raised by the labeling requirements for exports might violate U.S. obligations under the North American Free Trade Agreement. *See North American Free Trade Agreement* (NAFTA), 32 I.L.M. 605 (1993). As such, the packaging and labeling requirements of the Final Rules should not apply to cigars dedicated for export.

VII. EFFECTIVE DATE

CAA requests that the Final Rules become effective at least one year after issuance. The manufacturers of the products affected by the Final Rules will require substantial time to determine the viability of their products should they be reclassified from cigars to cigarettes, to make any changes to their products that may be required in order to comply with the Final Rules, to comply with any new labeling and packaging requirements, to obtain sufficient information from suppliers to file any certification required by section 40.13, to evaluate whether they may

continue to export product into traditional marketplaces, or to conduct an orderly winding down of their business should the business no longer be viable upon the imposition of the Final Rules.

VIII. PROPOSED REGULATORY LANGUAGE

A. Definitions

We recommend deleting the definition of "substance containing tobacco" in proposed sections 40.11, 41.11, 44.11 and 45.11 and substituting the following:

> *Substance containing tobacco.* Reconstituted tobacco sheet or any other material, other than leaf tobacco, containing any tobacco leaf or other fibrous material from the plant *Nicotiana tabacum* or the plant *Nicotiana rustica.*

We recommend deleting the definition of "substance not containing tobacco" in proposed sections 40.11, 41.11, 44.11 and 45.11 and substituting the following:

> *Substance not containing tobacco.* Paper or any other material containing no leaf or other fibrous material from the plant *Nicotiana tabacum* or the plant *Nicotiana rustica.*

B. Classification Rules

We recommend adopting the following formulation in place of proposed section 40.12, with conforming changes made to proposed sections 41.12, 44.12 and 45.12:

> **§ 40.12 Classification of cigars and cigarettes.**
>
> The rules set forth in this section control in determining whether a tobacco product is classified as a cigar or as a cigarette for purposes of this part.
>
> (a) *Classification of cigars.* A tobacco product is classified as a cigar if:
>
> (1) It consists of a roll of tobacco wrapped in leaf tobacco; or
>
> (2) It consists of a roll of tobacco wrapped in a substance containing tobacco; and –
>
> (i) It has a wrapper that contains two thirds or more, by weight, tobacco leaf or other fibrous material from the plant *Nicotiana tabacum* or the plant *Nicotiana rustica*; or

(ii) It is not classifiable as a cigarette under paragraph (b)(2) of this section.

(b) *Classification of cigarettes.* A tobacco product is classified as a cigarette if:

(1) It consists of a roll of tobacco wrapped in paper or a substance not containing tobacco; or

(2) It consists of a roll of tobacco wrapped in a substance containing tobacco; and –

(i) It has a wrapper that contains less than two thirds, by weight, tobacco leaf or other fibrous material from the plant *Nicotiana tabacum* or the plant *Nicotiana rustica* and has the appearance of paper or a substance not containing tobacco; or

(ii) It has a typical cigarette size and shape (*i.e.*, a cylinder 85 or 100 mm in length) and has a filler containing more than 3.0 percent by weight of total reducing sugars;[58] or

(iii) It is put up in a package that bears a product designation or tax classification specified in § 40.215; or

(iv) It is put up in a traditional cigarette-type package that does not bear all of the notice requirements for cigars specified in § 40.214.

C. Cigar Certifications and Disclosure of Tax Status

We recommend that proposed section 40.13 should read as follows (with conforming changes made to proposed sections 41.13, 44.13 and 45.13):

(a) *Certification Language for Cigars*

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

[58] As indicated above, CAA believes that TTB also should develop and apply a second test, in addition to the sugar reduction test, to distinguish pipe tobacco from cigarette tobacco.

____ 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.

(b) *Change in Product.* If, after the filing of a certification for a product under paragraph (a) of this section, there is a change in the composition or presentation of that product that would change the tax classification of the product, the manufacturer 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.

D. <u>Notice for Cigars</u>

We recommend that proposed section 40.214 read as follows (with conforming changes made to proposed sections 41.73 and 45.44):

(a) *General.* Before removal subject to tax, every package of cigars shall have adequately imprinted on it, or on a label securely affixed to it:

(1) The designation "cigars";

(2) The quantity of cigars contained in the package; and

(3) For small cigars, the classification of the product for tax purposes (i.e., either "small" or "little").

(b) *Additional notice for small cigars.* In addition to the notice required under paragraph (a) of this section, the following notice requirements apply to small cigars put up in a package that is comparable to a traditional cigarette-type package.

(1) The declaration "cigars," "small cigars," or "little cigars" must appear in direct conjunction with, parallel to, and in substantially the same conspicuousness of type and background as the brand name each time the brand name appears;

(2) A conspicuous "cigars," "small cigars," or "little cigars" declaration must appear on the front, back, and bottom panels of the package even if the brand name does not appear on one or more of these panels; and

(3) A carton containing multiple packages must bear the declaration "cigars," "small cigars," or "little cigars" in conjunction with the brand name and on each panel of the carton that is likely to be visible in a retail sale display.

(c) *Conspicuousness of type.*

(1) For purposes of Section 40.214(b)(1) "conspicuousness of type" 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

Proposed section 44.186 should not be revised. We recommend that the section remain as set forth below:

Before removal from a factory under this subpart, every package of cigars shall have adequately imprinted on it, or on a label securely affixed to it—

(a) The designation "cigars";

(b) The quantity of cigars contained in the package; and

(c) For small cigars, the classification of the product for tax purposes; (i.e., either "small" or "little").

Proposed section 44.253 should not be revised. We recommend that the section remain as set forth below:

Before withdrawal of cigars from a customs warehouse under this subpart, every package of cigars shall have adequately imprinted on it, or on a label securely affixed to it –

(a) The designation "cigars";

(b) The quantity of cigars contained in the package; and

(c) For small cigars, the classification of the product for tax purposes; (i.e., either "small" or "little").

IX. CONCLUSION

We respectfully request that TTB modify its Proposed Rules to reflect the points raised by CAA above and to adopt the recommendations of CAA set forth herein in the Final Rules.