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TOBACCO: TAXES OWED, AVOIDED, AND EVADED

HEARING

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COMMITTEE ON FINANCE
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TOBACCO: TAXES OWED, AVOIDED, AND EVADED

TUESDAY, JULY 29, 2014

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:06 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Ron Wyden (chairman of the committee) presiding.

Present: Senators Cardin, Warner, Hatch, Grassley, Crapo, and Thune.

Also present: Democratic Staff: Jocelyn Moore, Deputy Staff Director; David Berick, Chief Investigator; Chris Arneson, Tax Policy Advisor; and Anne Dwyer, Professional Staff Member. Republican Staff: Chris Campbell, Staff Director; Kimberly Brandt, Chief Healthcare Investigative Counsel; and Nicholas Wyatt, Tax and Nominations Professional Staff Member.

OPENING STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The Finance Committee will come to order.

Today the Finance Committee will examine a classic case of tax evasion; specifically, how dozens of companies making tobacco products are able to dodge taxes owed under current law by changing only a few words on the packaging labels. This evasion fleeces American taxpayers out of billions of dollars, and it means children and teens are more easily hooked on tobacco.

The tax evasion tale goes like this. In 2009, the Congress renewed the Children's Health Insurance Program, which currently provides insurance coverage to more than 8 million children each year. To pay for that coverage, the Congress raised excise taxes on certain types of tobacco products, including cigarettes and loose roll-your-own tobacco. The tax rate on tobacco for pipes and some large cigars, however, remained lower.

So, immediately after the law was enacted, companies pried open a big loophole. They started changing the labels on their packaging. Products that would have been labeled "roll-your-own tobacco" one day were labeled "pipe tobacco" the next, and the tax bill on them plummeted. Companies also stuffed small cigars with a few extra grams of tobacco. That way they could be considered large cigars and be taxed at a lower rate.

Now, the numbers show just how big this loophole has become. Sales of pipe tobacco have skyrocketed more than 10-fold in just 5 years. It just seems implausible that so many more Americans would suddenly start smoking pipes.

Today the Finance Committee is going to inquire as to why it is so easy to skirt the law. Clearly there has been a lapse in good government. After 5 years, the Treasury Department's Alcohol and Tobacco Tax and Trade Bureau, or TTB, still has not drawn a meaningful distinction between tobacco products. Instead, they have ignored everything except for the words on the package: "roll-your-own" or "pipe." All it takes to exploit this loophole is some ink on the label, and the committee is going to see that demonstrated today. No muss, no fuss, no teams of tax lawyers poring over legal documents.

Unfortunately, the financial burden this loophole inflicts on American taxpayers is enormous. The committee is going to hear today that the tobacco loophole has cost taxpayers more than $2 billion over the last 5 years—more than $2 billion. Furthermore, the loophole seriously undermines the effort to discourage smoking among America's children and our teens. According to the Surgeon General, evidence shows that raising the cost of cigarettes is a factor in stopping kids from smoking, but when tobacco is cheap because of a blatant loophole, young people are more likely to buy it.

TTB has had ample time to solve this problem, but it has not followed through. So today the Finance Committee is going to inquire why that is the case. Is it a lack of resources needed to mount an adequate enforcement effort? TTB has four criminal agents at this point to enforce the law for the entire country. Could it be that one hand does not know what the other hand is up to? When the Food and Drug Administration was dragged into the situation, it made matters worse by actively allowing companies to continue using the loophole. The Food and Drug Administration even sent letters to companies giving them the green light.

My bottom line, as we begin this inquiry, is that this loophole hurts taxpayers, it hurts kids, and it needs to be closed. As has been our practice, we are going to work on this important issue, we are going to work on it in a bipartisan way, and I am very pleased to yield to Senator Hatch for his comments.*

[The prepared statement of Chairman Wyden appears in the appendix.]

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Well, thank you, Mr. Chairman. According to written testimony we received today, the Alcohol and Tobacco Tax and Trade Bureau collected approximately $23 billion in taxes in fiscal year 2013, making it the third-largest tax collection agency in the U.S. Government. This amount is even more significant when you consider the number of tobacco-related transactions undertaken and that millions of Americans are represented somewhere in that $23 billion. Of that amount, around $14 billion came from collecting taxes on tobacco products. It seems that there is some truth to the quip attributed to former House Majority Leader

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*For more information, *see also,* "Present Law and Background Relating to Tobacco Excise Taxes,"Joint Committee on Taxation staff report, July 25, 2014 (JCX–93–14), *https://www.jct.gov/publications.html?func=startdown&id=4659.*

Thomas Foley that "if you don't drink, smoke, or drive a car, you're a tax evader." [Laughter.]

Now, because of the large sums of money involved in this issue and because of the number of people and businesses affected, it is important that Federal excise taxes are administered accurately and fairly. In fact, Senator Kennedy and I made the tobacco tax the basis for the Children's Health Insurance Program and the State Children's Health Insurance Program, otherwise known as SCHIP.

But, as with the income tax and our tax system as a whole, compliance needs to be based on a belief that clear rules are constantly enforced in a way that does not put taxpayers at a disadvantage to those who do not follow the rules. We also need to keep in mind—and this is true for all tax policy—that tax avoidance and tax evasion are very different behaviors. The tax code should consist of clear rules, and people will either follow them or they will not. To the taxpayer, the tax code is not a bill for a government program or a claim on whatever someone might consider to be the patriotic amount, it is a set of rules for arriving at a specific and definite number.

During today's hearing, we will specifically discuss two market shifts in tobacco products that seem prevalent since the passage of the Children's Health Insurance Program Reauthorization Act, or CHIPRA, in 2009, which increased tobacco taxes. One of these is an apparent shift from roll-your-own tobacco to pipe tobacco, as the chairman has suggested, which is taxed at a lower rate. As one of our witnesses noted in his written testimony, one tobacco manufacturer has "acknowledged that there was no real difference between its roll-your-own tobacco and its pipe-cut tobacco." Given the fact that roll-your-own tobacco is taxed at around 10 times the rate of pipe tobacco, this market shift deserves our attention. Another market trend that I expect to be highlighted in this hearing concerns an apparent shift from what the Internal Revenue Code defines as "small cigars" to "large cigars," which results in tax savings if the manufacturer's price is below a certain amount.

In addition to these recent market shifts, we need to be mindful of more longstanding issues that clearly deal with tax evasion. For example, smuggling of counterfeit or diverted products where Federal taxes have not been paid is a serious problem, possibly costing the U.S. billions of dollars in tax revenue every year.

Finally, since we are discussing tobacco, the health component of this issue is also important. Evasion, counterfeiting, and black markets, in addition to denying Federal, State, and local governments revenue, also side-step health-related requirements along with restrictions intended to reduce the appeal of tobacco to minors.

I hope this hearing sheds light on how we can improve tax administration by ensuring that our tax laws are being enforced appropriately. I also hope that it will help us understand if the laws themselves have not been written in a way to accomplish what was intended. And, though we are talking about a specific set of Federal excise taxes on a product that is controversial, that should not distract us from the fundamentals of good tax policy. One of the things I have always worried about in taxing tobacco is that we have to be careful how we do that, because you are going to have an underground economy doing things that we will not be able to control. So I am very concerned about how we approach this.

I appreciate the chairman's interest in trying to do what is right here, and we will see what we can do. I have to tell you, Mr. Chairman, I can only stay for a few minutes and then I have to leave, but I appreciate your leadership.

The CHAIRMAN. Well, Senator Hatch, first of all, I want everyone to understand that one of the reasons it is so important to get this right is that you have led this fight with respect to children and the Children's Health Insurance Program for years. You and Senator Kennedy—and I think we know our colleague Senator Rockefeller—have been partners in this effort. I so appreciate the advocacy on behalf of children that you have engaged in for many, many years. I think it drives home why both of us are committed to getting this right, and I look forward to working with you.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. Our hearing today is going to consist of two panels. The first panel will include two government witnesses from the Alcohol and Tobacco Tax and Trade Bureau, known as TTB, and the Government Accountability Office. Our second panel includes industry members and experts on the cost of tobacco tax evasion. We are going to, therefore, have six witnesses, so we would like our guests to limit their testimony to 5 minutes.

Our first witness will be Mr. John Manfreda, the Administrator of the Alcohol and Tobacco Tax and Trade Bureau that is part of the Department of the Treasury. Our second witness will be Dr. David Gootnick, Director of International Affairs and Trade at the Government Accountability Office. We thank both of you for your cooperation and for coming. Your prepared statements are going to be made a part of the record.

We will start with you, Mr. Manfreda.

STATEMENT OF JOHN J. MANFREDA, ADMINISTRATOR, ALCOHOL AND TOBACCO TAX AND TRADE BUREAU, WASHINGTON, DC

Mr. MANFREDA. Mr. Chairman, Ranking Member Hatch, and distinguished members of the committee, thank you for the opportunity to testify about TTB's tobacco enforcement activities. We greatly appreciate your interest in our bureau.

The Internal Revenue Code imposes Federal excise taxes on tobacco products and establishes a comprehensive framework to protect the revenue. Under this authority, we collected over $14 billion in tobacco excise taxes in fiscal year 2013. Our tax authority also extends to alcohol products, firearms, and ammunition, under which we have collected an additional $9 billion last year.

Our tax enforcement strategy involves the development and application of multiple tools and skills to ensure compliance with the Internal Revenue Code and to detect and address tax evasion. Our specialists evaluate permit applications to ensure that only qualified persons operate in the tobacco industry, and we investigate high-risk applicants prior to approval.

Through the use of risk models and other intelligence, our analysts identify diversion schemes and refer cases for further field work. Our auditors and investigators then apply advanced investigative techniques to pursue these leads, deploying teams with diverse skill sets for large, complex investigations. As these cases develop, if there are indications of criminal activity, they are referred to our special agents for investigation and potential referral for prosecution. We also operate a tobacco laboratory which ensures the appropriate tax classification of products and provides analytical support for audits, investigations, and rulemaking.

The Children's Health Insurance Program Reauthorization Act increased the tax rate for all tobacco products and equalized the tax rate for cigarettes, roll-your-own, and small cigars. The tax rate for pipe tobacco was also increased, but to a significantly lower rate. These tax changes resulted in increased tobacco tax collections, although the amount of the increase has decreased steadily since fiscal year 2010, the first full year following CHIPRA. Overall, however, tobacco tax collections remain higher than they were pre-CHIPRA. The tax rate differentials resulting from CHIPRA created new incentives for manufacturers, importers, and consumers of certain tobacco products.

Since CHIPRA increased the tax on small cigars and small cigarettes, we have not found evidence of widespread misclassification of cigarettes as cigars under the Internal Revenue Code. We have, however, seen a notable shift in the cigar market. Although CHIPRA raised the tax on both small and large cigars, it created an incentive to shift production to the large cigar category because, depending on price, the tax rate on a large cigar can be significantly lower than the tax on small cigars. Large cigars are the only tobacco product for which the excise tax is based on the manufacturer's or importer's sale price.

Since CHIPRA, we have found that cigar manufacturers and importers are structuring operations or sales to lower their taxable sale price, resulting in a decrease in the average tax collected per large cigar. We have also seen a significant shift in removals of pipe and roll-your-own tobacco. Because the two products can be similar, and because the tax on roll-your-own tobacco was significantly increased as compared to pipe tobacco, a portion of the roll-your-own tobacco market has switched to pipe tobacco since CHIPRA. We believe that this disparity, combined with the tax rate increase on cigarettes, has resulted in an increase in the popularity of machines that can make cigarettes from roll-your-own or pipe tobacco. These issues will likely exist as long as incentives remain under the Internal Revenue Code for manufacturers to reclassify products or restructure transactions to achieve a lower tax by taking advantage of rate differentials.

In addition, a 150-percent increase in the Federal excise tax on cigarettes imposed by CHIPRA increased the incentive to evade Federal taxes through tobacco diversion. We have seen numerous diversion schemes and are addressing them through multiple means, including criminal prosecution. Our Criminal Enforcement Program is critical to our ability to effectively curtail current illicit operations and deter others from engaging in diversion activity.

I am proud of this bureau and what we have been able to accomplish in the 11 years since we were established. Despite our small size of about 465 employees, we have worked to maximize the reach of our resources, collecting roughly $23 billion in fiscal year 2013, which represents a return of approximately $450 for every dollar invested in TTB's revenue collection activities.

I sincerely appreciate the opportunity to testify before the committee today and would be happy to answer any questions you have.

Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Manfreda appears in the appendix.]

The CHAIRMAN. Dr. Gootnick?

STATEMENT OF DR. DAVID GOOTNICK, DIRECTOR, INTERNATIONAL AFFAIRS AND TRADE, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Dr. GOOTNICK. Thank you, Mr. Chairman. Mr. Chairman and members of the committee, thank you for asking GAO to participate in this hearing.

As you know, Federal excise taxes on tobacco products have long aimed to both raise revenue and discourage tobacco use. My statement today will focus first on the market shifts among smoking tobacco products that followed the 2009 changes to the Internal Revenue Code, and second, on the impact of these market shifts on tax revenues.

I will focus on the four tobacco products: roll-your-own tobacco, pipe tobacco, small cigars, and large cigars. Consumption of these four products has increased over the past decade and now represents 12 percent of smoking tobacco sales in the United States.

As Figure 2 from my written testimony shows, CHIPRA eliminated certain tax disparities among these products and created others, as we have been discussing. You can see here the pre-CHIPRA rates and the post-CHIPRA rates, and you can see that the rates on cigarettes, roll-your-own tobacco, and small cigars were raised and made equivalent. However, you can also see that the post-CHIPRA rate on pipe tobacco is now roughly one-tenth of the rate of roll-your-own.

Unlike these products and not shown in the slide, the large cigar tax, as has been mentioned, is calculated as a percentage of the manufacturer or importer's sales price, up to a maximum. This is the so-called "ad valorem" tax. The key point on large cigars is that, after CHIPRA, inexpensive large cigars are now taxed at a much lower rate than their counterpart small cigars. So, as you would expect, the market shifted in response to these changes. Manufacturers shifted their products to take advantage of lower tax rates, and price-sensitive consumers shifted their preferences.

As you can see in Figure 4, the sales of low-tax products spiked after CHIPRA, and high-tax products plummeted. Specifically in this figure, you see that sales of large cigars more than doubled, while sales of small cigars declined by nearly 90 percent. So the immediate spike in large cigars is shown here on the heavy line, and the crash of the small cigar market on the thin line. Likewise in Figure 3, you see sales of pipe tobacco increasing over 7-fold, 744 percent, and sales of roll-your-own tobacco declining by over 80 percent.

The key here is that manufacturers can shift their products because the tax code differentiates roll-your-own and pipe tobacco in large measure by their appearance, packaging, and labeling, which allow firms to re-label their products with minimal, if any, changes. Likewise, the tax code distinguishes small and large cigars only by their weight, and at a breakpoint of 3 pounds per thousand, a small cigar can undergo minimal changes, as you have mentioned, to qualify as a large cigar.

Regarding the revenue consequences of these shifts, we modeled what tax revenues would have been if market shifts resulting from the substitution had not occurred. Our analysis used the long-term trends in consumption prior to CHIPRA and the expected fall in demand due to higher tax rates. Thus, we believe our estimates made conservative assumptions on the magnitude of tax avoidance.

In the bottom line, we estimate the tax avoidance due to the observed market shift to be in the range of $2.6 to $3.7 billion since the enactment of CHIPRA. Over the same interval, actual post-CHIPRA revenue on these four products is roughly $5.3 billion, so you can see that the tax avoidance, in both magnitude and as a percentage, is significant.

As you have heard, TTB has limited options in response. They have sought to curtail the growing availability of unpermitted roll-your-own tobacco machines in commercial use that emerged after CHIPRA; however, the core incentives towards pipe tobacco remain. In addition, the Bureau has analyzed proposals to differentiate roll-your-own and pipe tobacco based on the physical attributes, but there is no real consensus on what, if any, characteristics truly distinguish these two products.

Finally, there are additional challenges with the ad valorem tax on large cigars, which creates opportunities for tax avoidance or evasion through intermediary transactions. These transactions truly blur the line between tax avoidance and tax evasion.

In conclusion, we maintain that Congress should consider equalizing the tax rates on roll-your-own and pipe tobacco and, with TTB, consider options for reducing tax avoidance due to the gap between small and large cigars. Proposals in this regard have included establishing a floor on the ad valorem tax or increasing the weight threshold for large cigars.

Mr. Chairman, this completes my remarks. I am happy to answer your questions.

The CHAIRMAN. Doctor, thank you very much.

[The prepared statement of Dr. Gootnick appears in the appendix.]

The CHAIRMAN. Obviously, when you are talking about $2.6 billion to $3.7 billion being evaded in taxes, if anything, the committee has understated this challenge. You are talking about sums of money that are very substantial. Of course, the whole point of this exercise, which Senator Hatch and Senator Kennedy and Senator Rockefeller started, is to try to make sure that we are taking steps to protect children.

Now, Mr. Manfreda, at this point we have 39 States asking you to issue new rules to more clearly distinguish between cigarettes and cigars. So that is the majority—well over the majority—of our States that are asking for clarification on this central point, which of course goes right to the tax evasion that Dr. Gootnick is talking about.

Now, almost 8 years ago you all issued a Notice of Proposed Rulemaking, but nothing happened. So let us start by having you tell us why that is the case, that after 8 years and 39 States asking for clarity on something that is right at the heart of this tax evasion question, why it has not been done.

Mr. MANFREDA. That is a fair question. Back in 2006, we did do a Notice of Proposed Rulemaking regarding differentiating a cigarette from a cigar. However, with CHIPRA equalizing the tax rates between a small cigarette and a small cigar, the priority for the revenue issue associated with that was pretty much neutralized. What I mean is, they are now taxed the same way.

Given the fact that we are a very small agency, we have very small resources, CHIPRA created other rather large problems for us to address in regard to classification issues, specifically roll-your-own tobacco versus pipe tobacco.

So we have been looking at and we have been going forward with the research and the differentiation; however, it has not had that big a priority from a tax collecting point of view as roll-your-own tobacco or pipe tobacco does have. So we are in the process. We have it on track as a rulemaking effort. Down the road we will be coming out with rulemaking on that.

The CHAIRMAN. So when will that be? Because, as of right now, the small cigars are getting through the loophole. So when?

Mr. MANFREDA. Well, small cigars are getting called a loophole. What they are exercising their right to do is increase the tobacco with regard to the weight of the small cigar to make it a large cigar. That is a statutory line we cannot change, sir. By that, when they are adding maybe 2 or 3 ounces of more tobacco to make it a large cigar, that is how they are crossing the line.

The CHAIRMAN. The problem, however, is that cigarettes are now in effect cigars, and that is the problem. I just keep looking at all these proposals that you make, and the tax evaders always seem to get around them. Then you say there is some other reason that you cannot act.

So let us go then to the question of pipe tobacco after the Children's Health Insurance Program Reauthorization. A number of participants in the roll-your-own tobacco cigarette market quickly shifted to labeling their products as lower-taxed pipe tobacco. Then they got a wink and a nod from the retailers, to direct consumers to the right bag, and the companies were able to dodge $22-per-pound in tax by slapping pipe tobacco labels on bags full of cigarette tobacco.

Now again, in 2010, you issued an Advanced Notice of Proposed Rulemaking to deal with a problem that GAO has spotlighted and I have spotlighted. But again, somehow the regulation just was not issued. In fact, I gather there was not even a formal proposed regulation, and GAO points out that billions of dollars are being lost as a result of this loophole. So what is the reason for the delay here?

Mr. MANFREDA. Again, a fair question, sir. If you will remember, we put out an Advanced Notice of Proposed Rulemaking back in 2010. We extended that comment period in 2011, airing industry proposals for differentiation.

In our airing, we looked at characteristics that could differentiate these products, from cut size, moisture content, residual sugar, the amount of black tobacco in a product, or the amount of weight associated with flavors or other non-tobacco products.

The CHAIRMAN. The bottom line is—because I want to ask one other question—we do not have a regulation that will ensure that we are not seeing tax law evaded. When is that regulation going to come out? Can you give us a firm commitment now?

Mr. MANFREDA. We are going to air a rulemaking in January.

The CHAIRMAN. Of 2015?

Mr. MANFREDA. Of 2015.

Sir, the issue here, and what has made this so very difficult is, if you go back and you look at our comments from our 2011 rulemaking, we got an additional 170 comments, 32 of which came from industry members. Those comments were so diverse, and, when you dug into them, you actually got into the point of, they were reflective of their own individual products that were on the market. So what we are left with is, we are trying to come up with an objective, measurable, not easily manipulated standard that draws the line at the right place.

The CHAIRMAN. But of course an agency gets comments. To not have issued even a proposed rule is, I just think—we have had a classic case of tax evasion, and it seems like we are looking at a classic case of foot-dragging, and we have to do better.

I want to ask you one other question, and my time is up. That is, there of course is tremendous interest in the question of e-cigarettes. After decades of work, there has been an effort to cut down on kids smoking, and fewer Americans pick up a cigarette every day, but there has been an explosion in the use of e-cigarettes, especially among young people.

I am concerned about whether history is going to repeat itself, because it was not very long ago when I was in the House and I went down a row with tobacco executives and asked whether nicotine was addictive and they all said no, and I am very concerned about whether we are going to go down the same route with people saying, let us study this and then we will finally decide whether these nicotine delivery devices ought to be taxed and regulated. So it would be very helpful to have on the record whether or not TTB now has the authority to tax e-cigarettes.

Mr. MANFREDA. Sir, we do not, under the Internal Revenue Code, have the authority to tax an e-cigarette that does not contain tobacco. We have to have tobacco in the product to meet an Internal Revenue Code definition of a tobacco product, so currently we do not.

The CHAIRMAN. All right.

Let us go, next, to Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. Thank you for holding this hearing. Let me also say I concur with you that it appears, on these tax avoidance issues, the failure to have at least a regulatory framework is losing the government revenue. It is not fair; it is not right.

I was curious to hear comments about at least some level of a floor, since it seems like your ability to manipulate a little bit of tobacco in or out of a product puts you above or below a threshold that could have a huge change in your taxation. Obviously, I think the charts were pretty powerful about how the market has diverged so much.

In Virginia we have a tradition of tobacco products. Most of our companies are extraordinarily responsible in how they deal with this. I do not think there should be such a wide variety of tax consequences between products that may have equal or similar health concerns.

What I want to ask the witnesses is, let's move a little away from this question of straight avoidance, or manipulation in a sense, to issues around just plain illicit activities. Mr. Manfreda, I want to start with you, and then I will go to Dr. Gootnick. My understanding is that, at this point, there is little to no transparency regarding what entities actually hold TTB permits, so investigative efforts are in many ways hindered from their inception.

Without adequate enforcement—and I believe either in my notes or in your testimony I read that you have only about four enforcement agents—manufacturers without permits, that do not have any authorization at all, are free to operate without fear of enforcement of any laws. Often without that enforcement, they avoid any payments at all of Federal or State excise tax.

I have heard actually some extraordinary and astounding numbers. In some places, as much as half the cigarettes consumed may be either totally non-taxed or under-taxed, particularly in certain jurisdictions with very high-tax components around cigarettes.

So, Mr. Manfreda, I understand that you are a small agency. I want to associate myself with the chairman's remarks that I do think we need to start this regulatory process sooner rather than later. But when we are talking about just plain illicit activities, how concerned are you about this? Can you talk about efforts that your office is undertaking with State enforcement agencies to deal with this illicit trade of tobacco?

Mr. MANFREDA. Yes, sir. Our criminal enforcement function over the last 4 years has actually developed 72 cases, 70 of which are presently accepted by U.S. Attorneys' Offices to pursue as criminal cases. Out of that, we have identified over $345 million in potential tax liability, and we have physically seized over $121 million worth of merchandise as well. But diversion is a real problem, especially with a commodity like we are regulating. When the intrinsic value of the commodity is dwarfed by its tax liability, it is a recipe for illegal conduct.

Senator WARNER. But is it safe to say that some of the numbers that I have referenced, that in some States as much as half of the tobacco products sold may be fully illicit and not have even appropriate TTB permits, is that too high a number, or is that in the range?

Mr. MANFREDA. Sir, I do not have statistics on that. I am unable——

Senator WARNER. But you are the enforcement entity.

Mr. MANFREDA. Yes, but diversion——

Senator WARNER. It seems fairly stunning to me that you do not have statistics, plus or minus 10 percent, or up to 50 percent of the tobacco products in a State like New York with a high tobacco tax, are illicit.

Mr. MANFREDA. Well, again, are we talking about Federal excise tax or are we talking about State taxes that are covered under the jurisdiction of ATF?

Senator WARNER. Pick your poison.

Mr. MANFREDA. We do not have jurisdiction over contraband cigarette taxing. That is when you——

Senator WARNER. But because there is a failure to have any kind of transparency about which of these manufacturers that are not following the rules at all in terms of TTB permits——

Mr. MANFREDA. Well, we coordinate our efforts with State authorities. We have ongoing dialogue with most States. We have tax agreements to give us the ability to share tax information with State authorities.

Senator WARNER. Mr. Chairman, may I take one more moment to ask one other question?

The CHAIRMAN. Of course.

Senator WARNER. It just seems to me we should have concerns about this agency, both in terms of the regulatory approach as well as the fact that we do not seem to have a lot of good data in terms of actual illicit activities that are also potentially losing us revenue. That is where, Dr. Gootnick, I wanted to ask you, can you talk in any detail about how the illicit trade is affecting tax collection and how changes in CHIPRA may have affected that positively or negatively?

Dr. GOOTNICK. Right. Start with the observation that, for a pack of cigarettes, for example, more than 50 percent of the retail sales price of a pack of cigarettes is taxes and fees. That is the Federal excise tax the TTB is responsible for, plus State excise taxes, local taxes in many cases, the master settlement agreement, the tobacco buy-out. That set of taxes and fees is over 50 percent of the price of a pack of cigarettes. So, when you get a product where the profit margin for illicit activity is high and the penalty is relatively low, there is going to be a range of activities.

Those activities range from true smuggling across international boundaries to diversion of product that is deemed for export but is reintroduced into the domestic market absent the Federal excise tax, to what I think you are talking about, which is movement of cigarettes from, say, Virginia, a low-tax State, to New York, a high-tax State. In addition, there are Internet sales that do not pay required taxes.

There have been estimates that the magnitude of diversion on State excise taxes is in the range of $5 billion annually. I do not know how reliable those numbers are. It is inherently difficult to quantify what is covert and what is an underground activity.

Senator WARNER. Mr. Chairman, I guess my final point—and I appreciate you giving me a little bit of extra time here—is that it seems like there may be two buckets here. One bucket, which I think you focused appropriately on, is, do we have a floor? How do we make sure that there is not an ability to game the system somehow within the, at least quasi-legal, context of roll-your-own or moving from small cigar to large cigar, these kind of manipulations which affect us in terms of a lot of revenue?

There is also this other bucket of activities which we have heard referenced of up to 50 percent full tax evasion or fully illicit manipulation, or failure to even have any kind of registration. Those just seem to be out-and-out wrong actions. I believe we need to take action in both areas.

Again, I appreciate the chairman giving me this extra time and having this very important hearing.

The CHAIRMAN. The Senator from Virginia is being too logical. Heaven forbid that logic should break out on this, but I very much appreciate your separating those two considerations out. I look forward to working with you to pursue that.

Let us move on again to kind of stay with this question of what is behind the inaction. Dr. Gootnick, you have reviewed the roll-your-own tobacco issue, the shift to large cigars. You have said that the problem is getting worse, this effort to circumvent the higher taxes, and it has gotten worse since you last looked at it.

Now, given all that, the committee, back in 2012, included a provision in the Highway Bill that required roll-your-own machines offered for use at retail locations—we would be talking about convenience stores, tobacco shops—to be registered as commercial cigarette manufacturers. It was the point of the committee back then that this provision would stop the use of these machines for tobacco tax evasion and reduce the use of mislabeled roll-your-own tobacco.

My sense is that that has not happened, and that is pretty much what you have said. But what is your sense of why the transportation bill provision has not worked? I mean, why has that not been an effective tool to close the loophole and block the bleeding of these enormous sums of money?

Dr. GOOTNICK. Right. I would say, in a nutshell, it is because the incentive remains to switch from roll-your-own to pipe tobacco. But you are very correct that the transportation legislation in 2012 made clear that roll-your-own machines in commercial use were to be considered manufacturers of tobacco and should be taxed accordingly.

The use of commercial roll-your-own machines went underground a little bit more than it had been. Insofar as these roll-your-own machines still exist, they do not necessarily as frequently exist right inside a retail tobacco outlet, but they do exist right next door.

So we have observed—I had a team go, in this local area within 20 to 30 miles from here, to retail outlets and observe one retail outlet that formerly had a roll-your-own machine on its premises. Now there was a wall between the roll-your-own machine and the tobacco outlet where an individual could buy the pipe tobacco and the tubes, go around the corner to the roll-your-own machine. We actually observed an individual walk in, join the club for $10, and then provide them with their tobacco and walk out with a carton of cigarettes. Using roll-your-own tobacco, they saved easily 10 bucks on a carton of cigarettes. So the incentives remain, and the process still goes on.

The CHAIRMAN. And, Mr. Manfreda, what is your response to that? I mean, again, we have a substantial question of enforcement, where it seems like the government is just behind those who would try to skirt the laws and rules. What is your response to exactly what Dr. Gootnick just said?

Mr. MANFREDA. I would concur with him that the major incentive here is the tax differentiation between the products. I would tell you that, at present, we have over 72 investigations under way regarding cigarette-making machines. All but six of those have raised issues of whether or not a social club is exempt from the liability as a manufacturer.

We have not seen any representation where a social club would fall within the exemption from being considered a manufacturer of tobacco products. Some of the issues associated with finding this—and I do agree with the doctor that these have gone underground—when MAP–21 * was issued, we sent out over 1,467 letters to locations where we knew these machines were.

The problem is, we have no jurisdiction over these machines or their operators, they are not required to keep records, and they are not required to cooperate with us. They are really easily moveable. So enforcement of this becomes a very difficult problem.

I do know that, out of the 72 investigations we have under way, the liability associated with any one location is about $54,000. So it is time-consuming. They do not cooperate with us. Even the manufacturers of the machines have an incentive not to cooperate with us. So, it is a very difficult problem to put to bed, because they are mobile and they hide.

The CHAIRMAN. Fourteen hundred machines, 72 investigations, and still—unless I am missing something—no actual enforcement actions. Part of my concern is that, when there are no enforcement actions, it basically says to those who try to skirt the laws, you are home free.

I mean, the whole point of enforcement, especially with scarce resources—and I am aware that you all are pressed in terms of resources—is, if you do not have some enforcement actions where you go the distance, it just sends the worst possible message, because those who would try to make money and exploit these loopholes to take advantage know they are home free. That is what I am so troubled about.

I want to move on to one other area where I need to know whether new legislation is actually needed, and that is the question of processed tobacco and the diversion of it. Now, in 2009 the Congress expanded your authority to address this issue, the shipment of untaxed processed tobacco, so that the agency could get a better handle on whether or not the manufacturers were paying the right taxes.

Now, you all have asked for additional authority in this area because of your concern that untaxed processed tobacco shipments are being diverted through intermediaries and your ability to track the shipments is being lost. So why was the authority in the Children's Health legislation inadequate on this point, so we know exactly why you need the additional authority that you are talking about?

Mr. MANFREDA. In the President's budget, we proposed that any transfer to a non-permittee would be regarded as a removal of roll-your-own tobacco. The reason the current framework is a problem is that, when a manufacturer or processed manufacturer ships to

* The Moving Ahead for Progress in the 21st Century Act of 2012.

a non-permittee, the first shipment is required to be reported to us, but what we have seen is there are multiple shipments after that that are not required to be reported to us.

The ability to follow that shipment is at the whim of the persons we are going to, who are not required to report to us, keep records, or do anything like that, so the audit trail becomes almost impossible to follow without cooperation. That is why we would want to limit the transferability of processed tobacco to non-permittees.

The CHAIRMAN. Did you want to add anything to that, Dr. Gootnick?

Dr. GOOTNICK. I was just going to say that processed tobacco is really, I think, a straightforward example of an intermediate good being treated as a consumer item. So the intention under the definition of processed tobacco is that it is used as a factor in the making of a consumer good, but indeed it is just simply being used, and can be used with minimum modification in, for instance, these commercial roll-your-own machines to make cigarettes.

The CHAIRMAN. Thank you very much, Dr. Gootnick.

I am going to excuse you both at this time, but I want it understood that, with the problem now more serious even than we had originally assessed, Mr. Manfreda, we need some clear rules. The idea that 39 States, as I stated, wait around for years and years, and there are proposals, it kind of reminds me of the marquee at the old movie house where it says “coming soon” and it never gets there.

I mean, you all make these proposals, and year after year after year goes by, as those who would try to skirt the laws get more inventive and more and more creative, and the combination of the lack of clear rules—for reasons that I am still not clear on—plus the fact that we cannot even have a handful of enforcement actions to send a message of deterrence, I think is a prescription for trouble. So at this point I am going to ask——

Senator Crapo is here, and I will just make a unanimous consent request, and then see if my colleague has questions.

At this point I am going to ask unanimous consent to include in the record two analyses prepared by the TTB analyzing the number of tobacco companies that switched their small cigars to large cigars and roll-your-own cigarette tobacco to pipe tobacco. The identity of the individual companies is not included in these analyses because the information is considered protected under section 6103 of the Internal Revenue Code. These analyses were provided to and were discussed with minority staff. Without objection, they will be made part of the record.

[The analyses appear in the appendix on p. 178.]

The CHAIRMAN. So let me recognize my friend and colleague Senator Crapo for any questions he has for the first panel.

Senator CRAPO. Senator, I have no questions for the first panel, and I look forward to moving on to see what the next panel has.

The CHAIRMAN. Very good. Gentlemen, you are excused.

Our next panel will be Mr. Ronald Bernstein, president and CEO of Liggett Vector Brands of Morrisville, NC; Mr. Rocky Patel, owner of Rocky Patel Premium Cigars and board member of Cigar Rights of America in Naples, FL; Mr. Michael Tynan, Policy Officer, Oregon Public Health Division in Portland, OR; and Mr. Scott

Drenkard, economist and manager of State projects, Tax Foundation of Washington, DC.

Gentlemen, if you all will come forward. All right. I am very pleased that we have this panel, and let us begin with you, Mr. Bernstein.

STATEMENT OF RONALD J. BERNSTEIN, PRESIDENT AND CEO, LIGGETT VECTOR BRANDS LLC, MORRISVILLE, NC

Mr. BERNSTEIN. Chairman Wyden, Ranking Member Hatch, and members of the committee, my name is Ron Bernstein, and I am president and CEO of Liggett Vector Brands. Liggett is the fourth-largest cigarette manufacturer in the United States and has been operating since 1873. Thank you for inviting me to testify today.

Seventeen years ago, Liggett became the first tobacco company to break ranks with the industry and settle tobacco-related litigation. We also were the first, and remain the only, company to state that smoking is addictive on our packaging and to voluntarily list ingredients on our cartons. These actions reflect Liggett's long-standing cooperative relationship with Congress, the public health community, and regulators. With that backdrop, we are here today to shine a light on illegal conduct that is costing the U.S. billions in tax revenues.

In 2009, Congress raised tobacco taxes to help fund the State Children's Health Insurance Program. The taxes on cigarettes, roll-your-own tobacco, and on little cigars were raised to the equivalent of $10.07 per carton. At the same time, Congress only marginally raised the tax on pipe tobacco to $1.15 per carton equivalent. That means the Federal excise tax on cigarette tobacco is roughly 10 times that on pipe tobacco. Before the ink was dry on the legislation, certain tobacco manufacturers embarked on a campaign to evade the tax increase by relabeling roll-your-own tobacco as pipe tobacco.

For example, what a smoker would have found in a store before the tax increase was called Kentucky Select cigarette tobacco. The product made available after the tax increase is called Kentucky Select pipe tobacco. The chief differences between these products are the label and a substantially lower tax rate.

Here is a bag of Desperado. Astoundingly, this company pasted on a label that says "All Natural Pipe Tobacco" and used tape to cover the statement "Makes approximately 500 cigarettes" on the back. Everyone knows that this is cigarette tobacco. The manufacturer knows, the consumer knows, and I know. I know because I tried smoking it in a pipe and it was not a pleasant experience.

We met with representatives from TTB in 2010 and showed them that all of the growth in the category was coming from mislabeled pipe tobacco rather than genuine pipe tobacco. TTB advised they were aware and had expected this problem when Congress failed to equalize the tax on pipe tobacco with roll-your-own tobacco and cigarettes in 2009.

Since the existing tax code definition of RYO included anything sold as cigarette tobacco or roll-your-own tobacco, TTB already had clear authority to enforce the law, especially since the manufacturers of the product knew exactly what they were doing and were using a variety of tactics to inform consumers that the product was really roll-your-own tobacco.

We were pleased to learn shortly after the meeting that TTB had issued a statement on its website indicating that specific guidance would be forthcoming in the near future. Four years later, we are still waiting for that guidance. Meanwhile, sales of pipe tobacco have grown by over 700 percent, while roll-your-own has declined by over 80 percent, and cigarettes have declined by over 20 percent.

This chart—which is included in my written statement—looks very similar to the one that GAO put up and really tells the whole story. None of the manufacturers of genuine pipe tobacco have seen any real growth during this period, nor are we aware of any growth in the sale of pipes. Yet products labeled as pipe tobacco have grown in sales from less than 1 percent of the total cigarettes equivalent market to over 6 percent, or more than 18 billion cigarette equivalents. Despite this, TTB has issued no specific guidance, and over $3 billion in excise taxes have been lost by the Federal Government.

Even after a GAO report clearly demonstrated that the explosion of pipe tobacco sales was entirely due to roll-your-own tobacco sales and had admissions from manufacturers to this fact, TTB still failed to act. Under the definition of cigarette tobacco in the Tobacco Control Act, FDA also has clear authority to treat mislabeled pipe tobacco as misbranded and to require it to be properly labeled and regulated as cigarette tobacco, but they too have allowed two markets to exist, one regulated and properly taxed, the other not.

Additionally, since 2009 the renegade tobacco industry has also relabeled little cigars as filtered cigars. Here is an example, which you can see looks exactly like a pack of cigarettes and also contains menthol, which is not typically found in real cigars. This has created another tax dodge that has cost the Federal Government close to $900 million. Together with mislabeled pipe tobacco, these products now comprise over 8 percent of the cigarette market.

We welcome the attention that Congress is once again bringing to this issue and look forward to working with you to address the problem. Thank you for your attention.

The CHAIRMAN. Mr. Bernstein, thank you. I just am struck by the fact that, 2 decades ago when I asked tobacco executives whether nicotine was addictive and they were under oath, they said "no," and you have come here today and in effect given us real candor as to what is going on in the marketplace. I very much appreciate it, and we will have some questions for you in a moment.

Mr. BERNSTEIN. Thank you, Mr. Chairman.

[The prepared statement of Mr. Bernstein appears in the appendix.]

The CHAIRMAN. Mr. Patel, welcome.

STATEMENT OF ROCKY PATEL, OWNER, ROCKY PATEL PREMIUM CIGARS INC., AND BOARD MEMBER, CIGAR RIGHTS OF AMERICA, NAPLES, FL

Mr. PATEL. Thank you, Chairman Wyden, Ranking Member Hatch, and members of the committee, for granting me this opportunity to testify before this committee. My name is Rocky Patel, and I am the owner and CEO of Rocky Patel Premium Cigars, founded in Naples, FL.

The 20 million premium cigars we handle each year embody the values of artisan craftsmanship, strict quality control, and the use of the finest aged tobaccos. While not defined under the tax code, premium cigars are made from a 100-percent wholly tobacco wrapper, are made by hand with 100-percent tobacco binder and filler containing no filter, tip, or non-tobacco mouthpiece, and weigh in at at least 6 pounds per thousand. These are considered to be high-grade tobacco products. The closest approximation to a premium cigar in the tax code is the large cigar, which weighs at least 3 pounds per thousand. As a result, there are physical weight differences between what we consider a premium cigar and what is considered a large cigar under the code.

The premium cigar culture is also unique and is rooted in the social nature of premium cigar consumption, often used in celebrations. The typical cigar shop is a family-owned brick-and-mortar store that is the modern-day equivalent of a general store or barbershop where men and women who share a passion for premium cigars can enjoy each others' company, share common interests, and discuss the issues of the day in a relaxed, comfortable environment. Many of these experienced tobacconists have spent years visiting my farms and factories so as to provide the superior expertise their customers expect. Premium cigars occupy a niche within the overall cigar and tobacco market, serving an adult consumer base with a complex palate and appreciation for high-quality tobacco products.

Since the 1970s, cigars have been classified as either small or large based upon weight and taxed differently based upon this classification. Premium cigars are lumped into the large cigar category under the code. In 2009, the enactment of CHIPRA transformed tobacco taxation by significantly raising the Federal excise taxes on both small and large cigars, along with other tobacco products including cigarettes, pipe tobacco, and roll-your-own tobacco.

Before CHIPRA, premium and large cigars were taxed at a greater amount of either 20.719 percent per cigar or not more than 4.875 cents per cigar. After CHIPRA, these rates rose to the greater amount of either 52.75 percent per cigar and 40.26 cents per cigar, respectively. This resulted in as much as a 726-percent tax increase on premium cigars per thousand, one of the highest increases in the history of the U.S. tax code. However, taxes on small and large cigarettes only increased by approximately 158 percent per thousand sticks after CHIPRA.

The 2012 GAO report highlighted that price-sensitive manufacturers and consumers began substituting higher-taxed products with lower-taxed ones. Some industry participants took steps to avoid taxes by reclassifying their products by adding weight to small cigars in order to qualify as large cigars. Our solution to this issue would be to define premium cigars in the code to distinguish between non-premium cigars and premium cigars. A premium cigar could be defined according to several unique factors, including that premium cigars are unfiltered products that are hand-wrapped, are 100-percent leaf tobacco, and weigh more than 6 pounds per thousand.

These differences would make it impossible to game the definition of premium cigars based on weight alone, allowing Congress and the regulators to focus on the differences between small, large, and premium cigars and reduce the opportunity and incidences of tax avoidance. We also support a lower flat tax for premium cigars, which should have the added benefit of simplicity and certainty, reducing the compliance burden on the premium cigar industry and the enforcement burden on the TTB.

Such a flat tax could, and should, be lower than the current rate applied to large cigars to more appropriately calibrate the relative differences between the tax rates. We also believe that the policies adopted in the response to the GAO report should focus on key sources of revenue loss and not focus on tobacco products that are not the source of tax avoidance. Importantly, cigars represented less than 4 percent of the Federal excise tax revenue from all tobacco products in 2012.

Thank you again for this opportunity to testify before the committee. I would be pleased to answer any questions.

The CHAIRMAN. Thank you very much, Mr. Patel. We will have questions in a moment.

[The prepared statement of Mr. Patel appears in the appendix.]

The CHAIRMAN. We are glad to see Oregon well-represented here today. Mr. Tynan, please proceed.

STATEMENT OF MICHAEL TYNAN, POLICY OFFICER, OREGON PUBLIC HEALTH DIVISION, PORTLAND, OR

Mr. TYNAN. Thank you, Chairman Wyden, Ranking Member Hatch, and members of the committee. My name is Michael Tynan. I am the Policy Officer for the Public Health Division in the Oregon Health Authority. Prior to that, I was at the Centers for Disease Control and Prevention's Office on Smoking and Health. I have been invited here to talk to you today about studies I published on changes that have happened since the Federal excise tax increased in 2009, but before that, since I am the only public health voice, I want to talk about the dangers and health effects of smoking.

Tobacco use is the leading cause of death and disease in the United States. Each year, 480,000 people die from smoking and exposure to second-hand smoke, and CDC estimates that 18.1 percent of adults in the United States are smokers. The good news is, we know how to end the tobacco use problem in this country. Ending the tobacco use problem is a political question, not a scientific one.

We know what works. Increasing the price of tobacco, establishing smoke-free environments, warning about the dangers of second-hand smoke with aggressive media campaigns, and increasing access to cessation are the tools available to public health that can significantly reduce smoking and tobacco use.

Increasing the price of tobacco is the most effective tobacco prevention tool available for public health. Simply put, the more cigarettes cost, the less people will smoke. Every 10-percent increase in the price of cigarettes results in a 4-percent decline in consumption and can have an even greater impact on youth.

Dr. Gootnick already spoke to you about reports published by GAO concerning changes in the tobacco use patterns and product design since 2009, and my full testimony contains a summary of the papers that I have published, and my colleagues at CDC and in Oregon, on this topic. I will summarize those by saying that our papers reached complementary conclusions to what GAO reported to you earlier today. Our papers included an estimate of Federal revenue loss, and, although we used different timelines and slightly different methodologies, we found that, through June 2013, Federal tax receipts on the pipe/roll-your-own switching alone reduced Federal tax receipts by $2.3 billion. There were additional losses to State governments in lost excise taxes and lost State revenue.

But let me walk you through what this means practically for a smoker. This, as you have seen earlier, is a 1-pound bag of roll-your-own tobacco. However, as you can see, it has a pipe label on it. This bag can be purchased online for about $10. I went to my neighborhood roll-your-own shop on Sunday. I walked to it. I did not ride my bike, but I walked to it, Senator, and it cost me $16. So, because it has a pipe label on it, that is why it is so inexpensive. Had it had a roll-your-own label on it, it would have been at least $22 more.

But the interesting thing was, even though the store's name is Roll-Your-Own Mart, they do not even sell roll-your-own tobacco. All of the tobacco they sell there is pipe tobacco. The clerk told me that roll-your-own tobacco is too expensive, so they do not carry it. They sell pipe tobacco instead.

This $16 bag will make approximately 500 cigarettes. That is about 2½ cartons of cigarettes. So for comparison, a single carton of cigarettes in Oregon costs $45. Two hundred cigarettes for $45, or you can make 500 for $16—if you were a smoker and your taxes went up, which product would you buy?

The public health community is concerned about this, because, instead of quitting in response to the 2009 Federal cigarette tax increase, it appears that some smokers have switched to pipe tobacco, allowing them to maintain their addiction to tobacco products. Also, as you heard earlier, the changes do not stop at pipe tobacco. There have been changes to the type of cigars people smoke, or at least in the way that those cigars are taxed.

So this is a machine-made cigarette, which you saw earlier, made by Cheyenne Tobacco. This is a small cigar made by Cheyenne Tobacco. They are identical. The difference is, this one is wrapped in white paper, this one is wrapped in tobacco leaf. That is how this is classified as a small cigar. Then what manufacturers did after 2009 is, they took these products, still sold in a pack of 20, that were small cigars, made them a little bit heavier, and classified them as large cigars. In some cases, as you mentioned, Senator, that was done by adding a little bit more tobacco to the product. It has also been done by adding kitty litter to the filter to make them heavier.

So again, the public health concern is that smokers who might have otherwise quit have instead switched to products that have allowed them to maintain their addiction to tobacco products. Public health is also concerned because the morbidity and mortality effects of all forms of combustible tobacco are the same. If you smoke a cigar the way you smoke a cigarette, it does not matter how it is taxed, there are going to be health effects.

Changing how these products are classified also does not just result in lost revenue, but also changes how these products are regulated by the Food and Drug Administration. These products are now available in candy flavors and with misleading descriptors like "Lite," "Mild," and "Low," even though those practices are banned by the Food and Drug Administration and by Congress in the Tobacco Smoking Act.

So at least two policy approaches exist that can address these tax and policy loopholes. First, as was discussed earlier, the objective characteristics could be identified that could classify these products separately from one another. Second though, and more importantly, tax parity for combustible tobacco is the direct way to impact this practice.

Congress was wise in 2009 when it created tax parity for cigarettes and small cigars and roll-your-own to discourage switching between these products. The issue we are discussing today, Senators, is an unfortunate consequence of tax inequity between pipe tobacco, large cigars, and other combustible tobacco. Simply put, tax parity would expand the public health benefit of the 2009 Federal tax increase.

The CHAIRMAN. I want to make sure I heard that right, but I thought you said that clay in kitty litter was added to the filter to make the small cigar heavier. Is that true?

Mr. TYNAN. There are some instances where that has been done. Yes, Senator.

The CHAIRMAN. Could you get us that for the record? I had not heard that before.

Mr. TYNAN. Yes.

[The prepared statement of Mr. Tynan appears in the appendix.]

The CHAIRMAN. All right. Let us hear from Mr. Drenkard.

STATEMENT OF SCOTT DRENKARD, ECONOMIST AND MANAGER OF STATE PROJECTS, TAX FOUNDATION, WASHINGTON, DC

Mr. DRENKARD. Thank you, Chairman Wyden and members of the committee. I appreciate the opportunity to speak today. In our 77 years since our founding in 1937, the Tax Foundation has monitored tax policy trends at the Federal and State levels, and our data and research are heavily relied upon by policymakers, the media, and the general public.

Tobacco taxes today are the highest they have ever been in the United States. The Federal rate currently stands at $1.0066 cents per pack of cigarettes, and State and local rates can add as much as an additional $6.16 per pack, as in Chicago, IL. These combined rates are equivalent to a tax in excess of 200 percent in some locales. Now, these taxes have a really substantial effect on the price of cigarettes as well. The most recent survey I found is that a pack of cigarettes costs $14.50 in New York City.

The high tax burden on tobacco results in de facto prohibition on the products, bringing with it all the undesirable outcomes associated with the alcohol prohibition in the 1920s. The largest of these is cigarette smuggling. Our research shows substantial empirical evidence of tobacco smuggling from low- to high-tax jurisdictions, with criminals pocketing the profits that would otherwise go to State revenue coffers.

The Mackinac Center for Public Policy estimates that 57 percent of the cigarettes consumed in New York State in 2012 were smuggled into the State from other locales. Other States with substantial smuggling problems include Arizona at 51.5 percent, New Mexico at 48.1 percent, Washington at 48 percent, and Wisconsin at 34.6 percent.

On top of that, the news stories surrounding the black market for tobacco are shocking. We have uncovered instances of violent crime, like one disturbing episode in California where criminals sacked a distribution center, rounded up the employees at gunpoint, and made off with $1 million in cigarettes, and most importantly, the tobacco tax stamps. We have seen crime rings that involve corruption of law enforcement officers—this happened in Maryland—and even one instance of a crime ring running cigarettes from Charlotte to Detroit which was funding operations of the terrorist organization Hezbollah.

In addition to smuggling authentic cigarettes from low- to high-tax jurisdictions, criminals sometimes skirt the legal market altogether with counterfeit name-brand products and tobacco tax stamps. Counterfeiting is highly profitable. It is an international business that exposes consumers to products with increased levels of dangerous chemicals like lead and thallium. Various sources report finding insect eggs, dead flies, mold, and human feces in counterfeit cigarettes. One source estimates that the Chinese counterfeit cigarette business produces 400 billion cigarettes per year to meet international demand.

This problem is far more pervasive than people are aware of, and even I am surprised by it sometimes. Last week when I was preparing for this testimony, I thought it might be interesting to see how quickly I could buy a pack of improperly stamped cigarettes, and I kid you not, the very first store I walked into in the District of Columbia to try to do this sold me a pack of cigarettes with a Virginia tax stamp. This is illegal.

I brought along a few visual aids to help me make my point today. The first map—Figure 1 in my written statement—shows the large amount of the cigarette smuggling problem. Some States are outflow States, and those tend to be places where taxes are low, or at least relatively low compared to neighboring States. Other States are a lot higher, and New York is the most shocking, with the rate of 57 percent of the cigarette market being under the table.

The second chart—Figure 2—is a scatter plot where each dot represents a State's cigarette tax rate and their corresponding smuggling percentage. As you can see, as the taxes go up, the rates of smuggling go up in a pretty clear fashion.

Then finally—on the last page of my written statement—is a picture of a car, what an apprehended smuggler looks like. As you can see, the smugglers are capable of fitting hundreds of cartons into just one regular-sized vehicle. In fact, the Virginia Crime Commission estimated in 2012 that a well-structured crime ring could pocket $4 million if they could fit a 16-wheeler with contraband cigarettes.

This is not what sound tax policy looks like. Subjecting certain products, even unhealthy ones, to wildly prohibitory rates has damaging unintended consequences. In 1994, the Canadian government found that smuggling rates were so high and crime was so senseless that they cut the Federal excise tax rate from $16 to $11 per carton. Many provinces followed suit, and smuggling rates declined in response. Canadian tax rates have since, unfortunately, crept up little by little, and smuggling rates have grown with them. The point here is that cigarette taxes are not a good revenue source and the products are currently over-taxed.

Any conversation of raising rates needs to have a realistic expectation of how consumers will respond. We have learned from these panels that consumers will shift their purchases to lower-tax options because it is cheaper. It is our responsibility to make sure that we are not giving them incentives to shift them to the black market instead. Thank you.

The CHAIRMAN. Thank you, Mr. Drenkard. We will have some questions in a moment.

[The prepared statement of Mr. Drenkard appears in the appendix.]

The CHAIRMAN. Let me start with you, Mr. Bernstein, because it is a pretty rare event in America when a major corporation like your company asks to come to Washington, DC and say to the government, we need to meet with you and talk about better oversight and better regulation. But as far as I can tell, that is what you all did. You asked to come to Washington to meet with the Treasury Department over this issue. Why did your company take this step in terms of asking to come to Washington to meet with Treasury officials?

Mr. BERNSTEIN. Well, Senator, thank you. This is a big issue. We obviously operate on the street and we know what is going on, and we are able to see things quickly that the regulatory agencies may not be able to register as quickly.

So we went to make them aware—and, at that point, the lost revenue was not as dramatic as it is today, because it has gradually increased over the 5 years. But at that time we could see that clearly there were two markets that were developing: one that was properly regulated and taxed and the other not.

We felt it was appropriate to bring that to their attention. As I said in my comments, we were pleased to find out that they were, in fact, aware of it. We think we may have enlightened them on a few aspects of it that they had not seen, particularly the proliferation of the cigarette machines that had started at that time. We were hopeful when we left the meeting that there would be quick action. Unfortunately, as this hearing has indicated, that has not happened.

The CHAIRMAN. And so they told you what at the meeting? What did they tell you they were going to do?

Mr. BERNSTEIN. They did not tell us they were going to do anything. What they did was, they indicated that they were not surprised, that they were aware that it was a problem, that they had been aware that it would be a problem from the time that pipe tobacco was not raised to the same level as cigarettes and roll-your-own in 2009.

Just one other comment: our primary objective was to assure that the playing field is the same for everybody in the tobacco business.

The CHAIRMAN. That is what I wanted to ask you about next, because we are looking today at Federal tobacco excise taxes, but there are additional incentives to mislabel and convert the cigarette-type products and the lower-tax pipe and cigar products because you can get around some State and local taxes as well.

When you add all of this up, how big a price advantage do the firms that deliberately mislabel and convert their products to low-tax products have compared to firms like yours that are trying to comply with what the Congress at least intended?

Mr. BERNSTEIN. Well, I think as was indicated by your gentleman from Oregon, you can go and buy 2½ packs of cigarette equivalent in pipe tobacco for about $15, $16, whereas you cannot get a pack of legitimate and properly taxed cigarettes for under $30. I am using national averages when considering State excise tax variations. But if you look at it, I mean, the gap can be anywhere from $15 to $40 or $50 when you are talking about premium cigarettes.

The CHAIRMAN. All right. Let us move on to Mr. Tynan. We thank you for coming, Mr. Tynan. We are glad to have you.

As I pointed out in my opening statement, the reauthorization of the Children's Health Insurance Program tried to establish the principle that all cigarette-type products would be taxed at the same rate, especially small cigars. When it became clear that there were those who were going to try to circumvent that principle by using these rolling machines, Congress passed legislation to try to shut that particular loophole. Your research indicates that all of these dodges together cumulatively have meant that the 2012 legislation has not had any real impact. In your view, why is that the case?

Mr. TYNAN. We do not know why that is the case. The machines do not appear to be in the stores anymore, at least not anecdotally in the stores we have gone into in Oregon. But that does not mean that they have not gone underground or that that is different in other States.

There needs to be some sort of national assessment of the retail space to identify what has occurred in the retail space or to see if the stores have gone underground. But simply, Senator, it may just be that smokers did not understand how much of a tax advantage there was with roll-your-own tobacco.

When these machines came into the stores, maybe consumers just got a taste of it, so to speak. But one thing I want to point out is that this is not just happenstance that this happened. I was still at the CDC at the time when the 2009 tobacco tax increase occurred. We were very interested to see if we could see an immediate impact of the increase, and we did not yet know that there was this pipe/roll-your-own difference that was going to happen.

So I was tracking the TTB data on a month-to-month basis. When the new data came out for April 2009, I called TTB because I thought they had made a mistake in their data. I called them and said, you guys mixed up your pipe and your roll-your-own data. I think you reported them in the opposite. They said, no, no, we didn't, that data is right. So the fact that it happened the month it came out says to me that this was not an accident.

The CHAIRMAN. What in your view, since you are a public health office, are the impacts to children of these various tax dodges? I want to get Mr. Drenkard into this debate about taxes a little bit later, but in your view what are the implications for children and the take-up rate and that sort of thing?

Mr. TYNAN. Well, the implications for children are twofold. One is, if cigarettes cost less, we know children will be more likely to start smoking. Raising the price of tobacco products is one of the most effective tools to prevent youth from even starting.

Eighty percent of people who start smoking start by the age of 18. I am going to say that again: 80 percent of people who start smoking start by the age of 18. We know that flavors, flavors like candy flavors, like vanilla and wild cherry that these products are available in, are some of the things that make tobacco products attractive to children.

We have published studies with my colleagues at CDC that show that 40 percent of youth who smoke tobacco products smoke a flavored tobacco product. So it is not only the price, Senator, but it is the fact that by classifying your product as a cigar you are able to get around FDA regulations that prohibit flavors, candy-like flavors, in cigarettes.

The CHAIRMAN. Let us go to you, Mr. Patel, if we could. I am new chairing the committee and trying to think about the steps ahead. As you know, we have been talking about 2006, 2009, trying to clarify the difference between cigarettes and cigars.

In 2009, when faced with the task of trying to prevent cigarette-type products from being rebranded as cigars to avoid the new higher tax on cigarettes, Congress just said, we will apply the new higher tax to small cigars. That pretty clearly has not been exactly an ideal situation.

Would you support the idea of, in effect, going back to the drawing board and just getting a clear definition of what constitutes a cigarette and what constitutes a cigar?

Mr. PATEL. Certainly. I represent the premium cigar category. In regards to cigars in general, I think under the TTB tax code, the language is very, very broad. There needs to be a concise definition separating what a premium cigar is, what a large cigar is, and what a small cigar is. Unfortunately, right now we have the migration from the small cigars to the large cigar category because of the weight requirement, the weight requirement being 3 pounds per thousand.

What we suggest for the premium cigar category is to shift that weight to 6 pounds per thousand. That would stop the migration for the small cigars to the large cigar category. I think there needs to be a separate definition for the premium cigar category, which is the one I represent, because premium cigars are totally unique, they are different, they are an art form, they are a culture that has transited over generations.

By the time we plant the seedling in the ground to the time we get a cigar in the box takes 4 to 5 years, and 300 different hands touch the tobacco. It is a totally different audience. It is marketed to adults, sold to adults. Minors cannot buy it, cannot enter tobacco stores where premium cigars are sold. So it is a unique product, and I certainly think that narrowing the definition for premium cigars, large cigars, and small cigars would certainly help the cause.

The CHAIRMAN. Well, it is clear there are some clever people out there trying to rejigger their tax bills, and I am anxious to pick up on your suggestions.

Let me ask you a question, Mr. Drenkard. It goes to this question of the e-cigarettes. I have worked with you all at the Tax Foundation on a variety of issues, especially tax reform, and always enjoy getting your input about where markets are headed. If e-cigarettes are not taxed and tobacco products are taxed, in your view, where is the market going to go?

Mr. DRENKARD. Well, the market is going to go to electronic cigarettes to some degree. Now, I think it depends more on how that sort of thing affects the price. Also, that might be a desirable outcome from a public health perspective.

Electronic cigarettes are found by many people who have looked at them to have a lower risk profile associated with them. To put it very basically, there are tens of thousands of carcinogens in a traditional incinerated tobacco product, and there are really only three items in electronic tobacco liquid. It is propylene glycol, nicotine, and glycerine. Other than nicotine, those two other items are found in food products.

So my reading in the literature is that the risk profile is a lot lower. To me that indicates that there are a lot of desirable outcomes to be had from people switching from traditional incinerated tobacco to smokeless tobacco like that, or electronic tobacco like that. My brother, for example, quit cigarettes and moved to electronic tobacco, and I think that was a good move.

The CHAIRMAN. Well, as you know, some who study the e-cigarette industry have said that these products have not been on the market long enough to know whether they have any negative health effects.

I am very much, as we get into this, affected by that testimony that I heard in 1994, where clear scientific evidence was ignored. That is why I think there are real implications for this debate about when something is untaxed and something is taxed. We ought to get to the bottom of how markets work.

Let us just give Mr. Tynan an opportunity to respond to the same question. If e-cigarettes go untaxed and traditional tobacco products are taxed, where do you think the market goes?

Mr. TYNAN. I mean, the challenge with e-cigarettes is that they are currently an unregulated product, Senator. We do not know what the long-term health effects are going to be from smoking e-cigarettes. Being unregulated, we could have two e-cigarettes that come from the same manufacturer on the same assembly line that have completely different constituents in them. Many of them also come from China. I would not put a plastic toy from China in my mouth, let alone something you have to inhale that puts things into your lungs. So, I mean, I think we have to be very careful when we think about the impact that it could have on long-term population health and the impact that it could have on youth starting to smoke.

What we do not want is people to become addicted to nicotine through an e-cigarette and then switch later to smokeless tobacco or cigarettes, which we know are harmful. So there need to be more long-term studies on the health effects. The challenge with many of the studies that are out there is that they have not necessarily been independent studies.

We know from the 2006 Federal court case that the tobacco industry has been found by a Federal judge to be racketeers. One of the findings in that court case was that the tobacco industry manipulated scientific studies. So we need to be very thoughtful and look very closely at the studies that have found that e-cigarettes are safe and effective.

The CHAIRMAN. And what is your take, Mr. Bernstein, on that same question of where the market will go if e-cigarettes are untaxed and traditional tobacco products are taxed?

Mr. BERNSTEIN. Yes, Senator. Before I answer that, if I could just point out that when Mr. Tynan referenced the tobacco industry being convicted of racketeering, it is important to note that the judge dismissed Liggett from that because of Liggett's behavior and viewed it in a much more positive light.

The e-cigarette is a big question mark. I think the first question is, what is it? I think that has to be determined. In my opinion, it is either a medical device or it is a tobacco product, and it should be regulated as such in either case. I believe it is very difficult to predict where the e-cigarette market is going to go, because we do not know how it is going to be regulated, we do not know how it is going to be taxed. If it is not taxed and if it is not regulated, it will grow. But I cannot tell you that it will grow at an exponential rate, because there is not enough evidence yet to be able to say that.

What I will tell you, though, is that there are people who are—and I understand the concerns about China—mixing up vats of e-liquid in the back of their stores and then are selling it to individuals, and nobody has any idea what is in it.

The CHAIRMAN. In the United States?

Mr. BERNSTEIN. In the United States. In fact, our offices are in Morrisville, NC. There is a store in our center, the E-Liquid Lady, and she basically mixes up vats of——

The CHAIRMAN. And the E-Liquid Lady does exactly what?

Mr. BERNSTEIN. They mix up vats of e-liquid in the back, and then they inject it into devices that people buy.

The CHAIRMAN. And all of this takes place without any oversight?

Mr. BERNSTEIN. None.

The CHAIRMAN. All right.

You four have been very helpful. I came here this morning with the view that this was a classic case of tax evasion. I have added to that judgment that we are certainly moving towards a classic case of government foot-dragging. I think what all of you on this panel have demonstrated is that those who skirt the laws clearly look like they are going to get more inventive about how they go about it. Mr. Tynan talked about kitty litters, and Mr. Bernstein talked about e-liquid ladies making injections and the like.

That ought to give everybody pause. So we have a lot of work to do to follow up here, and I want to thank all of you for your testimony and your cooperation. Members of the committee are going to have until the close of business on Friday, August 8th, to submit questions for the record.

With that, the hearing is adjourned.

[Whereupon, at 11:34 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

STATEMENT OF RONALD J. BERNSTEIN
PRESIDENT AND CEO OF LIGGETT VECTOR BRANDS LLC
BEFORE THE UNITED STATES SENATE COMMITTEE ON FINANCE
JULY 29, 2014

Chairman Wyden, Ranking Member Hatch and members of the Committee:

My name is Ron Bernstein and I am President and CEO of Liggett Vector Brands. Liggett is the 4th largest cigarette manufacturer in the United States and has been operating since 1873. Thank you for inviting me to testify today.

Seventeen years ago, Liggett became the first tobacco company to break ranks with the industry and settle tobacco-related litigation. We also were the first— and remain the only-- company to state that "smoking is addictive" on our packaging and to voluntarily list ingredients on our cartons. These actions reflect Liggett's longstanding cooperative relationship with Congress, the public health community and regulators. With that backdrop, we are here today to shine a light on illegal conduct that is costing the U.S. billions in tax revenues.

In 2009, Congress raised tobacco taxes to help fund the State Children's Health Insurance Program. The taxes on cigarettes, "roll-your-own" tobacco, and on little cigars were raised to the equivalent of $10.07 per carton.

At the same time, Congress only marginally raised the tax on pipe tobacco — to $1.15 per carton equivalent. That means the federal excise tax on pipe tobacco is roughly 10% of that of cigarette tobacco.

Before the ink was dry on the legislation, certain tobacco manufacturers embarked on a campaign to evade the tax increase by re-labeling roll-your-own tobacco as "pipe tobacco."

For example, this is what a smoker would have found in a store before the tax increase — "Kentucky Select Cigarette Tobacco."

This product was made available after the tax increase — "Kentucky Select Pipe Tobacco."

The chief difference between these two products is the label — and a substantially lower tax rate.

Here is a bag of "Desperado." Astoundingly, this company just pasted on a label that says "all natural pipe tobacco," and used tape to cover the statement "makes approximately 500 cigarettes."

Everyone knows that this is cigarette tobacco. The manufacturer knows. The consumer knows. I know — because I tried smoking it in a pipe, and it was not a pleasant experience.

We met with representatives from TTB in 2010 and showed them that all of the growth in the category was coming from mislabeled "pipe tobacco" rather than genuine pipe tobacco. TTB advised that they were aware and had expected this problem when Congress failed to equalize the tax on pipe tobacco with RYO and cigarettes in 2009.

Since the existing tax code definition of RYO included anything sold as cigarette tobacco or RYO, TTB already had clear authority to enforce the law – especially since the manufacturers of the products knew exactly what they were doing, and were using a variety of tactics to inform consumers that the product was really RYO tobacco.

We were pleased to learn shortly after the meeting that TTB had issued a statement on its web site indicating that specific guidance would be forthcoming in the near future. Four years later, we are still waiting for that guidance. Meanwhile, sales of pipe tobacco have grown by over 700%, while "roll-your-own" has declined by over 80% and cigarettes have declined by over 20%.

This simple chart showing the growth of mislabeled "pipe tobacco" and related decline of roll-your-own tobacco following the 2009 FET increase tells the story.

None of the manufacturers of genuine pipe tobacco have seen any real growth during this period, nor are we aware of any growth in the sale of pipes. Yet, products labeled as "pipe tobacco" have grown from less than 1% of the total cigarette equivalent market to over 6.0%, or more than 18 billion cigarette equivalents.

Despite this, TTB has issued no specific guidance and over $3.0 billion in excise taxes have been lost by the federal government. Even after a GAO report clearly demonstrated that the explosion of "pipe tobacco" was entirely RYO, and had admissions from manufacturers to this fact, TTB still failed to act.

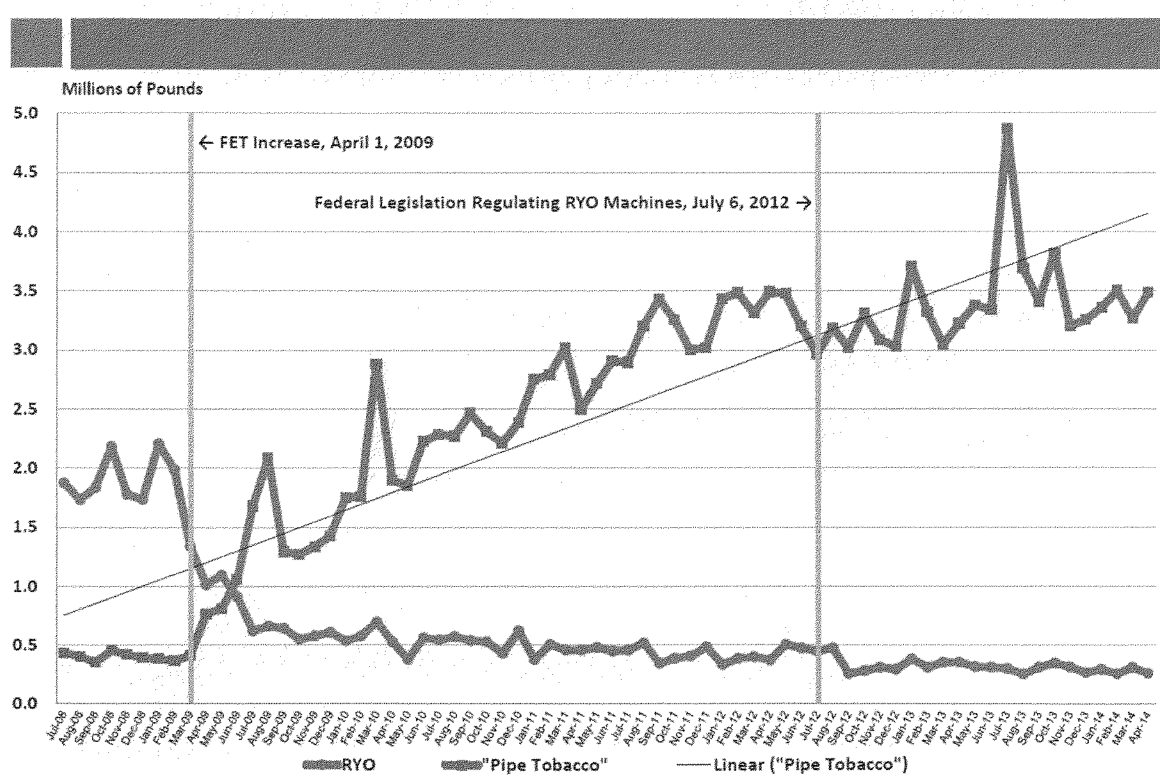
Under the definition of "cigarette tobacco" in the Tobacco Control Act, FDA also has clear authority to treat mislabeled "pipe tobacco" as misbranded and to require it to be properly labeled and regulated as cigarette tobacco. But they, too, have allowed two markets to exist; one regulated and properly taxed; the other not.

Additionally, since 2009, the renegade tobacco industry has also re-labeled "little cigars" as "filtered cigars" while making minimal changes to the weight of the product. This has created another tax dodge that has cost the federal government close to $900 million. Together with mislabeled "pipe tobacco," these products now comprise over 8% of the cigarette market.

We welcome the attention that Congress is once again bringing to this issue and look forward to working with you to address the problem.

Thank you for your attention.

Volume of RYO vs. "Pipe Tobacco" by Month 2008 – 2014



Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau.

APPENDIX TO

STATEMENT OF RONALD J. BERNSTEIN
PRESIDENT AND CEO OF LIGGETT VECTOR BRANDS LLC

BEFORE THE UNITED STATES SENATE COMMITTEE ON FINANCE

JULY 29, 2014

Federal Excise Tax Evasion Has Driven Explosive Growth of Mislabeled "Pipe Tobacco"

* * *

$3.1 Billion in Federal Excise Tax Lost Since April 2009

$812 Million in Federal Excise Tax Lost in 2013 Alone

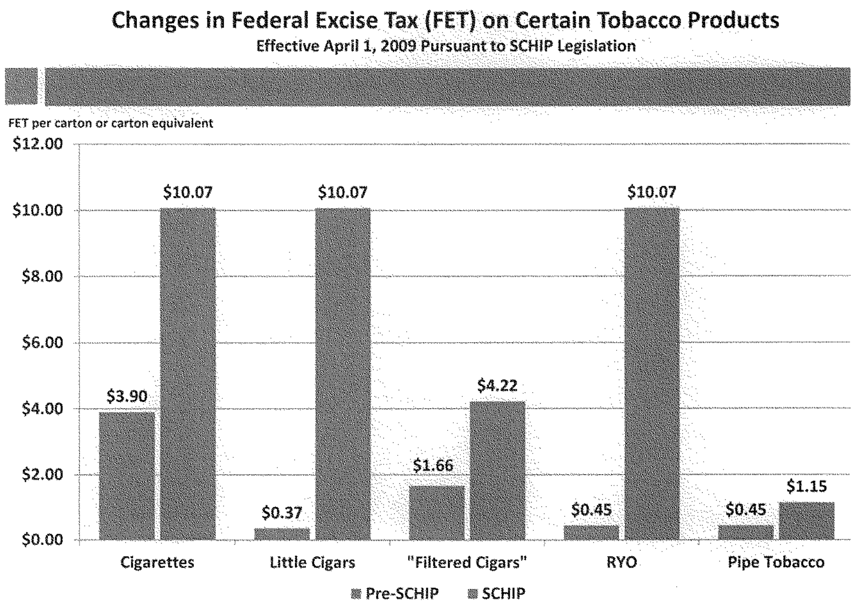
State MSA and Escrow Payments Greatly Reduced

Overview

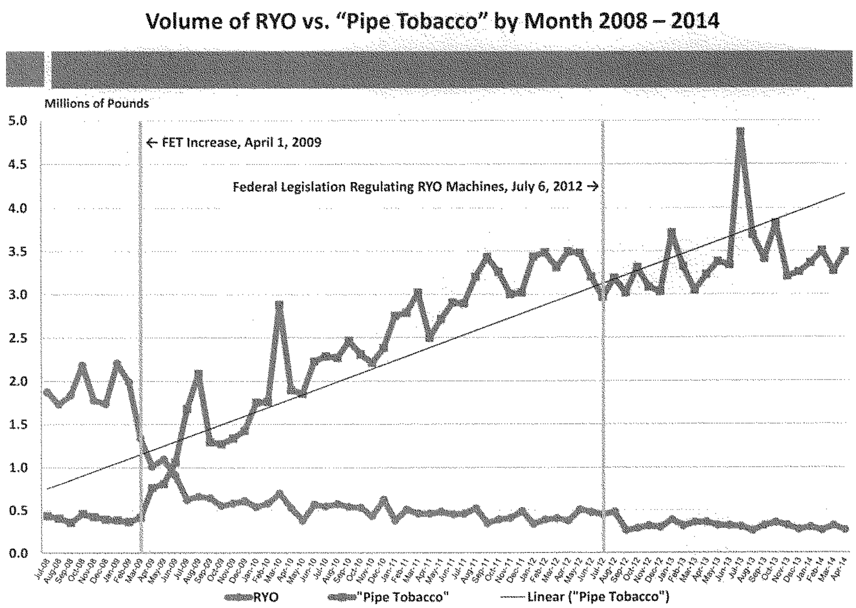
- Explosion of sales of RYO mislabeled as "pipe tobacco" and taxed at a fraction of legitimate RYO
- Mislabeled "pipe tobacco" accounted for an estimated 6.2% of total cigarette volume in 2013
- Mislabeled "pipe tobacco" responsible for loss of $3.1 billion in FET since April 2009 and $812 million in 2013 alone
- Sales of leading genuine pipe tobacco brands have been flat to down since 2009
- Mislabeled "pipe tobacco" meets definition of RYO under Internal Revenue Code § 5702(o) and should be taxed as such
- Failure to enforce proper FET rate results in a huge back-door subsidy to self-selected tobacco manufacturers who are flouting the law

Overview

- Manufacturers of mislabeled "pipe tobacco" have been brazen in making clear to consumers the true intended use of their product through such tactics as:
  - Marketing the product with comparisons to cigarettes, including as substitutes for specific brands
  - Including cigarette warning labels on their product
  - Flavoring their tobacco with menthol — which is only used in cigarettes, not in genuine pipe tobacco
  - Using traditional cigarette descriptors such as "light" and packaging in 16 oz. bags
  - Marketing their products at trade shows and other venues as tobacco for making cigarettes
  - Marketing mislabeled "pipe tobacco" with cigarette papers, cigarette tubes, and cigarette rolling machines

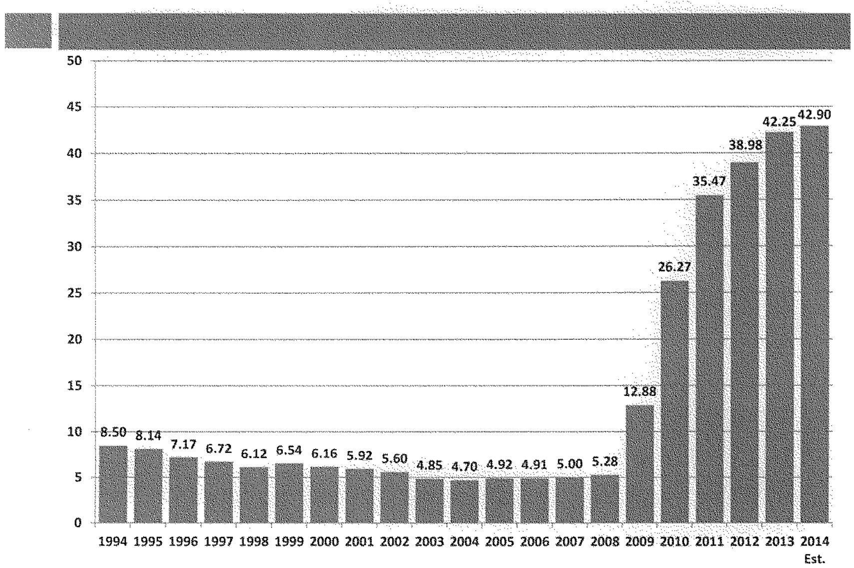


Note: The term "filtered cigars" is used to mean cigars that were classified as "small cigars" for FET purposes (less than 3 pounds per 1000) before the 2009 FET increase, and that thereafter were slightly increased in weight in order to claim classification as "large cigars" for FET purposes, and thereby gain the advantage of a lower effective FET rate.

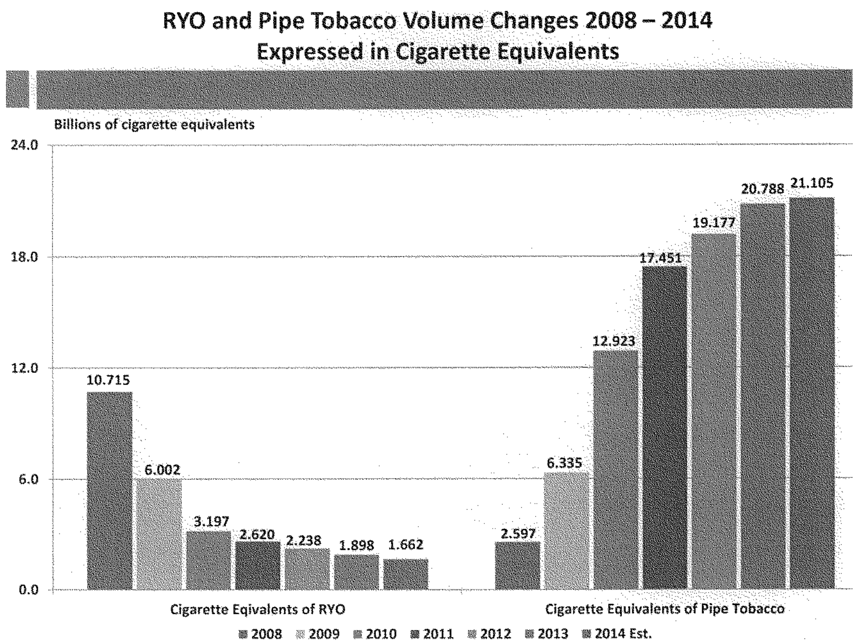


Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau.

Pipe Tobacco Volume 1994 – 2014 in Millions of Pounds



Source: Statistical Reports, U.S. Treasury Department, Alcohol and Tobacco Tax and Trade Bureau



Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau.

Approximate 2013 Costs, Including Taxes and Fees, in One Carton of Cigarettes and Cigarette Equivalents

	Cigarettes	Little Cigars	RYO	"Pipe Tobacco" Cigarettes
COG	$2.50	$2.50	$1.00	$1.00
FET	$10.07	$10.07	$10.07	$1.15
TQB	$0.63	$0.63	$0.63	$0.07
FDA	$0.37	0	$0.37	0
MSA	$6.20	0	$2.24	0
SET	$14.80	$7.02	$7.39	$1.19
Total	$34.57	$20.22	$21.70	$3.41

NOTES: One carton contains 200 cigarettes. One pound of RYO or mislabeled "pipe tobacco" makes 492 cigarettes (2½ cartons).

COG Approximate cost to manufacture and distribute one carton or carton equivalent.

FET SCHIP legislation equalized FET on cigarettes, little cigars, and RYO. "Filtered cigars" are classified as large cigars for FET purposes because they weigh over 3 pounds per 1000. FET on "filtered cigars" is 52.75% of manufacturer price. Manufacturer prices for "filtered" cigars are substantially equivalent to little cigars they replaced, typically in the range of $6 to $8 per carton. This chart assumes manufacturer price of $8 per carton.

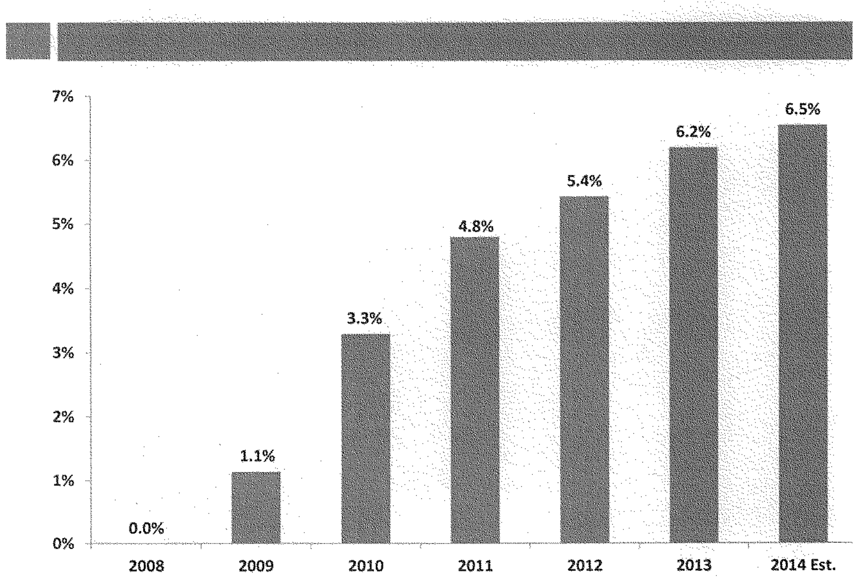
TQB Federal tobacco quota buy-out assessment. Based on FET paid, so products with lower FET rate pay less.

FDA User fees paid to FDA pursuant to Family Smoking Prevention and Tobacco Control Act. Also based on FET paid.

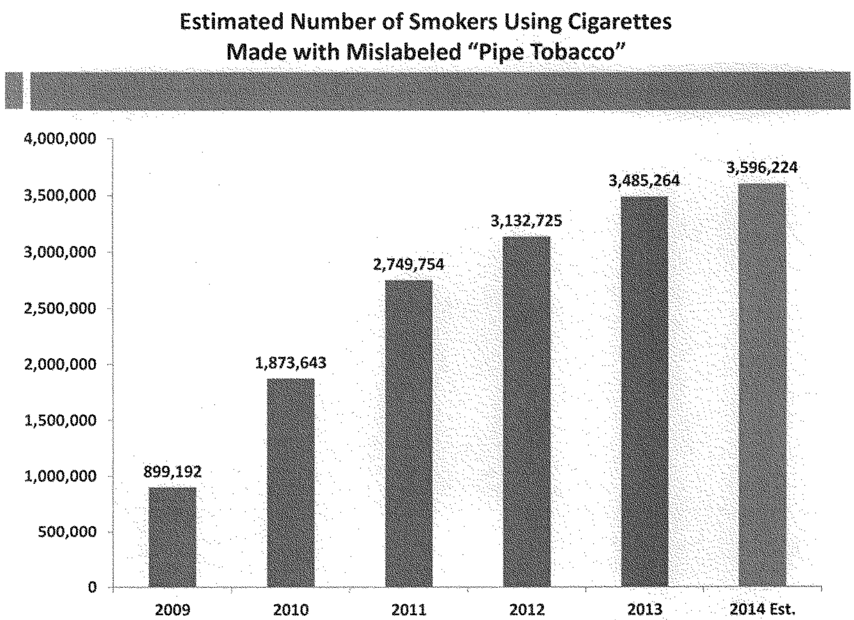
MSA Master Settlement Agreement payments or related state escrow deposits. MSA and escrow payment apply only to cigarettes and RYO.

SET National average state excise tax on cigarettes is $14.80 per carton (www.tobaccofreekids.org/reseach/factsheets/pdf/0097.pdf) (12/13/12). Most states tax other tobacco products (OTP) as a percent of the manufacturer price to wholesale. State OTP taxes vary, but average is approximately 35%. This chart assumes national average OTP tax rate of 35% after a 50% markup by manufacturer.

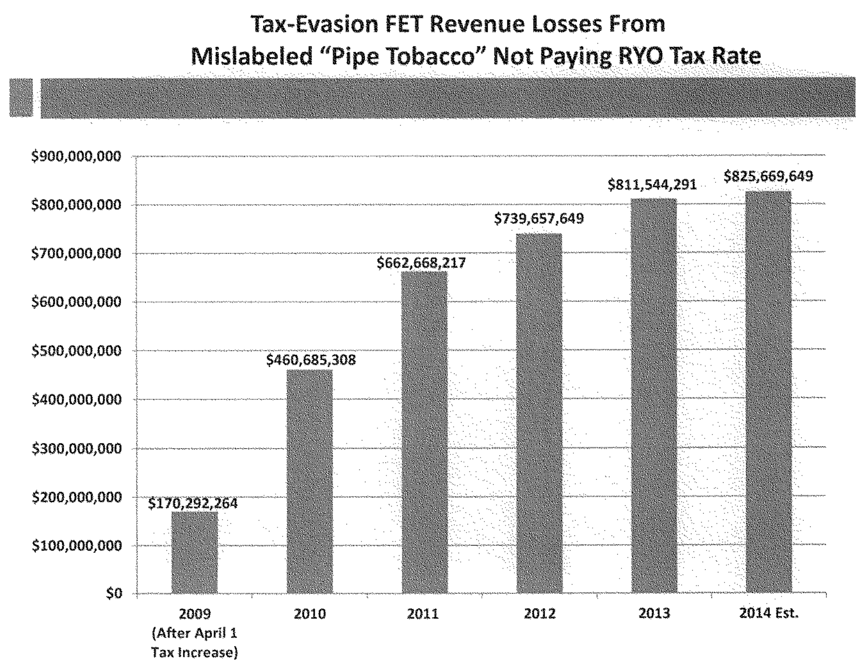
Mislabeled "Pipe Tobacco" Share of Total U.S. Cigarette Market

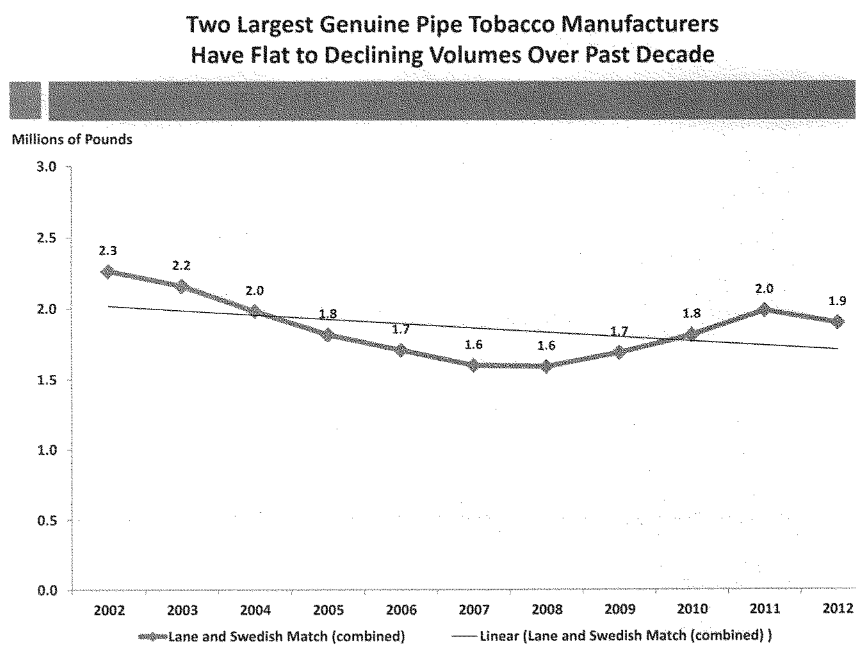


Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau.



Based on straight-line extrapolation from national mean of 16.7 cigarettes per day (CPD) in 2005 to an estimated 14.2CPD in 2013. *See* Centers for Disease Control and Prevention, *Morbidity and Mortality Weekly Report*, Sept. 9, 2011, www.cdc.gov/mmwr (Jan. 9, 2012).


Tax-Evasion FET Revenue Losses From
Mislabeled "Pipe Tobacco" Not Paying RYO Tax Rate
$900,000,000
$800,000,000
$700,000,000
$600,000,000
$500,000,000
$400,000,000
$300,000,000
$200,000,000
$100,000,000
$0
$170,292,264
$460,685,308
$662,668,217
$739,657,649
$811,544,291
$825,669,649
2009
(After April 1
Tax Increase)
2010
2011
2012
2013
2014 Est.



Source: EuroMonitor International 2002-2011. Data for 2012 estimated from EuroMonitor/MSA Data.

GAO Report Confirms Mislabeling of "Pipe Tobacco"

Representatives of industry and nongovernmental organizations provided examples of current pipe tobacco brands that had been roll-your-own brands prior to CHIPRA, with minimal differences in the packaging and the appearance of the tobacco itself. We also found examples of Internet retailers signaling to customers in their marketing that pipe tobacco was suitable for smoking in roll-your-own cigarettes. One manufacturer of pipe tobacco had designed its label with three-letter markings, to indicate to customers the product's similarity to brand-name cigarettes. For example, the marking MRD indicated Marlboro Red and CML indicated Camel Light.

We approached 15 pipe tobacco manufacturers to ask about their companies' actions in response to the CHIPRA tax changes. Each of the three tobacco manufacturers that agreed to speak with us explained that their companies switched from selling higher-taxed roll-your-own tobacco to lower-taxed pipe tobacco in order to stay competitive. One company changed the cut of its roll-your-own tobacco and labeled it as pipe tobacco, although a company representative acknowledged that there was no real difference between its pipe-cut tobacco and its roll-your-own tobacco. A representative from another company that switched from selling roll-your-own tobacco to selling pipe tobacco stated that she was not aware of any difference in the two products other than the federal excise tax rate.

***Large Disparities in Rates for Smoking Products Trigger Significant Market Shifts to Avoid Higher Taxes*,**
United States Government Accountability Office, Report to Congressional Committees, April 2012, GAO-12-475, page 17.
See video included in GAO report at: http://www.gao.gov/multimedia/video#video_id=589493

Tax Evasion Revenue Losses are Huge — and Growing

- Mislabeled "pipe tobacco" is actually RYO — it is used to make cigarettes
- Makers of mislabeled "pipe tobacco" pay 90% lower FET than they should
- Also much lower state excise tax and <u>no</u> MSA or state escrow payments
- Tax-evasion revenue losses from mislabeled "pipe tobacco" not paying RYO tax rate (federal only, does not count state or MSA losses) —
  - $170 million in calendar year 2009 (partial year starting with FET change on April 1)
  - $461 million in calendar year 2010
  - $663 million in calendar year 2011
  - $740 million in calendar year 2012
  - $812 million in calendar year 2013
  - Estimated $826 million in calendar year 2014

Manufacturers Violate TTB Policy — From TTB Website

"TTB has received many questions about how to differentiate between pipe tobacco and roll-your-own tobacco for purposes of the Federal excise tax and related provisions . . . . ."

"We are currently evaluating methods to differentiate between the two products and foresee providing specific guidance in this regard in the near future . . . ."

"In the meantime, the packaging and labeling of the products in question will have particular significance. For example, TTB will consider the extent to which the packaging and labeling for a pipe tobacco product clearly presents the product to the consumer as such and not as roll-your-own tobacco, or whether there are representations or implications on the package or in other materials which tend to contradict the stated tax declaration."

Source: www.ttb.gov/tobacco/pipe-tobacco.shtml (July 16, 2014) (emphasis added).

Federal Tax Code Definitions of Tobacco Products

- "Cigarette" means—
  (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco, and
  (2) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in paragraph (1).

- The 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.

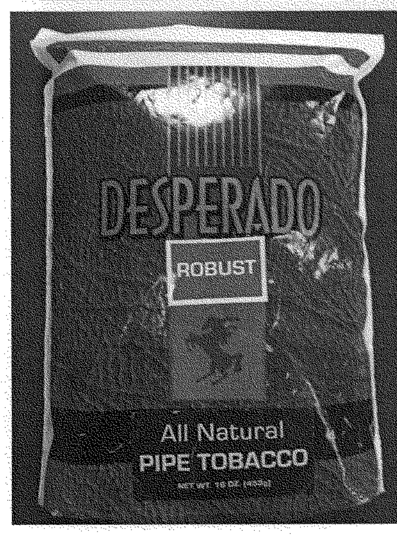
- The term "roll-your-own tobacco" means any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes.

Source: Internal Revenue Code, 26 U.S.C. § 5702(a), (n), (o).

Appearance, Type, Packaging and Labeling —
Stickers Used to Relabel RYO as "Pipe Tobacco"

Note: "All Natural Pipe Tobacco" sticker has been applied to front of pre-existing package. Tape on back of package covers up the following words, which can still be read through the sticker: "MAKES APPROXIMATELY 500 CIGARETTES."

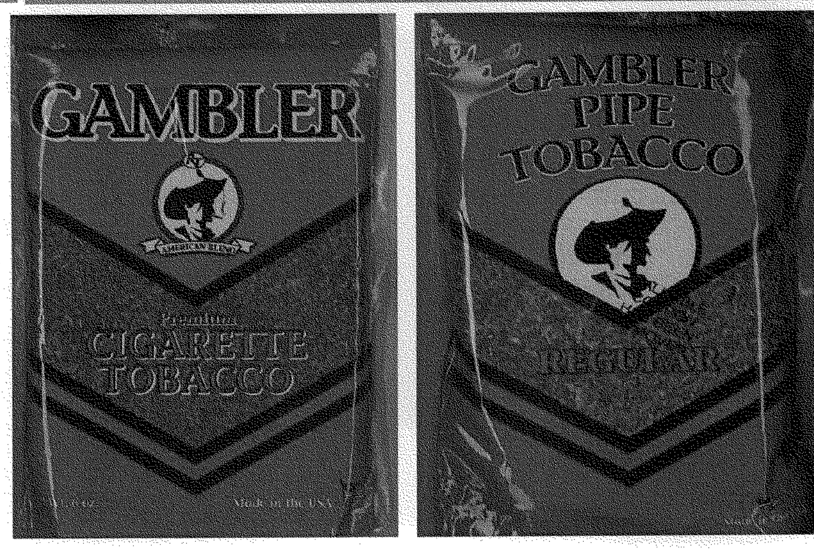
Appearance, Type, Packaging and Labeling —
Tape Used to Cover Statement "Makes Approximately 500 Cigarettes"



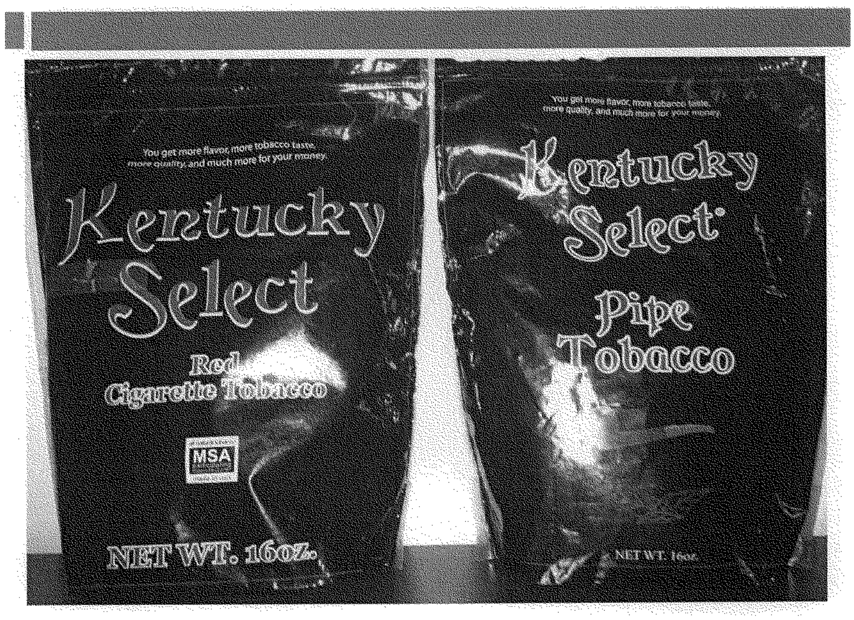
Appearance, Type, Packaging and Labeling —
Tape Used to Cover Statement "Makes Approximately 500 Cigarettes"

**Appearance, Type, Packaging and Labeling —
RYO and "Pipe Tobacco"**

**Appearance, Type, Packaging and Labeling —
RYO and "Pipe Tobacco"**



**Appearance, Type, Packaging and Labeling —
RYO and "Pipe Tobacco"**

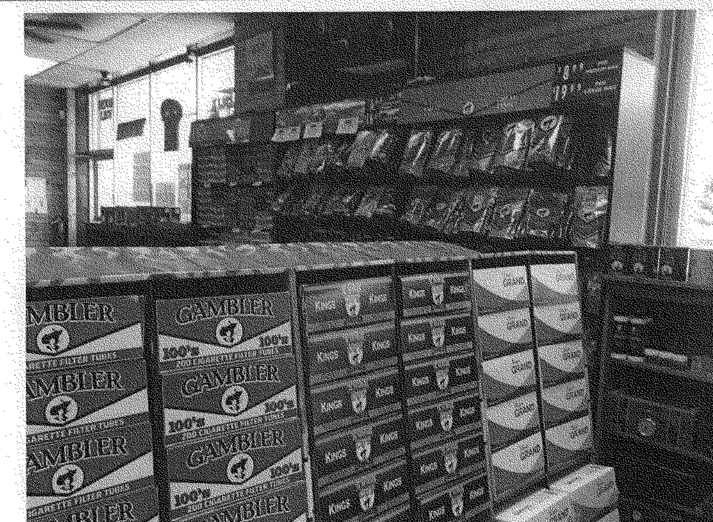


Appearance, Type, Packaging and Labeling — RYO and "Pipe Tobacco"

"Pipe Tobacco," Cigarette Tubes, and Cigarette Rolling Machines Marketed Together

Janesville, Wisconsin, July 2014

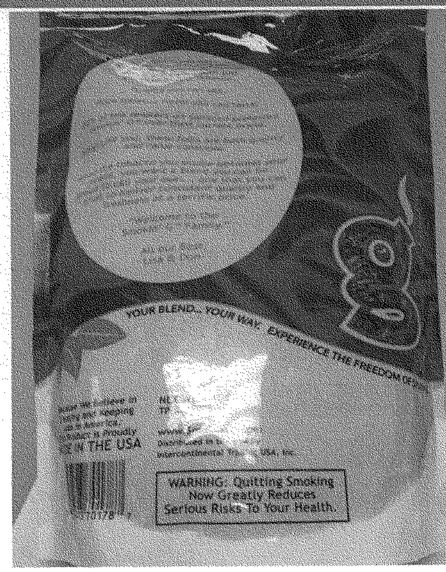
"Pipe Tobacco" and Cigarette Tubes Marketed Together



Janesville, Wisconsin, July 2014

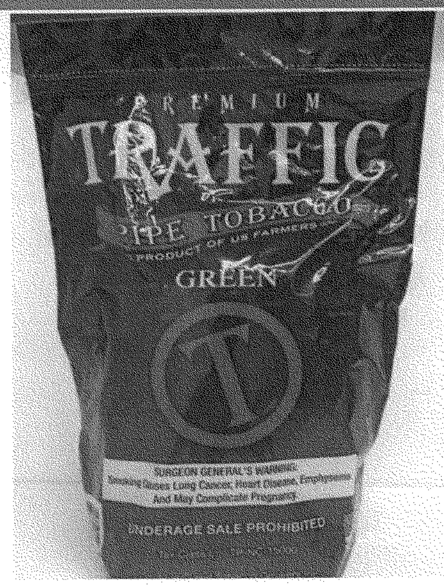
Packaging and Labeling — Cigarette Warning Labels on "Pipe Tobacco"

Packaging and Labeling — Cigarette Warning Labels on “Pipe Tobacco”

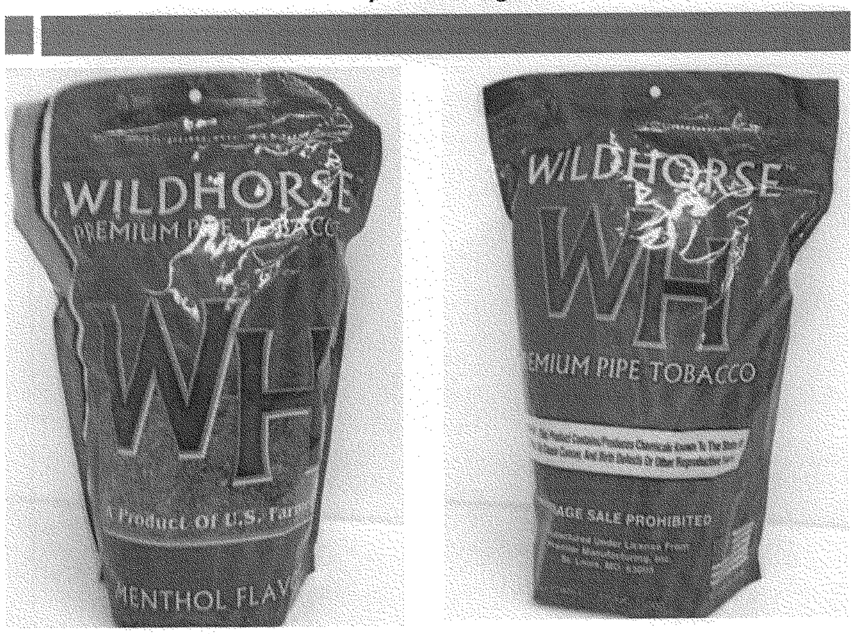


Packaging and Labeling — Cigarette Warning Labels on "Pipe Tobacco"

Packaging and Labeling — Cigarette Warning Labels on "Pipe Tobacco"



Appearance, Type, Packaging, and Labeling —
Menthol Only Used as Cigarette Flavorant



Suitable for, Offered to, Purchased by Consumers as Tobacco for Making Cigarettes

American Wholesale Marketers Association trade show, Las Vegas, Nevada, February 9-10, 2011.

Suitable for, Offered to, Purchased by Consumers as Tobacco for Making Cigarettes

American Wholesale Marketers Association trade show, Las Vegas, Nevada, February 9-10, 2011.

Suitable for, Offered to, Purchased by Consumers as Tobacco for Making Cigarettes

BnB Enterprise, 344 Maple Ave #110, Vienna, VA 22180. www.bnbtobacco.com/product/good-stuff-ryo-starter-package-full-flavor (5-16-12).

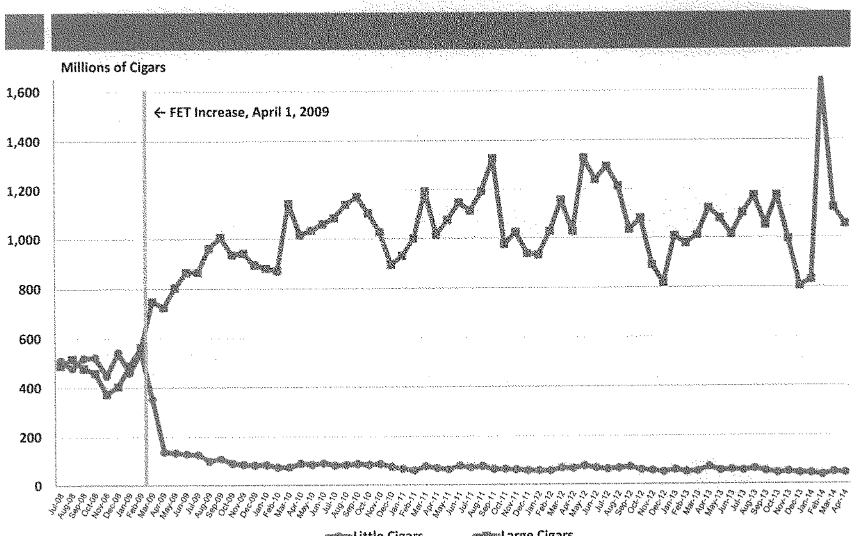
Suitable for, Offered to, Purchased by Consumers as Tobacco for Making Cigarettes

$14.99 —
Jay's Mini Mart price for pound of RYO.

$24.78 —
Federal excise tax on pound of RYO.
26 USC § 5701(g).

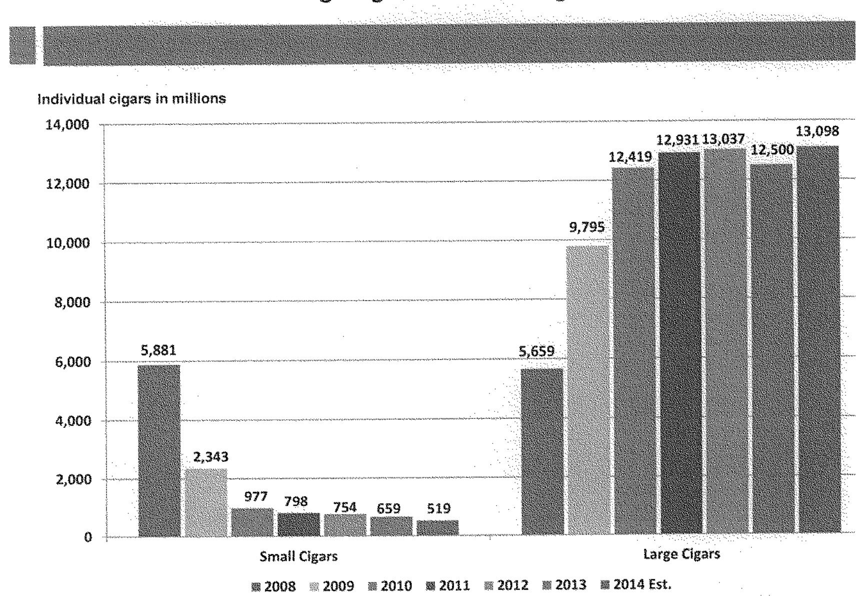
Jay's Mini Mart, 1512 North Wells Street, Fort Wayne, IN 46808 (5-30-12)

Volume of Little Cigars vs. Large Cigars by Month 2008 – 2014



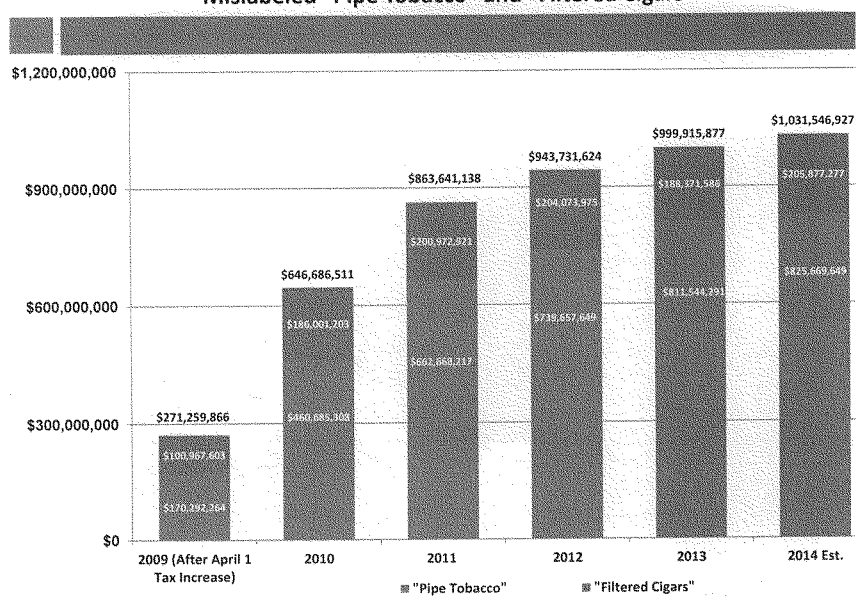
Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau. When the FET on "small cigars" (less than 3 pounds per 1000) was equalized to cigarettes in 2009, many "small cigar" manufacturers slightly increased their product weight in order exceed 3 pounds per 1000 in order to claim classification as "large cigars" for FET purposes and thereby gain the advantage of a much lower effective FET rate.

Small and Large Cigar Volume Changes 2008 – 2014

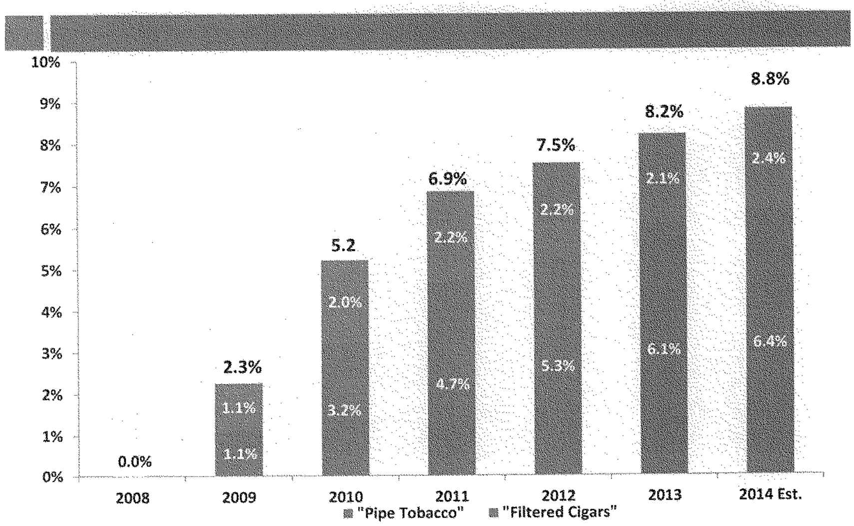


Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau.

Annual FET Revenue Lost from Tax Evasion by Mislabeled "Pipe Tobacco" and "Filtered Cigars"



Mislabeled "Pipe Tobacco" and "Filtered Cigar" Share of Total U.S. Cigarette Market



Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau. The term "filtered cigars" is used to mean cigars that were classified as "small cigars" for FET purposes (less than 3 pounds per 1000) before the 2009 FET increase, and that thereafter were slightly increased in weight in order to claim classification as "large cigars" for FET purposes, and thereby gain the advantage of a lower effective FET rate.

Questions for the Record
"Tobacco: Taxes Owed, Avoided, and Evaded"
Hearing Date: July 29, 2014
Questions for Mr. Ronald Bernstein

Chairman Ron Wyden

1. Mr. Bernstein, federal tobacco policy consists of two main components—taxation and regulation. E-cigarettes are not currently subject to federal tobacco regulations such as limitations on flavoring, marketing, and sales to minors. These regulations are primarily intended to discourage smoking among youth and adolescents. E-cigarettes are also not subject to federal tobacco taxes. Experts tell us that tobacco taxes are one of the most effective tools for discouraging smoking among young people.

   You stated during the hearing that if an e-cigarette is marketed as a tobacco product it should be subject to the same regulations as tobacco products. Do you believe e-cigarettes marketed as tobacco products should also be taxed like other tobacco products?

   Mr. Bernstein's Response:

   If our government classifies e-cigarettes as nicotine delivery devices (which I believe them to be), then the products should be required to comply with the approval, regulatory and taxation regimes to which medical devices are subject.

   If e-cigarettes are marketed as tobacco products, and deemed to be such by the federal government, they should be taxed and regulated like other tobacco products, and subject to limitations on flavoring, marketing and sales to minors.

   Manufacturers who make claims that e-cigarettes are smoking cessation products should be required to seek and obtain approval for such claims in accordance with FDA guidelines and requirements.

Ranking Member Orrin Hatch

1. Mr. Bernstein, in your testimony you note that since tobacco taxes were set at their currents rates, sales of pipe tobacco have increased by more than 700% while what is currently taxed as roll-your-own has declined by more than 80% while sales of cigarettes have declined by more than 20%.

   Is the decrease in cigarette sales part of a long-term trend in decreasing use of cigarettes, or are more customers gravitating to a product taxed as pipe-tobacco but used as roll-you-own tobacco?

   Mr. Bernstein's Response:

   It is a combination of the two. There is a long-term trend of declining cigarette use. However, the decline has been tempered by the availability of low-cost cigarette tobacco being sold in packaging mislabeled (and wrongfully taxed) as "pipe tobacco." The shift by a significant percentage of cigarette smokers to low-tax mislabeled "pipe tobacco" means that estimates for cigarette shipment declines have been overstated.

   When excise taxes on cigarette and roll-your-own tobacco were raised in 2009, consumers made a variety of choices. Historically, cigarette shipments have declined on average between 2.5 and 3.5% per year. In 2009, due largely to the excise tax increase, shipments declined by 9.3% and, in 2010, by 6.3%. Since 2010, the declines have been more in line with historical norms. A number of smokers likely reduced their consumption or quit, while others simply migrated to the lower-priced products that emerged in 2009: mislabeled "pipe tobacco" and "filtered cigars." I believe it is likely that without these alternatives, more of the price sensitive smokers would have left the category entirely, rather than switching to mislabeled pipe tobacco or filtered cigars. Indeed, when use of mislabeled "pipe tobacco" and filtered cigars are taken into consideration, the cigarette shipment decline rate in 2009 was actually 7.2% (as opposed to 9.3%) and 3.4% in 2010 (as opposed to 6.3%).

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Tobacco Taxation and Unintended Consequences

Scott Drenkard
Economist & Manager of State Projects, Tax Foundation

Hearing on Tobacco: Taxes Owed, Avoided, and Evaded
Before the Senate Committee on Finance
July 29, 2014

Chairman Wyden, Ranking Member Hatch, and members of the Committee:

I appreciate the opportunity to submit this statement on tobacco taxes and their impact across the country. In the 77 years since our founding in 1937, the Tax Foundation has monitored tax policy trends at the federal and state levels, and our data and research are heavily relied upon by policymakers, the media, and the general public. Our analysis is guided by the idea that taxes should be as simple, neutral, transparent, and stable as possible, and as a 501(c)(3) nonprofit, nonpartisan organization, we take no position on any pending legislation.

We hope that the material we provide will be helpful in the Committee's consideration of the issue.

Executive Summary

- Tobacco taxes are the highest they have ever been in the United States. The federal rate currently stands at $1.0066 per pack of cigarettes, and state and local rates add as much as an additional $6.16 per pack (as in Chicago, Illinois). These combined rates are equivalent to a tax in excess of 200 percent in some locales.
- The high tax burden on tobacco results in de facto prohibition of the products, bringing all the undesirable outcomes associated with alcohol prohibition in the 1920s. In our research we have found evidence of substantial tobacco smuggling from low to high tax jurisdictions, violent crime, theft of tobacco and tobacco tax stamps, corruption of law-enforcement officers, and even funding of terrorist organizations through crime rings.
- The Mackinac Center for Public Policy estimates that 56.9 percent of the cigarettes consumed in New York State in 2012 were smuggled into the state from other locales. Other states with substantial smuggling problems include Arizona (51.5 percent), New Mexico (48.1 percent), Washington (48.0 percent) and Wisconsin (34.6 percent).
- In addition to smuggling authentic cigarettes from low to high tax jurisdictions, criminals sometimes skirt the legal market altogether and counterfeit name brand products and state tobacco tax stamps. Cigarette counterfeiting is a highly profitable international business that exposes consumers to products with increased levels of dangerous chemicals like lead and thallium. Other sources report finding insect eggs, dead flies, mold, and human feces in

counterfeit cigarettes. One source estimates that the Chinese cigarette counterfeiting business produces 400 billion cigarettes per year.

- In 1994, federal cigarette excise taxes in Canada were cut from $16 to $11 per carton because cigarette smuggling had grown so pervasive.
- The steady decline in tobacco consumption since the 1960s makes tobacco tax revenue an unstable revenue source. Administration plans to fund pre-kindergarten education with a federal cigarette tax increase are not sustainable in the long term, because revenues are projected to decline, while costs will grow.

Tobacco Tax Differentials across States Cause Significant Smuggling

Public policies often have unintended consequences that outweigh their benefits. One consequence of high state cigarette tax rates has been increased smuggling as criminals procure discounted packs from low-tax states to sell in high-tax states. Growing cigarette tax differentials have made cigarette smuggling both a national problem and a lucrative criminal enterprise. The Virginia Crime Commission found that a well-organized cross-state smuggling operation could bring in $4 million with one shipment.[1]

Each year, scholars at the Mackinac Center for Public Policy, a Michigan think tank, use a statistical analysis of available data to estimate smuggling rates for each state.[2] Their most recent report uses 2012 data and finds that smuggling rates generally rise in states after they adopt large cigarette tax increases. Figure 1 shows smuggled cigarettes as a percentage of consumption in each of the fifty states.

New York is the highest net importer of smuggled cigarettes, totaling 56.9 percent of the total cigarette market in the state. New York also has one of the highest state cigarette taxes ($4.35 per pack), not counting the local New York City cigarette tax (an additional $1.50 per pack). Smuggling in New York has risen sharply since 2006 (+59 percent), as has the tax rate (+190 percent).[3]

Other peer-reviewed studies provide support for these findings of substantial black market activity.[4] Recently, a study in *Tobacco Control* examined littered packs of cigarettes in five

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[1] Virginia Crime Commission, *SJR 21: Illegal Cigarette Trafficking* (Sept. 5, 2012), http://services.dlas.virginia.gov/User_db/frmvscc.aspx?ViewId=3160.

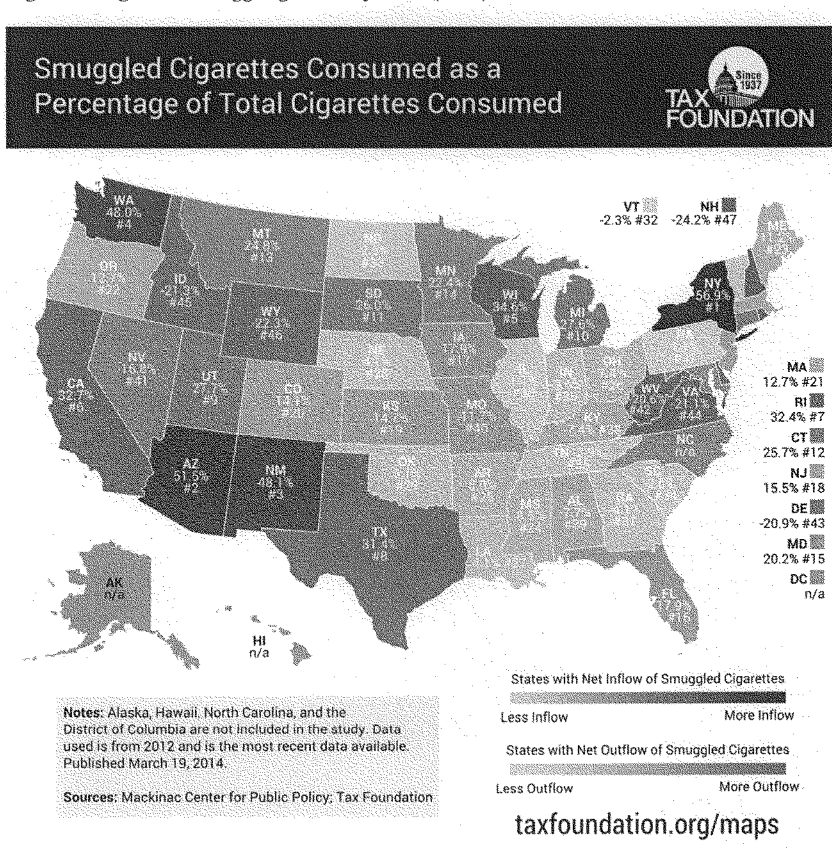
[2] *See, e.g.*, Mackinac Center for Public Policy, Michael LaFaive, & Todd Nesbit, *Cigarette Smuggling Still Rampant in Michigan. Nation* (Feb. 2014), http://www.mackinac.org/19725; Mackinac Center for Public Policy, Michael LaFaive, & Todd Nesbit, *Higher Cigarette Taxes Create Lucrative, Dangerous Black Market* (Jan. 2013), http://www.mackinac.org/18128; Mackinac Center for Public Policy, Michael LaFaive, *Cigarette Taxes and Smuggling 2010: An Update of Earlier Research* (Dec. 2010), http://www.mackinac.org/14210; Mackinac Center for Public Policy, Michael LaFaive, Patrick Fleenor, & Todd Nesbit, *Cigarette Taxes and Smuggling: A Statistical Analysis and Historical Review* (Dec. 2008), http://www.mackinac.org/10005.

[3] Joseph Henchman and Scott Drenkard, *Cigarette Taxes and Cigarette Smuggling by State*, TAX FOUNDATION FISCAL FACT NO. 421 (Mar. 19, 2014), http://taxfoundation.org/article/cigarette-taxes-and-cigarette-smuggling-state.

[4] *See, e.g.*, Michael F. Lovenheim, *How Far to the Border?: The Extent and Impact of Cross-Border Casual Cigarette Smuggling*, 61 National Tax Journal 7-33 (Mar. 2008), http://ntj.tax.org/wwtax/ntjrec.nsf/BF515771548F9D538525742E006CCBBA/$FILE/Article%2001-Lovenheim.pdf;

northeast cities, finding that 58.7 percent of packs did not have proper local stamps. The authors estimated 30.5 to 42.1 percent of packs were trafficked.[5]

Figure 1: Cigarette Smuggling Rates by State (2012)

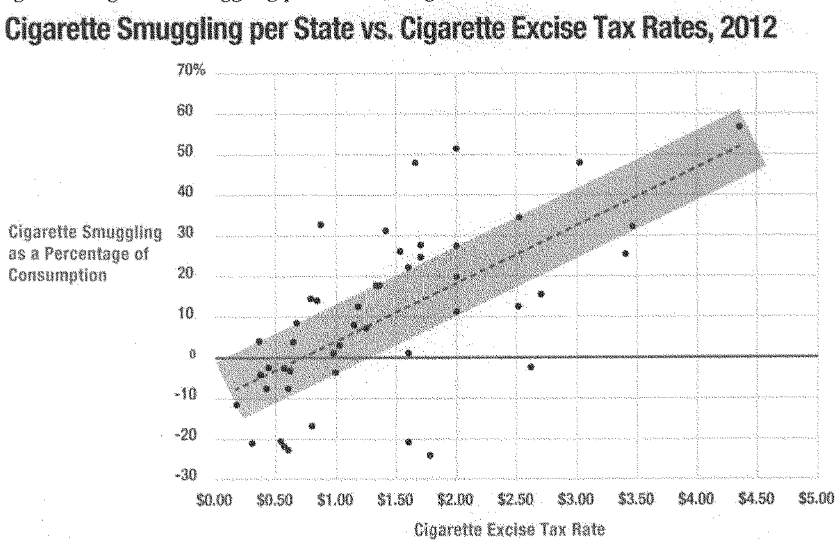


R. Morris Coats, *A Note on Estimating Cross Border Effects of State Cigarette Taxes,* 48 National Tax Journal 573-584 (Dec. 1995), http://ntj.tax.org/wwtax/ntjrec.nsf/notesview/D7AF38C6EF8BF6D7852567EF0057A8C0/$file/v48n4573.pdf; Mark Stehr, *Cigarette Tax Avoidance and Evasion*, 23 Journal of Health Economics 277-297 (2005), http://legacy.library.ucsf.edu/documentStore/h/j/o/hjo10j00/Shjo10j00.pdf.

[5] Kevin C. Davis et al., *Cigarette Trafficking in Five Northeastern US Cities* (Dec. 11, 2013), http://tobaccocontrol.bmj.com/content/early/2013/12/11/tobaccocontrol-2013-051244.

Smuggling takes many forms: counterfeit state tax stamps, counterfeit versions of legitimate brands, hijacked trucks, or officials turning a blind eye.[6] The study's authors, LaFaive and Nesbit, cite examples of a Maryland police officer running illicit cigarettes while on duty, a Virginia man hiring a contract killer over a cigarette smuggling dispute, and prison guards caught smuggling cigarettes into prisons. Policy responses have included banning common carrier delivery of cigarettes,[7] greater law enforcement activity on interstate roads,[8] differential tax rates near low-tax jurisdictions,[9] and cracking down on tribal reservations that sell tax-free cigarettes.[10] However, the underlying problem remains: high cigarette taxes that amount to a "price prohibition" of the product in many U.S. states (Figure 2).[11]

Figure 2: Cigarette Smuggling per State vs. Cigarette Excise Tax Rates, 2012



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[6] *See, e.g.*, Scott Drenkard, *Cigarette Smuggling Can Make You $4 Million Richer*, TAX FOUNDATION TAX POLICY BLOG, Sept. 27, 2012, http://taxfoundation.org/blog/cigarette-smuggling-can-make-you-4-million-dollars-richer.

[7] *See, e.g.*, Curtis Dubay, *UPS Decision Unlikely to Stop Cigarette Smuggling*, TAX FOUNDATION TAX POLICY BLOG, Oct. 25, 2005, http://taxfoundation.org/blog/ups-decision-unlikely-stop-cigarette-smuggling.

[8] *See, e.g.*, Gary Fields, *States Go to War on Cigarette Smuggling*, WALL STREET JOURNAL, July 20, 2009, http://professional.wsj.com/article/SB124804682785163691.html?mg=reno64-wsj.

[9] *See, e.g.*, Mark Robyn, *Border Zone Cigarette Taxation: Arkansas's Novel Solution to the Border Shopping Problem*, TAX FOUNDATION FISCAL FACT NO. 168 (Apr. 9, 2009), http://taxfoundation.org/article/border-zone-cigarette-taxation-arkansass-novel-solution-border-shopping-problem.

[10] *See, e.g.*, Joseph Henchman, *New York Governor Signs Law to Tax Cigarettes Sold on Tribal Lands*, *Tax Foundation Tax Policy Blog*, Dec. 16, 2008, http://taxfoundation.org/blog/new-york-governor-signs-law-tax-cigarettes-sold-tribal-lands.

[11] *See* Patrick Fleenor, *Tax Differentials on the Interstate Smuggling and Cross-Border Sales of Cigarettes in the United States*, TAX FOUNDATION BACKGROUND PAPER NO. 16 (Oct. 1, 1996), http://taxfoundation.org/article/tax-differentials-interstate-smuggling-and-cross-border-sales-cigarettes-united-states.

International Smuggling and Counterfeiting Puts Consumers at Risk

While the practice of buying cigarettes in low tax states and selling in high tax states is highly prevalent in the United States, other methods for evading federal, state, and local taxes are also popular. One way that criminals procure even higher profits is by skirting the legal market altogether and producing counterfeit cigarettes with all the look and feel of legitimate brands, and selling them with counterfeit tax stamps. Many of these products are smuggled from China, with one source estimating that Chinese counterfeiters produce 400 billion cigarettes per year to meet international demand.[12]

These counterfeit cigarettes are dangerous products, and do not adhere to quality control standards found in cigarettes from authentic brands. Pappas et al. (2007) find that counterfeit cigarettes can have as much as seven times the lead of legitimate brands, and close to three times as much thallium.[13] Other sources report finding insect eggs, dead flies, mold, and human feces in counterfeit cigarettes.[14]

As was the case during the prohibition of alcohol in the United States during the 1920s, increased enforcement has not yielded beneficial results for decreasing the prevalence of bootlegging because the profit margins are so large and the distribution networks are growing more sophisticated. The Center for Public Integrity reports that:

> In May, UK authorities seized over 20 million counterfeit Regals (valued at $8.6 million) imported from China into Southampton. Likewise that month, Spanish authorities grabbed 20 million fake Marlboros—falsely described as mattresses—imported from the Chinese ports of Chiwan and Shekou. Also in May, French customs intercepted more than 15 million made-in-China fake Marlboros outside Paris, some bearing Vietnamese as well as Arabic and French health warnings.
>
> Nevertheless, says OLAF's [Austin] Rowan, such seizures are just "the tip of the iceberg." Smugglers frequently ship cigarettes through an array of destinations such as Dubai and Singapore to mask a container's origin, with some spending up to three months at sea before delivery. And even if a container is seized, given exorbitant per-container profits, the loss is a slim deterrent. "With nine containers seized in ten," Rowan says, "[smugglers] still would not be losing money."[15]

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[12] Center for Public Integrity, Te-Ping Chen. *China's Marlboro Country* (June 29, 2009), https://reportingproject.net/underground/index.php?option=com_content&view=article&id=9:chinas-marlboro-country&catid=3:stories&Itemid=22.

[13] R.S. Pappas et al., *Cadmium, Lead, and Thallium in Smoke Particulate from Counterfeit Cigarettes Compared to Authentic US Brands*, 45 Food and Chemical Toxicology 202-209 (2007).

[14] International Chamber of Commerce, Commercial Crime Services, *Counterfeit Cigarettes Contain Disturbing Toxic Substances*, http://www.icc-ccs.org/component/flexicontent/85-news/360-counterfeit-cigarettes-contain-disturbing-toxic-substances.

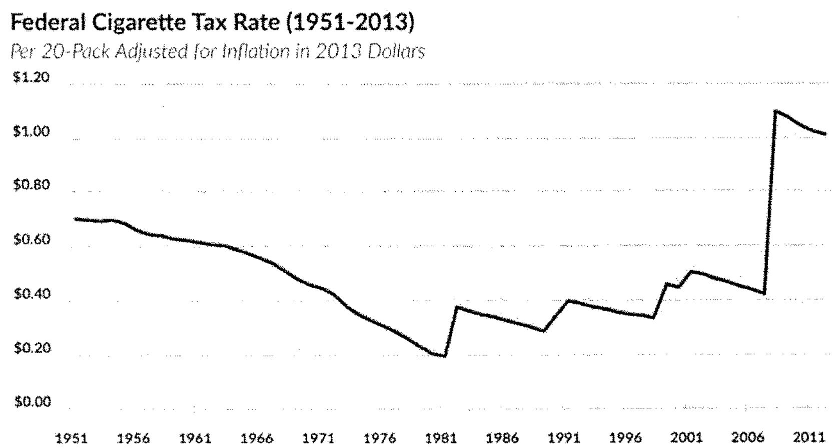
[15] Chen, *supra* note 12.

Canada had such tremendous problems with counterfeit and smuggled cigarettes that in 1994 the federal cigarette excise tax was cut from $16 to $11 per carton.[16]

SCHIP Reauthorization in 2009 Was the Largest Federal Cigarette Excise Tax Increase in History

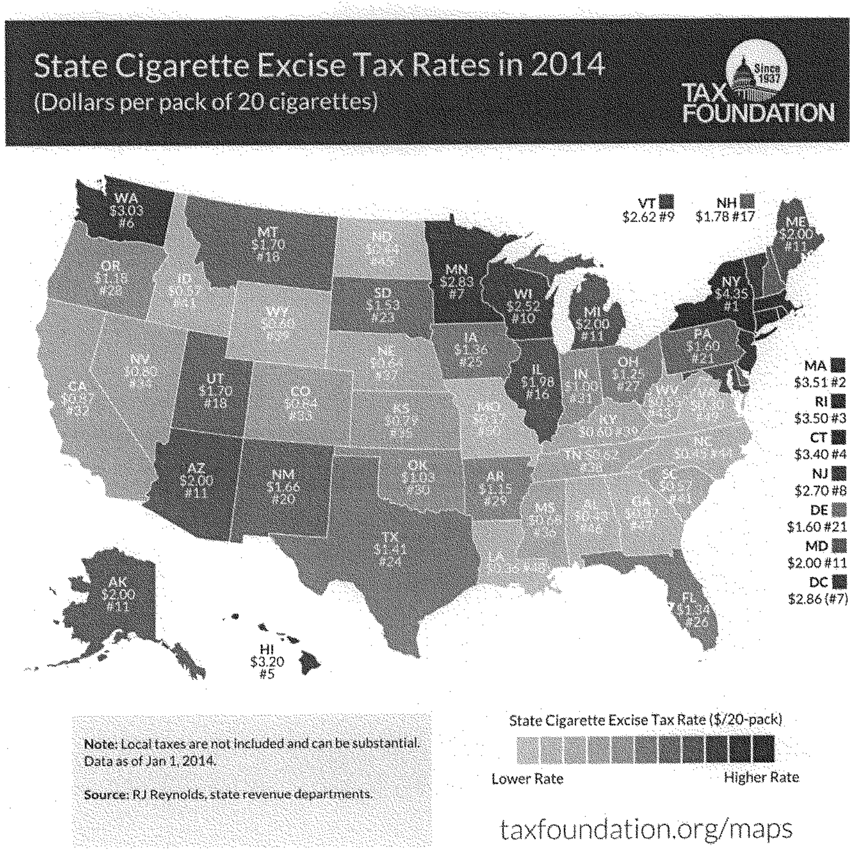
The reauthorization of SCHIP in 2009 included the largest federal cigarette excise tax increase in history, bringing the tax to one of its highest levels ever in inflation-adjusted terms (See Figure 3).[17] State and local cigarette excise tax rates have grown dramatically in recent years as well, with the highest combined federal, state, and local rate totaling to $7.17 in Chicago, Illinois, and $5.85 in New York, New York (See Figure 4). These taxes contribute substantially to the cost of a pack of cigarettes, with prices in New York reaching as high as $10.54 according to an official price survey in 2013,[18] and as high as $14.50 according to a more recent informal survey.[19]

Figure 3: Inflation-Adjusted Federal Cigarette Excise Tax Rates Per 20-Pack (1951-2013)[20]



[16] Clyde Farnsworth, *Canada Cuts Cigarette Taxes to Fight Smuggling*. The New York Times, February 9, 1994. http://www.nytimes.com/1994/02/09/world/canada-cuts-cigarette-taxes-to-fight-smuggling.html.
[17] Centers for Disease Control, *Federal and State Cigarette Excise Taxes—United States, 1995—2009* (May 22, 2009), http://www.cdc.gov/mmwr/preview/mmwrhtml/mm5819a2.htm.
[18] Orzechowski & Walker, *The Tax Burden on Tobacco* (2013).
[19] Sarah Jampel, *What A Pack Of Cigarettes Costs Now, State By State*, THE AWL, July 12, 2013, http://www.theawl.com/2013/07/what-a-pack-of-cigarettes-costs-now-state-by-state.
[20] *See* Orzechowsi & Walker, *supra* note 17, at 305. Author's calculations completed using Bureau of Economic Analysis CPI-U.

Figure 4: State Cigarette Excise Tax Rates as of January 1, 2014

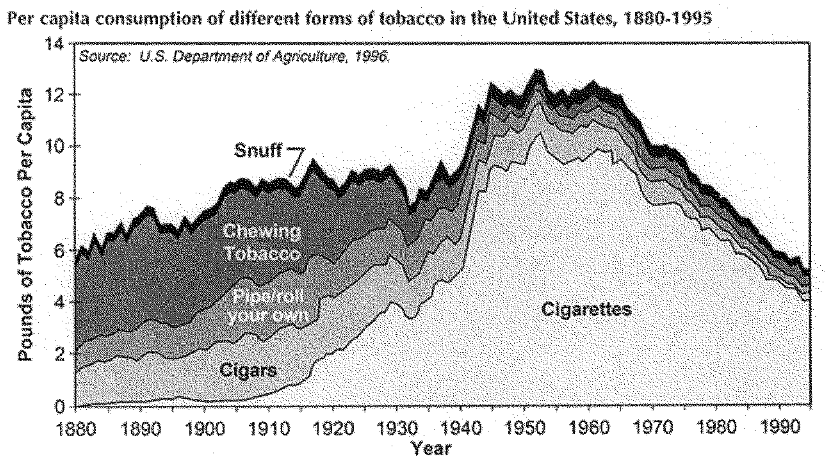


Tobacco Consumption is Declining, Making Tax Revenue a Poor Long-Run Funding Mechanism

One recent proposal circulated by the administration is to fund universal preschool by increasing the federal cigarette excise tax from $1.0066 to $1.95 a pack. While it might be politically expedient to isolate a small, unpopular group (smokers) to pay for a service to a popular group (preschoolers), universal education would in fact be universal—and therefore should be paid for with broad based, universal taxes.

Further, funding pre-kindergarten education with tobacco tax revenue is not sustainable in the long run, as tobacco use has steadily declined since 1963.[21] As Figure 5 demonstrates, per capita consumption of tobacco surged in the mid-20th century, but has since declined year after year.

Figure 5: Per Capita Tobacco Consumption by Type



Source: David M. Burns et al.[22]

Table 6, from the president's FY 2014 Budget, shows revenue projections for increasing the tobacco tax and indexing it for inflation.

In the first ten years, the tax will raise $78.091 billion, which is enough to pay for the $75 billion costs of the program. But the administration predicts that the revenue from the tax will decline towards the end of the ten year window. Revenue from the tax would peak in 2015 at $9.844 billion, but by 2023, the revenue would fall to just over $6 billion. The table also shows that the majority of the new revenue would come during the first five years of the program (2014-2018). Consider also that the President's own projections show spending on universal preschool approaching $8 billion in 2023, even though projected revenues would be just over $6 billion.

This is a recipe for increasingly large deficits, as the cigarette tax will fail to raise enough revenue beyond the first ten years. If states are unable to pay for their share of the universal preschool as the plan dictates, it is also possible that the federal government will have to pick up an even bigger percentage of the cost.

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[21] American Lung Association, *Trends in Tobacco Use* (July 2011), http://www.lung.org/finding-cures/our-research/trend-reports/Tobacco-Trend-Report.pdf.

[22] David M. Burns et al, *Cigarette Smoking Behavior in the United States*, *in* SMOKING AND TOBACCO CONTROL MONOGRAPH NO. 8, http://cancercontrol.cancer.gov/brp/tcrb/monographs/8/m8_2.pdf.

Table 6: Revenue and Spending Expectations for Preschool for All
(billions of dollars)

											Totals	
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-2018	2014-2023
Additional Mandatory and Receipt Proposals												
-Early Childhood Investments												
--Support preschool for all	130	1,235	3,110	5,456	7,360	8,773	9,787	10,560	10,275	9,356	17,291	66,042
--Extend and expand home visiting	...	150	250	625	900	1,150	1,450	1,900	2,075	2,225	1,925	10,725
-Total, early childhood investments	130	1,385	3,360	6,081	8,260	9,923	11,237	12,460	12,350	11,581	19,216	76,767
-Increase tobacco taxes and index for inflation	-7,725	-9,844	-9,264	-8,718	-8,205	-7,723	-7,268	-6,842	-6,440	-6,062	-43,756	-78,091
Source: President Obama's FY 2014 Budget												

Conclusion

Tobacco excise taxes are not a reasonable revenue source for additional public spending. Already sizeable burdens at the federal, state, and local level have made for lucrative black market operations that result in violent crime and a breakdown of the rule of law. Tobacco excise taxes also fail the test of providing for sustainable revenues, as their revenue declines year over, making budgeting more difficult than it already is.

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Source: Virginia Crime Commission

Questions for the Record
"Tobacco: Taxes Owed, Avoided, and Evaded"
Hearing Date: July 29, 2014
Questions for Mr. Scott Drenkard

Ranking Member Orrin Hatch

1. *Mr. Drenkard, in your testimony you discuss the international black market in the smuggling of tobacco products. I noticed that in his testimony, Mr. Manfreda noted that "the 150 percent increase in the federal excise tax on cigarettes imposed by CHIPRA increased the incentive to evade federal taxes through tobacco diversion."*

   Please elaborate on how higher excise taxes may contribute to increased black market activity.

   Answer: Right now, the vast majority of American cigarette smuggling is simply movement of authentic brands from low tax jurisdictions to high tax jurisdictions. While this is highly undesirable and raises a lot of concerns, it isn't really a worst case scenario just yet. In Europe, for example, the situation is often more dire, as smuggled cigarettes are largely counterfeit. They are not made by the brands displayed on the package, and they do not pay any taxes owed.

   My assessment is that raising the federal excise tax rate on cigarette smuggling would invigorate the incentives for bringing in counterfeit cigarettes to the United States, skirting the legal tobacco market altogether.

2. *Mr. Drenkard, in your testimony you discuss how state and federal excise taxes may lead to unintended consequences such as increased criminal activity. Though we are focused on federal excise taxes here, does the federal tax interact with state tax rates in generating these unintended consequences?*

   Answer: Certainly. The more heavily we choose to tax these products at the federal, state, and local levels, the more consumers are going to look for lower cost options. My testimony documents many examples of consumers doing this; sometimes by buying cigarettes from out of state, sometimes by buying cigarettes from nearby Indian lands, or most troublingly, getting duped into buying counterfeit products.

   State and local taxes on cigarettes reach as high at $6.16 per pack (as in Chicago, Illinois). The federal tax stands at $1.0066. Increasing the federal rate would be increasing the tax rate on a product that already stands in excess of 150 percent of the price of the product in many locales. This has profound effects on the way that consumers behave.

United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance, U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. ET
Tuesday, July 29, 2014

TOBACCO TAXES

Disparities in Rates for Similar Smoking Products Continue to Drive Market Shifts to Lower-Taxed Options

Statement of David Gootnick, Director,
International Affairs and Trade

GAO-14-811T

GAO Highlights

Highlights of GAO-14-811T, a testimony before the Committee on Finance, U.S. Senate

Why GAO Did This Study

In 2009, CHIPRA increased and equalized federal excise tax rates for cigarettes, roll-your-own tobacco, and small cigars. Although CHIPRA also increased federal excise tax rates for pipe tobacco and large cigars, it raised the pipe tobacco tax to a rate significantly below the equalized rate for the other products, and the large cigar excise tax can be significantly lower, depending on price. Treasury collects federal excise taxes on domestic tobacco products. Customs and Border Protection (CBP) collects federal excise taxes on imported tobacco products.

This testimony highlights and provides selected updates to key findings from GAO's April 2012 report (GAO-12-475) by examining (1) market shifts among smoking tobacco products since CHIPRA, and (2) the impact of the market shifts on federal revenue and Treasury's actions to respond to these shifts. GAO analyzed Treasury and CBP data to identify sales trends for domestic and imported smoking tobacco products and to estimate the effect of the market shifts to lower-taxed products on federal tax revenues.

What GAO Recommends

GAO is not making any new recommendations in this testimony. In its 2012 report, GAO suggested that Congress consider equalizing tax rates on roll-your-own and pipe tobacco and, in consultation with Treasury, consider options for reducing tax avoidance due to tax differentials between small and large cigars. Treasury generally agreed with GAO's conclusions and observations.

View GAO-14-811T. For more information, contact David Gootnick at (202) 512-3149 or gootnickd@gao.gov.

July 29, 2014

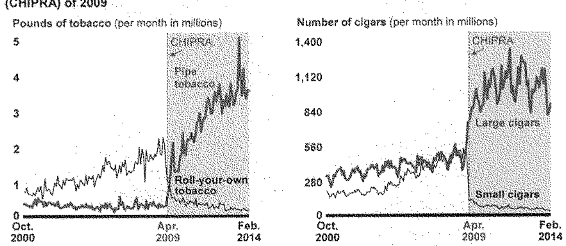
TOBACCO TAXES

Disparities in Rates for Similar Smoking Products Continue to Drive Market Shifts to Lower-Taxed Options

What GAO Found

Large federal excise tax disparities among smoking tobacco products, which resulted from the Children's Health Insurance Program Reauthorization Act (CHIPRA) of 2009, created opportunities for tax avoidance and led to significant market shifts toward lower-taxed products by manufacturers, importers, and price-sensitive consumers. From fiscal year 2008, the last year before CHIPRA, to fiscal year 2013, annual sales of domestic and imported pipe tobacco increased from about 5.2 million pounds to 43.7 million pounds, while sales of domestic and imported roll-your-own tobacco declined from about 21.3 million pounds to 3.8 million pounds. Over the same period, annual sales of domestic and imported large cigars increased from about 5.8 billion sticks to 12.4 billion sticks, while sales of domestic and imported small cigars declined from about 5.7 billion sticks to 0.7 billion sticks. According to government, industry, and nongovernmental organization representatives, many roll-your-own tobacco and small cigar manufacturers shifted to the lower-taxed products after CHIPRA to avoid paying higher taxes.

U.S. Sales of Roll-Your-Own and Pipe Tobacco and of Small and Large Cigars, both Domestic and Imported, before and after the Children's Health Insurance Program Reauthorization Act (CHIPRA) of 2009



Source: GAO analysis of data from the Department of the Treasury and Customs and Border Protection. | GAO-14-811T

While revenue collected for domestic and imported smoking tobacco products, including cigarettes, from April 2009 through February 2014, amounted to about $77 billion, GAO estimates that federal revenue losses due to market shifts from roll-your-own to pipe tobacco and from small to large cigars range from about $2.6 to $3.7 billion for the same period. GAO found that the Department of the Treasury (Treasury) has limited options to respond to these market shifts. Differentiating between roll-your-own and pipe tobacco for tax collection purposes presents challenges to Treasury because the definitions of the two products in the Internal Revenue Code do not specify distinguishing physical characteristics and are based on such factors as the use for which the products are suited and their packaging and labeling. GAO also found that Treasury continues to have limited options to address the market shift from small cigars to large cigars—which are differentiated in the Internal Revenue Code only by weight—and faces added complexity in monitoring and enforcing tax payments due to the change in large cigar tax rates.

Chairman Wyden, Ranking Member Hatch, and Members of the Committee:

Thank you for this opportunity to discuss the market shifts in smoking tobacco products since passage of the Children's Health Insurance Program Reauthorization Act (CHIPRA)[1] and the implications of those shifts for federal revenue from tobacco taxes. Tobacco use is the leading cause of preventable death, disease, and disability and a significant contributor to health care costs in the United States. Federal and state laws have aimed to discourage tobacco use and raise revenue by increasing excise taxes on tobacco products. The most recent federal increase occurred in April 2009 with the passage of CHIPRA, which amended the Internal Revenue Code of 1986 (IRC) by raising federal excise tax rates on tobacco products, while also equalizing the tax rates across some of them. The Department of the Treasury (Treasury) collects federal excise taxes on domestic tobacco products. Customs and Border Protection (CBP), within the Department of Homeland Security, collects federal excise taxes on imported tobacco products.

In my statement today, I will address two topics: (1) market shifts among smoking tobacco products since CHIPRA went into effect, and (2) the impact of the market shifts on federal revenue and Treasury's actions to respond to these shifts. Our study focuses on four smoking tobacco products: roll-your-own tobacco (sometimes called RYO), pipe tobacco, small cigars, and large cigars.

My statement is based on a GAO report issued in April 2012, which we have supplemented with updated market-shift data analysis and recent observations on tobacco marketing.[2] To identify sales trends for our 2012 report, we analyzed Treasury removals data[3] for domestic smoking

[1]Pub. L. No. 111-3, 123 Stat. 8.

[2]See GAO, *Tobacco Taxes: Large Disparities in Rates for Smoking Products Trigger Significant Market Shifts to Avoid Higher Taxes*, GAO-12-475 (Washington, D.C.: Apr. 18, 2012).

[3]As used in this testimony, for smoking tobacco products, "removals" means the amount removed for distribution in the United States from the factory or released from customs, as measured in pounds for roll-your-own and pipe tobacco or in the number of sticks for small and large cigars. We consider removals to be equivalent to sales and use the term "sales." We refer to tobacco products removed for distribution in the United States from U.S. factories as "domestic" and to products released from U.S. customs as "imported."

tobacco products from October 2000 through September 2011. To identify sales trends for this testimony, we included CBP's data on imported smoking tobacco products in our analysis.[4] To estimate federal tax revenue losses due to the market shifts after CHIPRA, we also analyzed Treasury's and CBP's revenue data and Bureau of Labor Statistics (BLS) price data for smoking tobacco products. We updated our analysis of sales trends to cover October 2000 through February 2014 and our estimate of revenue losses to cover April 2009 through February 2014. We assessed the reliability of the data by performing data checks for inconsistency errors and completeness and by interviewing cognizant officials. We determined that the Treasury, CBP, and BLS data were sufficiently reliable for our purposes. We estimated what the effect on tax revenue collection would have been if the sales trends for roll-your-own and pipe tobacco and for small and large cigars had not been affected by substitution between the products but had been affected by the increase in price due to the tax—in other words, if the market shifts resulting from the substitution of higher-taxed products with lower-taxed products had not occurred. Our analysis takes into account the expected fall in quantity demanded due to the price increases resulting from higher federal excise tax rates that CHIPRA imposed on all four of these smoking tobacco products. To update some of our previous observations of marketing practices, we returned to tobacco stores and some of the Internet retailers that we had visited for our April 2012 report. For that report, we reviewed documents and interviewed agency officials from Treasury's Alcohol and Tobacco Tax and Trade Bureau, the Food and Drug Administration (FDA), and the Centers for Disease Control and Prevention, as well as tobacco industry members, representatives of public health and other nongovernmental organizations, and academics, to obtain information on tobacco legislation and regulations, tobacco product sales trends, and

[4]We included data on imported large cigars because their sales have increased significantly since 2011. For consistency, we also included data on imported roll-your-own tobacco, pipe tobacco, and small cigars.

consumption patterns.[5] Appendix I in our 2012 report provides detailed information on our scope and methodology. For this testimony, we interviewed officials from Treasury's Alcohol and Tobacco Tax and Trade Bureau and from CBP, as well as other experts. The information contained in this testimony was reviewed for technical accuracy by Treasury and CBP officials.

The work upon which this testimony is based was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

While cigarettes are the smoking tobacco product preferred by most smokers, the consumption of other smoking tobacco products is growing. Cigarettes continue to dominate the market for domestic and imported smoking tobacco products, accounting for approximately 88 percent of sales in fiscal year 2013. However, sales of other smoking tobacco products increased in fiscal years 2001 through 2013, with combined sales of roll-your-own tobacco, pipe tobacco, and small and large cigars,

[5] Our 2012 report described differences in the regulation of various smoking tobacco products by FDA. Under the Family Smoking Prevention and Tobacco Control Act enacted in 2009, FDA was granted immediate regulatory authority over four products: cigarettes, cigarette tobacco, roll-your-own tobacco, and smokeless tobacco. In the report, we described FDA's plans to issue a regulation that would deem tobacco products meeting the statutory definition of "tobacco product" to be subject to FDA's tobacco control authorities. On April 25, 2014, FDA proposed a rule that would extend the agency's tobacco control authorities to cover additional tobacco products. FDA stated that products that would be deemed to be subject to FDA's regulation can include currently unregulated marketed products, such as cigars, pipe tobacco, and electronic cigarettes. Under the proposed rule, provisions that would apply to newly deemed tobacco products include minimum age and identification restrictions, requirements to include health warnings, and restrictions on vending machine sales. See 79 Fed. Reg. 23142 (Apr. 25, 2014).

both domestic and imported, growing from 3 percent of the smoking tobacco market to about 12 percent.[6]

Roll-your-own tobacco, pipe tobacco, and small and large cigars are broadly defined in the IRC.[7] Roll-your-own tobacco and pipe tobacco are defined by such factors as the use for which the product is suited and how the products are offered for sale, as indicated by their appearance, type, packaging, and labeling.[8] The definitions in the IRC do not specify the physical characteristics that would differentiate pipe tobacco from roll-your-own tobacco.[9] Cigars are differentiated from cigarettes by their wrapper and whether the product is, for a number of reasons, likely to be offered to, or purchased by, consumers as a cigarette.[10] The IRC distinguishes between small and large cigars only by weight; small cigars are defined as weighing 3 pounds or less per thousand sticks.[11] Figure 1 shows a sample of different smoking tobacco products.

[6]Not reflected in these sales data is the growing popularity of electronic cigarettes (also known as e-cigarettes). The Centers for Disease Control and Prevention reported a rapid increase in the use of e-cigarettes in recent years: among youth, the proportion of high school students who had tried e-cigarettes doubled from 4.7 percent in 2011 to 10 percent in 2012, and among adults, the proportion who had tried e-cigarettes nearly doubled from 3.3 percent in 2010 to 6.2 percent in 2011.

[7]26 U.S.C. § 5702.

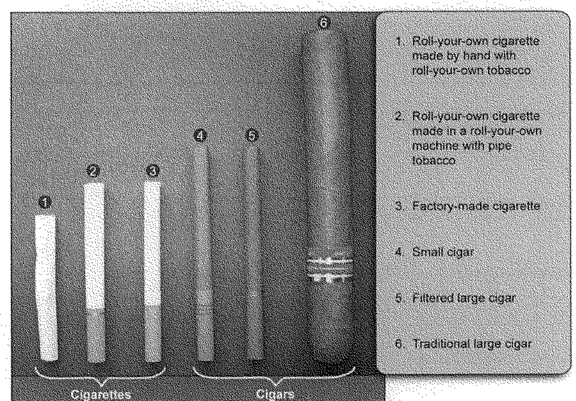
[8]*Id.*

[9]*Id.*

[10]*Id.*

[11]26 U.S.C. § 5701. Industry representatives, a nongovernmental organization, and government officials indicated that many small and large cigars have filters, are wrapped in a type of paper made with tobacco, and can be similar in size and appearance to cigarettes.

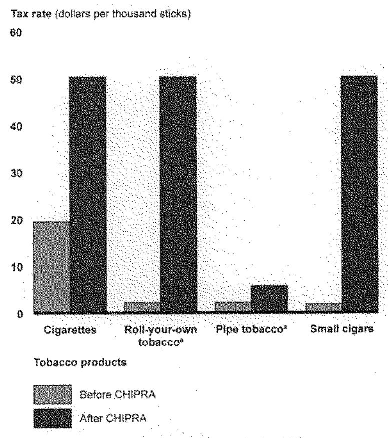
Figure 1: Examples of Cigarette and Cigar Products



Source: GAO photo. | GAO-14-811T

The federal excise tax rates on different tobacco products are calculated in different ways. Cigarettes and small cigars are taxed on a per unit basis—the number of sticks. Roll-your-own and pipe tobacco are taxed by weight. Before CHIPRA, the federal excise tax rate on cigarettes was higher than the rates on roll-your-own tobacco, pipe tobacco, and small cigars. In 2009, CHIPRA significantly raised the tax rates on these four products. The act equalized the rates for cigarettes, roll-your-own tobacco, and small cigars, but not for pipe tobacco (see fig. 2). Prior to CHIPRA, roll-your-own and pipe tobacco were taxed at the same rate ($1.10 per pound). However, CHIPRA raised the federal excise tax rates for roll-your-own tobacco and pipe tobacco by different amounts, resulting in a $21.95 per pound difference between the higher-taxed roll-your-own tobacco ($24.78 per pound) and the lower-taxed pipe tobacco ($2.83 per pound). As a result, of the three cigarette products shown in figure 1, the cigarette made with pipe tobacco (marked as number 2) is taxed at a much lower rate than either the factory-made cigarette (number 3) or the cigarette made with roll-your-own tobacco (number 1).

Figure 2: Changes in Federal Excise Tax Rates as a Result of the Children's Health Insurance Program Reauthorization Act (CHIPRA)—for Cigarettes, Roll-Your-Own Tobacco, Pipe Tobacco, and Small Cigars



Source: GAO analysis of the Internal Revenue Code. | GAO-14-811T

[a]Because roll-your-own tobacco and pipe tobacco are taxed based on weight, we converted weight to cigarette stick equivalent using the Master Settlement Agreement conversion rate that is based on the weight of 0.0325 ounces of tobacco per cigarette stick. In 1998, 46 states signed the Master Settlement Agreement with the four largest U.S. tobacco companies to settle state tobacco-related lawsuits and recover billions of dollars in costs associated with smoking-related illnesses.

CHIPRA also significantly changed the federal excise tax rate on large cigars. Large cigars are unique among tobacco products in that the tax rate is ad valorem—calculated as a percentage of the manufacturer's or importer's sale price—up to a maximum tax per thousand sticks. While CHIPRA increased the small cigar tax rate from $1.83 to $50.33 per thousand sticks (the same rate as cigarettes), the ad valorem rate for large cigars increased from 20.72 percent to 52.75 percent of the manufacturer's or importer's sale price, up to a maximum tax of $402.60 per thousand sticks (see table 1). As a result, cigars with a manufacturer's price of $50 per thousand, for example, would experience a tax savings of $23.95 per thousand if they qualified as large rather than small cigars. In figure 1, although the small cigar (marked as number 4) and the filtered large cigar (number 5) are similar in appearance, they are likely taxed at significantly different rates, depending on the price of the filtered large cigar.

Table 1: Federal Excise Tax Rates for Large Cigars before and after the Children's Health Insurance Program Reauthorization Act (CHIPRA)

Tobacco product	Unit of taxation	Before CHIPRA	After CHIPRA	Percentage increase
Large cigars	Ad valorem rate based on manufacturer's or importer's sale price up to a maximum tax rate	20.72%	52.75%	155%
	Maximum tax per thousand sticks	$48.75	$402.60	726%

Source: GAO analysis of the Internal Revenue Code, 26 U.S.C. § 5701. | GAO-14-811T

Domestic manufacturers and importers of tobacco products must obtain a permit from Treasury before engaging in business. Treasury collects the federal excise taxes on domestic tobacco products when these products leave manufacturing facilities. CBP collects the federal excise taxes on imported tobacco products when those products are released from customs. According to Treasury, when Treasury investigates or audits an importer of tobacco products and determines liability, Treasury refers the case to CBP for collection of the tax.

Large Tax Disparities among Similar Tobacco Products Triggered Significant Market Shifts to Avoid Higher Taxes

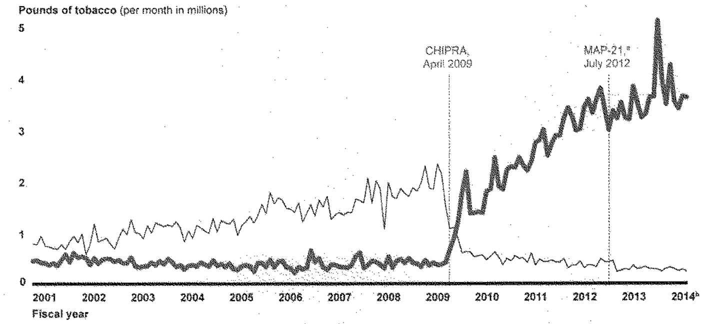
Large federal excise tax disparities among tobacco products resulting from CHIPRA created opportunities for tax avoidance and led to significant market shifts by manufacturers, importers, and price-sensitive consumers toward the lower-taxed products. Specifically, the market for roll-your-own tobacco shifted to pipe tobacco, and the cigar market shifted from small to large cigars. According to government, industry, and nongovernmental organization representatives, many roll-your-own tobacco and small cigar manufacturers shifted to the lower-taxed products after CHIPRA to avoid paying higher taxes.

The Market Shifted from Roll-Your-Own Tobacco to Pipe Tobacco after CHIPRA

Market trends for roll-your-own and pipe tobacco changed immediately after CHIPRA, with sales of pipe tobacco rising steeply while sales of roll-your-own tobacco plummeted. CHIPRA introduced a large disparity in rates on these two products, which had been taxed at the same rate, as shown previously in figure 2.

Figure 3 shows the market shift through monthly and annual sales of domestic and imported roll-your-own and pipe tobacco from October 2000 through February 2014. Total annual sales of pipe tobacco grew from about 5.2 million pounds in fiscal year 2008, the last year before CHIPRA, to 43.7 million pounds in fiscal year 2013, representing an increase of about 740 percent. Over the same period, total annual sales of roll-your-own tobacco declined from about 21.3 million pounds to 3.8 million pounds, a decrease of 82 percent.[12]

Figure 3: U.S. Sales of Domestic and Imported Roll-Your-Own and Pipe Tobacco before and after the Children's Health Insurance Program Reauthorization Act (CHIPRA)



Pounds of tobacco (per fiscal year in millions)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Roll-your-own tobacco	9.6	10.7	13.4	13.0	16.0	17.9	18.5	21.3	17.0	6.4	5.6	4.8	3.8	1.5
Pipe tobacco	5.7	5.8	5.0	4.7	4.5	4.8	4.9	5.2	10.7	23.3	33.1	40.0	43.7	18.5

Source: GAO analysis of data from the Department of the Treasury and Customs and Border Protection. | GAO-14-811T

[a]MAP-21 stands for the Moving Ahead for Progress in the 21st Century Act, which clarified the definition of "manufacturer of tobacco products" for tax purposes.

[b]Data for fiscal year 2014 cover the period from October 2013 through February 2014.

[12]In fiscal years 2011 through 2013, the amount of imported pipe tobacco increased from 2.6 million pounds (or 8 percent of the total pipe tobacco sales) to 5.6 million (13 percent), while the amount of imported roll-your-own tobacco decreased from 362,709 pounds (or 7 percent of the total roll-your-own tobacco sales) to 187,286 pounds (5 percent).

According to government officials, representatives of nongovernmental organizations, and industry, the new pipe tobacco products have minimal, if any, differences from roll-your-own tobacco products. Treasury also emphasized that it is unclear to what extent domestic manufacturers modified their roll-your-own tobacco beyond reclassifying it as pipe tobacco.[13] Representatives of industry and nongovernmental organizations provided examples of current pipe tobacco brands that had been roll-your-own brands prior to CHIPRA, with minimal differences in the packaging and the appearance of the tobacco itself. For both our 2012 report and this testimony, we found examples of Internet retailers signaling to customers in their marketing that pipe tobacco was suitable for smoking in roll-your-own cigarettes.

In 2011, we approached 15 pipe tobacco manufacturers based in the United States to ask about their companies' actions in response to the CHIPRA tax changes. Each of the three tobacco manufacturers that agreed to speak with us explained that their companies switched from selling higher-taxed roll-your-own tobacco to lower-taxed pipe tobacco to stay competitive. One company changed the cut of its roll-your-own tobacco and labeled it as pipe tobacco, although a company representative acknowledged that there was no real difference between its roll-your-own tobacco and its pipe-cut tobacco. A representative from another company that switched from selling roll-your-own tobacco to selling pipe tobacco stated that she was not aware of any difference in the two products other than the federal excise tax rate. As of April 2014, each of the three companies continued to manufacture the same brand of pipe tobacco.

The Market Shift from Roll-Your-Own to Pipe Tobacco Continues despite Provision in 2012 Law

We noted in our 2012 report that the rise in pipe tobacco sales after CHIPRA coincided with the growing availability of roll-your-own machines. Treasury officials stated that the use of roll-your-own machines, which enabled customers to produce a carton of cigarettes using pipe tobacco and cigarette-paper tubes with filters, had grown considerably. By using pipe tobacco instead of roll-your-own tobacco, customers were able to save almost $9 per carton in federal excise taxes. In addition, a roll-your-own machine could produce a carton of cigarettes in less than 10

[13]CBP officials shared a similar observation regarding imported roll-your-own and pipe tobacco.

minutes, providing a significant time saving compared with rolling cigarettes by hand.

Following the publication of our report in April 2012, the President signed the Moving Ahead for Progress in the 21st Century Act (MAP-21) on July 6, 2012, which clarified the definition of "manufacturer of tobacco products" for tax purposes.[14] The relevant MAP-21 provision amended the IRC and states that the term manufacturer of tobacco products shall include any person who, for commercial purposes, makes available for consumer use a machine capable of making cigarettes, cigars, or other tobacco products.[15] As a manufacturer of tobacco products, such a person is liable for the federal excise tax on the resulting tobacco products.[16] According to Treasury officials and experts, some retailers responded to the MAP-21 legislation by establishing social clubs that make available to their members machines capable of making cigarettes from pipe tobacco.[17] However, according to Treasury's guidance, the tax liability applies to any person who for commercial purposes makes the machine available for use by consumers of tobacco products regardless of whether the machine is used at a retail premises.[18] The guidance goes on to state that the nonprofit status of the "person" is not relevant in evaluating "commercial purposes."

The statutory and regulatory requirements for manufacturers of tobacco products include obtaining a permit from Treasury before engaging in business; filing tax returns and paying the federal excise tax on a semimonthly schedule; paying a special (occupational) tax; obtaining a bond; and complying with Treasury's record-keeping, reporting, and

[14] Pub. L. No. 112-141, § 100122, 126 Stat. 405, 914.

[15] *Id.*

[16] 26 U.S.C. § 5703.

[17] We visited one such social club in April 2014 and observed two roll-your-own machines on its premises.

[18] In October 2012, Treasury issued public guidance on MAP-21's provisions regarding roll-your-own machines. See Department of the Treasury, Alcohol and Tobacco Tax and Trade Bureau, TTB Public Guidance 2012-3, *Cigarette-Making Machines and Other Tobacco Product Machines Made Available for Use by Consumers* (Washington, D.C.: Oct. 4, 2012).

inventory requirements.[19] Following the passage of MAP-21, Treasury received 92 applications for tobacco manufacturer permits; it determined that only 4 of these applications involved roll-your-own machines. Of the 4 applicants, none are currently manufacturing under the requested permit: the applicants have either gone out of business, are no longer pursuing their application, or are currently being investigated by Treasury.[20]

As figure 3 above demonstrates, since July 2012 the sales of roll-your-own tobacco have continued to decline, while the sales of pipe tobacco have continued to grow. Despite the MAP-21 legislation, the disparity in the federal tax rates, introduced by CHIPRA in 2009, maintains an incentive for the substitution of higher-taxed roll-your-own tobacco with lower-taxed pipe tobacco by price-sensitive consumers and for the operation of roll-your-own machines for commercial purposes without proper permits and payment of federal excise taxes by retailers.[21] When we visited a tobacco store near Washington, D.C., in April 2014, we observed a large price differential between roll-your-own tobacco and pipe tobacco. For example, we bought a 6-ounce bag of pipe tobacco for $13.77 and a 6-ounce bag of roll-your-own tobacco for $26.49, inclusive of federal and state taxes.

As part of its ongoing enforcement efforts related to MAP-21, since October 2012 Treasury has sent out warning letters to 1,467 persons suspected of making roll-your-own machines available to consumers for commercial purposes. Treasury officials stated that to date Treasury's Alcohol and Tobacco Tax and Trade Bureau has completed 34 investigations of such persons. In all locations where roll-your-own machines were found, Treasury determined that they had been made available to consumers for commercial purposes without the proper permit. Treasury officials also stated that as of July 2014 the Alcohol and Tobacco Tax and Trade Bureau had 37 open investigations related to roll-

[19]26 U.S.C. §§ 5703, 5711-13, 5731-32; 27 C.F.R. §§ 40.26, 40.101, 40.162, 40.181-87, 40.201-02.

[20]Treasury conducts a field investigation for each application for a tobacco product manufacturer permit.

[21]Consumers can also continue to take advantage of the lower-taxed pipe tobacco by making cigarettes in roll-your-own machines sold for personal use.

your-own machines and that most of these investigations involved social clubs.[22]

Cigar Market Shifted from Small to Large Cigars after CHIPRA

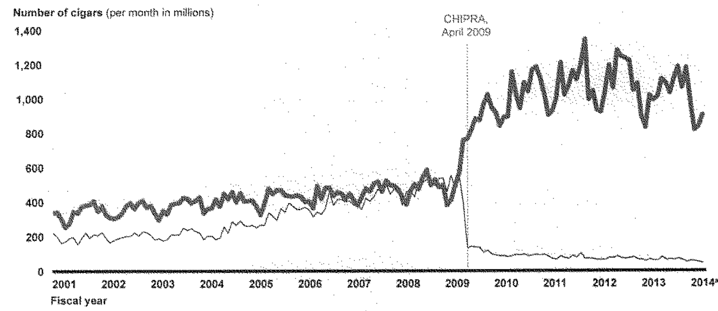
CHIPRA's 2009 changes in federal excise tax rates on tobacco products resulted in an immediate shift in the cigar market, with sales of lower-taxed large cigars rising sharply while sales of higher-taxed small cigars dropped. CHIPRA significantly changed the tax rates on cigars, resulting in a large tax-rate disparity between low-priced large cigars and small cigars.

Figure 4 shows the market shift through monthly and annual sales of domestic and imported small and large cigars from October 2000 through February 2014. Total annual sales of large cigars grew from about 5.8 billion sticks in fiscal year 2008 to 12.4 billion sticks in fiscal year 2013, an increase of about 115 percent. Over the same period, total annual sales of small cigars declined from about 5.7 billion sticks to 0.7 billion sticks, a decrease of 88 percent.[23] While sales for both domestic and imported large cigars increased significantly after CHIPRA, the sales of imported large cigars quadrupled, growing from about 1 billion sticks (or 17 percent of the total large cigar sales) in fiscal year 2008 to 4.4 billion sticks (36 percent) in fiscal year 2013. By contrast, the sales of imported small cigars decreased from about 357 million sticks to 58 million sticks over the same period.

[22]According to Treasury, the average federal tax liability identified for these locations was about $54,000 per investigation (about $4 million in total for the completed and open investigations). Treasury completed two investigations where no roll-your-own machines were found.

[23]Figure 4 shows an increase in large cigar sales in the months immediately prior to the tax change. For our 2012 report, Treasury officials stated that they had not specifically investigated the cause of this increase, but that there was an incentive for retailers and wholesalers to purchase and stockpile large cigars after the date CHIPRA was signed into law (Feb. 4, 2009) and before the tax increase went into effect (Apr. 1, 2009). In addition, these officials noted that a floor stocks tax was typically imposed to prevent stockpiling just before a tax increase, but the floor stocks tax imposed by CHIPRA did not apply to large cigars.

Figure 4: U.S. Sales of Domestic and Imported Small and Large Cigars before and after the Children's Health Insurance Program Reauthorization Act (CHIPRA)



Number of cigars (per fiscal year in millions)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014ª
Large cigars	3,984	4,180	4,414	4,770	4,989	5,167	5,440	5,764	8,366	12,044	13,051	13,169	12,396	4,704
Small cigars	2,230	2,345	2,451	2,685	3,648	4,368	4,965	5,693	3,647	981	876	770	689	218

Source: GAO analysis of data from the Department of the Treasury and Customs and Border Protection. | GAO-14-811T

ªData for fiscal year 2014 cover the period from October 2013 through February 2014.

> **Internal Revenue Code Descriptions:**
>
> **Small cigar**—Any roll of tobacco wrapped in leaf tobacco or in any substance containing tobacco (other than any roll of tobacco which is a cigarette) that weighs 3 pounds or less per thousand.
>
> **Large cigar**—Any roll of tobacco wrapped in leaf tobacco or in any substance containing tobacco (other than any roll of tobacco which is a cigarette) that weighs more than 3 pounds per thousand.
>
> Source: 26 U.S.C. §§ 5701-02. | GAO-14-811T

According to government officials and representatives of nongovernmental organizations, because weight is the only characteristic that distinguishes small cigars from large cigars, cigar manufacturers made their small cigars heavier to qualify for the large cigar tax rate and avoid higher taxes levied on small cigars after CHIPRA. CHIPRA's changes to the federal excise tax rate on large cigars created an incentive for small cigar manufacturers to switch to making large cigars when the manufacturer's or importer's sale price per thousand cigars is $95.40 or lower. According to Treasury officials and other industry experts, prior to CHIPRA, many small cigars weighed close to 3 pounds per thousand sticks, which is the dividing line between small and large cigars set by the IRC. Small cigars that weighed just under or exactly 3 pounds per thousand sticks would be able to qualify as large cigars with minimal changes. CHIPRA produced incentives for small cigar manufacturers to alter their product to meet the definition of a lower-taxed large cigar. The same companies could use the same machines to add a small amount of weight to their product, turning small cigars into a product legally defined and taxed as large cigars. For example, manufacturers could add weight by packing the tobacco more tightly. Some manufacturers then changed their labels from "small cigars" to "filtered cigars" or "cigars"—often with the same packaging and design. Treasury officials stated that the agency lacks the authority to remedy the tax revenue losses resulting from manufacturers' legitimate modifications of small cigars to qualify them for the lower tax rate on large cigars.

Market Shifts to Avoid Taxes Have Reduced Federal Revenue, and Treasury Has Limited Options to Respond

Estimated Federal Revenue Losses from Market Shifts after CHIPRA Range from $2.6 Billion to $3.7 Billion

While tax revenue collected for domestic and imported smoking tobacco products, including cigarettes, from April 2009 through February 2014, amounted to about $77 billion, we estimate that federal revenue losses due to the market shifts from roll-your-own to pipe tobacco and from small to large cigars range from approximately $2.6 billion to $3.7 billion for the same period.[24] This range includes combined tax revenue losses for the roll-your-own and pipe tobacco markets, as well as the small and large cigar markets. We conducted analyses of data from Treasury, CBP, and

[24]The difference between the revenues collected under current law and our estimate of the higher revenues that would have been due in the absence of the market shifts is what we refer to as "revenue losses." In its written comments on a draft of our April 2012 report, Treasury took issue with our use of revenue losses (see GAO-12-475). However, we noted in the report that Treasury's Alcohol and Tobacco Tax and Trade Bureau had developed its own estimates of what it also termed revenue losses stemming from the market shifts involving these products; we discussed those estimates in our 2012 report.

BLS to estimate tax revenue losses in these markets.[25] Our methodology takes into account the expected fall in demand for a product following a price increase, holding other variables constant. To calculate the range of federal revenue losses, we included high and low estimates based on assumptions about the effect of a price increase on projected sales. Economic studies show that, when the price of a product increases, the quantity demanded for the product will adjust downward, decreasing at an estimated rate based on the quantity demanded for the product, that is, price elasticity.[26] On the basis of our interviews with government officials and academics and our literature review, we determined that the price elasticity of demand for the smoking tobacco products ranges from -0.6 to -0.3 for the low and high revenue estimates, respectively. Our projections also take into account the historic sales trends for these products and the tax component of the price.[27]

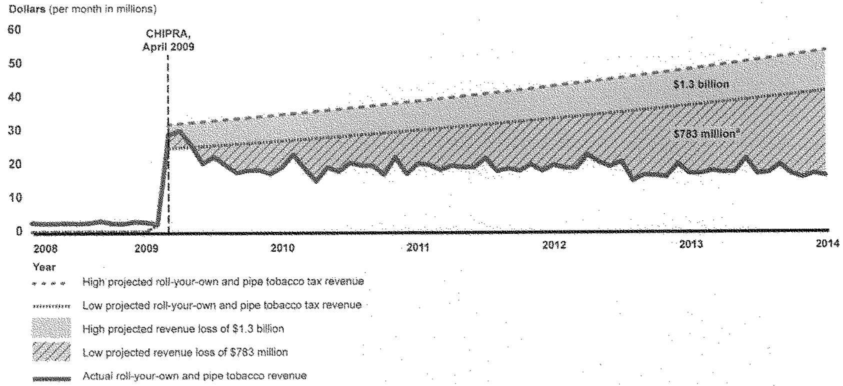
[25]In the absence of this market shift due to differential tax rates, more tax revenue would have been collected because roll-your-own tobacco and small cigars had historically much higher levels of sales than pipe tobacco and large cigars, and after CHIPRA these tobacco products also had a much higher tax rate. Cigarettes are taxed at the same rate as roll-your-own tobacco and small cigars, but our analysis does not take into account the likely impact of a similar market shift from cigarettes to pipe tobacco and large cigars.

[26]For example, a price elasticity of demand of -0.6 means that when prices go up by 10 percent, demand will decrease by 6 percent.

[27]For an example of the general modeling approach we use, see Frank Chaloupka and Jidong Huang, "A Significant Cigarette Tax Rate Increase in Illinois Would Produce a Large, Sustained Increase in State Tobacco Tax Revenues" (Chicago, IL: University of Illinois at Chicago, Jan. 3, 2011).

Tax revenue losses in the roll-your-own and pipe tobacco markets. Treasury and CBP collected about $1.1 billion in tax revenue from domestic and imported roll-your-own and pipe tobacco from April 2009 through February 2014. We estimate that during the same period the market shift from roll-your-own to pipe tobacco reduced federal revenue by between $783 million and $1.3 billion (see fig. 5).

Figure 5: Estimated Revenue Losses for Domestic and Imported Roll-Your-Own and Pipe Tobacco after the Children's Health Insurance Program Reauthorization Act (CHIPRA)



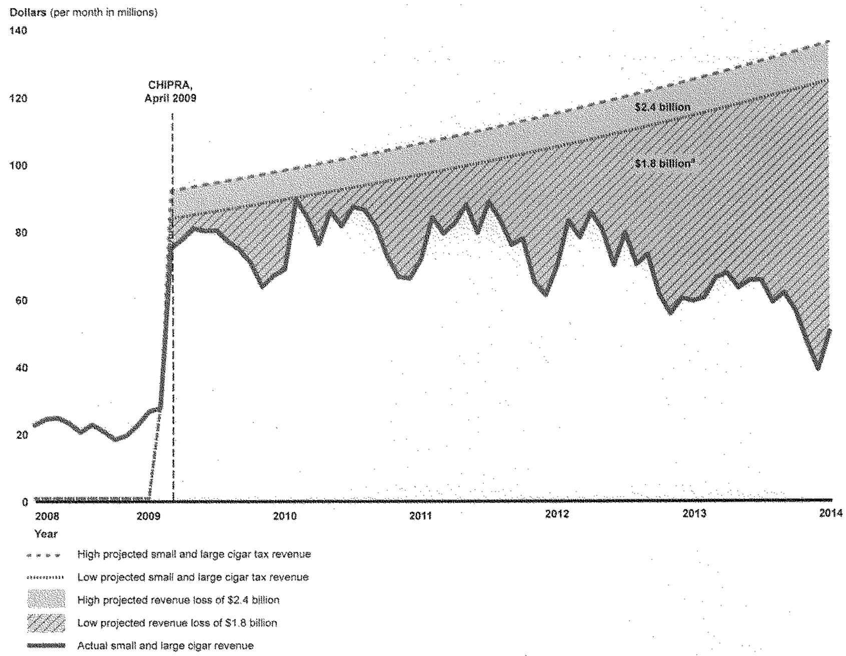
Source: GAO analysis of data from the Department of the Treasury, Customs and Border Protection, and Bureau of Labor Statistics. | GAO-14-811T

[a]Low projected revenue loss is calculated as the difference between the projected revenue in the low scenario and the actual collected revenue. When the actual revenue is higher than the low projected revenue, the estimated figure of $783 million includes the difference.

Tax revenue losses in the small and large cigar markets. Treasury and CBP collected about $4.2 billion in tax revenue from domestic and imported small and large cigars from April 2009 through February 2014. We estimate that during that same period the market shift from small to large cigars reduced federal revenue by between $1.8 billion to $2.4 billion (see fig. 6).[28]

[28]As with the roll-your-own and pipe tobacco estimates, the low and high scenarios were calculated using the price elasticity of demand of -0.6 and -0.3, respectively. Because large cigar taxes are based on price, our estimate included price data. Revenues on domestic small cigars were calculated by multiplying the number of sticks sold in each month by the tax rate. Revenues on domestic large cigars were calculated by subtracting revenues on domestic small cigars from total revenue on domestic cigars. Once revenues on domestic large cigars were calculated, we estimated the average tax paid by dividing large cigar revenues by the number of large cigar sticks. Total cigar revenues were calculated by adding revenues on domestic cigars and revenues on imported cigars.

Figure 6: Estimated Revenue Losses for Domestic and Imported Small and Large Cigars after the Children's Health Insurance Program Reauthorization Act (CHIPRA)



Source: GAO analysis of data from the Department of the Treasury, Customs and Border Protection, and Bureau of Labor Statistics. | GAO-14-811T

[a]Low projected revenue loss is calculated as the difference between the projected revenue in the low scenario and the actual collected revenue.

Developing Standards to Differentiate between Roll-Your-Own and Pipe Tobacco Presents Challenges to Treasury

Internal Revenue Code Definitions:

Roll-your-own tobacco—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 or cigars, or for use as wrappers thereof.

Pipe tobacco—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.

Source: 26 U.S.C. § 5702. | GAO-14-811T

Differentiating between roll-your-own and pipe tobacco for tax collection purposes presents challenges to Treasury because the definitions of the two products in the IRC do not specify distinguishing physical characteristics and are based on such factors as the use for which the products are suited and their packaging and labeling. Treasury officials and representatives of nongovernmental organizations we spoke with stated that because the two products were taxed at the same rate prior to CHIPRA, there was no revenue-related reason to clarify the differences between the two products beyond the existing statutory definitions.

After the CHIPRA tax changes and the market shift from roll-your-own to pipe tobacco that immediately followed, Treasury took rulemaking actions intended to more clearly differentiate the two products for tax collection purposes. The tobacco industry members' comments on Treasury's June 2009 temporary rule on packaging and labeling requirements and July 2010 advance notice of proposed rulemaking on standards to differentiate roll-your-own and pipe tobacco highlighted the complexity and difficulties in developing objective standards that clearly differentiate the two tobacco products. Some industry members expressed concerns that proposed standards could easily be manipulated by consumers.[29] As of July 2014, Treasury has not yet issued a final rule to distinguish the two products based on physical characteristics.

[29]For a more detailed description of the rulemaking actions taken until September 2010, see GAO-12-475.

CHIPRA's Changes to Tax Rates on Large Cigars Also Present Challenges to Treasury

Treasury's efforts to monitor and enforce tax payments became more complex after CHIPRA because many more manufacturers and importers must now determine their tax liability by applying the tax rate to the sale price per stick (ad valorem) rather than simply paying the set maximum tax. According to Treasury officials, prior to CHIPRA, the majority of domestic manufacturers of large cigars paid the federal excise tax at the maximum rate of $48.75 per thousand cigars.[30] CHIPRA's significant increase in the set maximum tax resulted in many more manufacturers and importers of large cigars paying taxes based on a percentage of the manufacturer's or importer's sale price, according to Treasury officials.

After CHIPRA, according to Treasury officials, some large cigar manufacturers and importers began to restructure their market transactions to lower the sale price for large cigars to obtain the tax savings of a lower ad valorem rate, creating enforcement challenges. These Treasury officials stated that some manufacturers and importers are "structuring" or "layering" sales transactions by including an additional transaction at a low price before the sale to the wholesaler or distributor and using this low initial price to calculate the tax. This transaction is conducted with an intermediary that may have a special contract arrangement with the manufacturer or importer. A large markup may then be added to the intermediary's subsequent sale to the wholesaler or distributor. This added transaction effectively lowers the manufacturer's or importer's sale price and thus reduces the taxes collected. According to Treasury officials, these layered transactions have become more common after CHIPRA. For our 2012 report, Treasury officials noted that manufacturers and importers of large cigars approached the agency for advice on different proposals to structure their sales transactions to lower their taxes and still comply with the law. They also stated that Treasury had not determined the legality of all these proposals and that, while Treasury could investigate individual cases, its authority to enforce additional tax collection from these kinds of large cigar transactions was limited. For our 2012 report, officials stated that Treasury was carefully examining the tobacco manufacturer and importer pricing arrangements and taking corrective actions where appropriate on a case-by-case basis. In May 2014, Treasury officials stated that the practice of layering cigar transactions to reduce tax payments continues. They also stated that

[30]Specifically, manufacturers or importers that sold large cigars priced at $235.30 per thousand and above paid the set maximum tax.

industry members may be able to further reduce their tax payments by importing, instead of domestically manufacturing, large cigars.[31] The federal excise tax on imported large cigars is based on the price for which they are sold by the U.S. importer upon release from customs.[32]

In conclusion, in equalizing the federal excise tax rates on roll-your-own tobacco and small cigars with the tax rate on cigarettes, CHIPRA was responding to concerns that these products were increasingly used as substitutes for factory-made cigarettes. However, by introducing large tax disparities between cigarettes, roll-your-own tobacco, and small cigars, on the one hand, and pipe tobacco and large cigars, on the other, CHIPRA has contributed to the substitution of higher-taxed tobacco products with lower-taxed products. Sales of the lower-taxed pipe tobacco and large cigars, both domestic and imported, saw significant growth following CHIPRA, as manufacturers, importers, and consumers sought to take advantage of the lower-taxed products. We estimate that this tax avoidance behavior has resulted in between approximately $2.6 billion and $3.7 billion in lost federal revenues since April 2009.

In the absence of legislative changes, Treasury has limited options for effectively addressing the continued tax avoidance behavior reflected in the market shifts to pipe tobacco and to large cigars. First, roll-your-own and pipe tobacco are similar and, in some cases, may be substitutable products, and the IRC lacks specificity on how they should be distinguished based on physical characteristics. Treasury has analyzed various proposals to more clearly and objectively differentiate the two products based on their physical characteristics. However, the lack of consensus on which characteristics or criteria truly define and differentiate roll-your-own from pipe tobacco reveals the complexity and difficulty of developing standards to distinguish the products from each other. In addition, there is the concern that products could easily be manipulated to negate any newly established standards. In a MAP-21

[31] As noted earlier in this testimony, the sales of imported large cigars increased significantly after CHIPRA.

[32] Treasury officials pointed out that a below-market sales price, by itself, does not prove that the sale was made pursuant to a special arrangement between a U.S. importer and a foreign manufacturer. Foreign manufacturers may have lower production costs, which can decrease the taxable sale price if U.S. importers are able to purchase less expensive products abroad and pass on the cost savings to their U.S. customers.

provision enacted in July 2012, Congress clarified the definition of "manufacturer of tobacco products" for tax purposes to include persons who make available to consumers machines capable of making cigarettes, cigars, or other tobacco products. However, the large tax disparity maintains the tax avoidance incentives driving the market shift from higher-taxed roll-your-own tobacco to lower-taxed pipe tobacco and may encourage the operation of roll-your-own machines for commercial purposes without proper permits and payment of federal excise taxes by retailers.

Because small and large cigars are distinguished in the IRC only by weight, and because many small cigars already weighed at or close to the 3 pounds per thousand threshold for classification as large cigars, many small cigar manufacturers were able to legally shift to the lower-taxed large cigar category with minimal changes to their products. In addition, the large cigar tax structure, which consists of an ad valorem tax rate up to a maximum rate, is complex and creates an incentive to lower the manufacturer's or importer's sale price to avoid paying higher federal excise taxes.

In responding to a draft of our report in April 2012, Treasury generally agreed with our overall conclusion that CHIPRA's introduction of large tax disparities between similar products contributed to the substitution of higher-taxed tobacco products with lower-taxed products. Treasury also agreed with our observation concerning modifying tobacco tax rates to eliminate significant tax differentials between similar products, which is consistent with the Matter for Congressional Consideration in our report. Our work to update the findings of our April 2012 report confirms that the negative revenue implications of the tobacco tax differentials have changed little since we issued that report.

We maintain that Congress should consider equalizing tax rates on roll-your-own and pipe tobacco and, in consultation with Treasury, also consider options for reducing tax avoidance due to tax differentials between small and large cigars.

Chairman Wyden, Ranking Member Hatch, and Members of the Committee, this concludes my prepared statement. I would be pleased to respond to any questions you may have at this time.

GAO Contact and Staff Acknowledgments

If you or your staff have any questions about this testimony, please contact me at (202) 512-3149 or gootnickd@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. GAO staff who made key contributions to this testimony include Christine Broderick (Assistant Director), Sada Aksartova, Pedro Almoguera, David Dayton, Etana Finkler, Jeremy Latimer, Grace Lui, and Alana Miller.

Questions for the Record
"Tobacco: Taxes Owed, Avoided, and Evaded"
Hearing Date: July 29, 2014
Questions for Mr. David Gootnick

Ranking Member Orrin Hatch

1. Dr. Gootnick, in reading your written testimony which focuses on market shifts from roll-your-own tobacco to pipe tobacco, and from small to large cigars, I noted that you seemed careful not to label the behavior you were describing as "evasion." This is true even though you note that in at least one case one company told GAO that there was no real difference between their roll-your-own tobacco and pipe tobacco.

Could you please describe how you approached the question of whether activity was tax evasion versus tax avoidance?

Our testimony analyzes the market shifts from roll-your-own tobacco to pipe tobacco and from small to large cigars following the passage of the Children's Health Insurance Program Reauthorization Act of 2009 (CHIPRA). By introducing large tax disparities between cigarettes, roll-your-own tobacco, and small cigars, on the one hand, and pipe tobacco and large cigars, on the other, CHIPRA contributed to the substitution of higher-taxed tobacco products with lower-taxed products. We view the market shifts to lower-taxed tobacco products as tax avoidance by manufacturers, importers, and consumers seeking to take advantage of the lower federal tax rates on pipe tobacco and some large cigars, which are smoking tobacco products that can be used as substitutes for cigarettes. When manufacturers, importers, and consumers engage in this tax avoidance behavior, they reduce the amount of taxes paid but do not altogether evade the payment of taxes.[1]

[1]We discuss direct tax evasion activities, such as smuggling of counterfeit tobacco products across the U.S. border, in our report *Illicit Tobacco: Various Schemes Are Used to Evade Taxes and Fees*, GAO-11-313 (Washington, D.C.: Mar. 7, 2011).

2. Dr. Gootnick, in your testimony, you estimate that federal revenue losses from certain market shifts range from $2.6 billion to $3.7 billion. Just for clarification, is this revenue that the government had collected and now is not collecting, or estimates of current law compared with an alternative scenario?

Our estimate of $2.6 to $3.7 billion does not represent revenue that the government had collected and now is not collecting. It represents the potential revenue that the U.S. government could have collected from April 2009—when CHIPRA took effect—through February 2014 if there had been no substitution of the higher-taxed products with the lower-taxed products. Put another way, the estimate represents the difference between actual tax revenue collected and a calculation of how much tax revenue would have been collected in the absence of substitution between roll-your-own and pipe tobacco and between small and large cigars.

3. Since the passage of the legislation increasing tobacco excise taxes in 2009, how have actual tax collections differed from collections projected when the bill was considered?

The Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) estimated in 2009 that CHIPRA would increase collected excise taxes for all tobacco products by $72.1 billion from 2009 through 2019.[2] GAO has not conducted work comparing tax collections projected before CHIPRA was enacted and actual tax collections since then.

4. Mr. Manfreda, in your testimony you note some of the diversion schemes you encounter, such as tobacco smuggling and products being made by an unlicensed manufacturer. Mr. Manfreda and Dr. Gootnick, how many unlicensed manufacturers do you estimate are in operation, and what challenges does TTB face in closing them down?

I am especially interested in any estimate you can place on the size of the black market in tobacco products. It seems to me that in addition to examining some behaviors that are being discussed as either evasion or avoidance, we should also focus on behaviors that

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[2]CBO, *Congressional Budget Office Cost Estimate: H.R. 2, Children's Health Insurance Program Reauthorization Act of 2009, as Cleared by the Congress and Signed by the President on February 4, 2009* (Washington, D.C.: Feb. 11, 2009).

are unquestionably evasion. What specific black market behaviors that you believe constitute evasion do you think have the greatest impact on tax collection?

GAO has not conducted work to estimate the total number of unlicensed manufacturers or examined challenges faced by the Department of the Treasury's Alcohol and Tobacco Tax and Trade Bureau (TTB) in addressing unlicensed manufacturing of tobacco products. However, we discussed the issue of unlicensed manufacturing in our 2011 report.[3] We noted in that report that most unlicensed cigarette manufacturing, according to government officials and experts, occurs in northern New York on land controlled by the St. Regis Mohawk tribe. A New York official estimated that there were between 15 and 18 unlicensed cigarette manufacturers on this land. We further noted that, according to a government official, most of these unlicensed cigarette manufacturers produce "rollies" or "baggies" of 200 cigarettes that may sell for as little as $20.

GAO has not conducted work to estimate the size of the illicit tobacco market. Estimating the size of the black market in tobacco products is inherently difficult due to the lack of available data on the extent and value of the illicit trade. For example, in its 2010 report to the Congress on federal tobacco tax receipts lost due to illicit trade, the Department of the Treasury stated that it is difficult to accurately measure federal tax receipts lost due to illicit tobacco trade because the activities are inherently clandestine, and any estimate of the extent of illicit trade will have a wide window of uncertainty.

In our 2011 report, we identified a range of schemes used by different actors to profit from illicit trade in tobacco products. We noted that these schemes can originate at different points in the tobacco supply chain in order to evade federal and state excise taxes or other duties and fees. In addition, according to federal and state law enforcement officials, the patterns of smuggling and diversion are not static but change in response to many factors, including changes in tobacco taxation, tobacco regulations, and law enforcement activity. The Department of the Treasury has reported that a significant component of the illicit tobacco trade in the United States is the illegal shipment of tobacco products from low-tax states to high-tax states with the purpose of evading state excise taxes.

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[3]GAO, *Illicit Tobacco: Various Schemes Are Used to Evade Taxes and Fees*, GAO-11-313 (Washington, D.C.: Mar. 7, 2011).

STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER U.S. SENATE COMMITTEE ON FINANCE HEARING OF JULY 29, 2014 TOBACCO: TAXES OWED, AVOIDED, AND EVADED

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing tobacco taxation:

Thank you, Mr. Chairman, for holding today's hearing.

According to written testimony we received today, the Alcohol and Tobacco Tax and Trade Bureau collected approximately $23 billion in taxes in fiscal year 2013, making it the third largest tax collection agency in the U.S. government.

This amount is even more significant when you consider the number of tobacco-related transactions undertaken and that millions of Americans are represented somewhere in that $23 billion. Of that amount, around $14 billion came from collecting taxes on tobacco products. It seems that there is some truth to the quip attributed to former House Majority Leader Thomas Foley, that "If you don't drink, smoke, or drive a car, you're a tax evader."

Because of the large sums of money involved in this issue and because of the number of people and businesses affected, it is important that federal excise taxes are administered accurately and fairly.

As with the income tax, and our tax system as a whole, compliance needs to be based on a belief that clear rules are consistently enforced in a way that doesn't put taxpayers at a disadvantage to those who do not follow the rules.

We also need to keep in mind – and this is true for all tax policy – that tax avoidance and tax evasion are very different behaviors.

The tax code should consist of clear rules, and people will either follow them or they won't.

To the taxpayer, the tax code is not a bill for a government program or a claim on whatever someone might consider to be the patriotic amount. It is a set of rules for arriving at a specific and definite number.

During today's hearing, we will specifically discuss two market shifts in tobacco products that seem prevalent since the passage of the Children's Health Insurance Program Reauthorization Act in 2009, which increased tobacco taxes.

One of these is an apparent shift from roll-your-own tobacco to pipe tobacco, which is taxed at a lower rate.

As one of our witnesses noted in his written testimony, one tobacco manufacturer has "acknowledged that there was no real difference between its roll-your-own tobacco and its pipe-cut tobacco."

Given the fact that roll-your-own tobacco is taxed at around 10 times the rate of pipe tobacco, this market shift deserves our attention.

Another market trend that I expect to be highlighted in this hearing concerns an apparent shift from what the Internal Revenue Code defines as "small cigars" to "large cigars" which results in tax savings if the manufacturer's price is below a certain amount.

In addition to these recent market shifts, we need to be mindful of more longstanding issues that clearly deal with tax evasion. For example, smuggling of counterfeit or diverted products where federal taxes have not been paid is a serious problem, possibly costing the U.S. billions of dollars in tax revenue every year.

Finally, since we are discussing tobacco, the health component of this issue is also important. Evasion, counterfeiting and black markets, in addition to denying federal, state, and local governments revenue, also sidestep health-related requirements along with restrictions intended to reduce the appeal of tobacco to minors.

I hope this hearing sheds light on how we can improve tax administration by ensuring that our tax laws are being enforced appropriately. I also hope that it will help us understand if the laws themselves have not been written in a way to accomplish what was intended. Though we're talking about a specific set of federal excise taxes on a product that is controversial, that should not distract us from the fundamentals of good tax policy.

Thank you, once again, Mr. Chairman, for holding this hearing. I look forward to hearing from our witnesses.

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

John J. Manfreda, Administrator
Before the
U.S. Senate
Committee on Finance

July 29, 2014

Mr. Chairman, Ranking Member Hatch, and distinguished members of the Committee, thank you for this opportunity to testify on the Alcohol and Tobacco Tax and Trade Bureau's (TTB) enforcement activities related to tobacco. We greatly appreciate your interest in our bureau.

TTB's Jurisdiction

The Internal Revenue Code of 1986 (IRC), 26 U.S.C. chapter 52, imposes federal excise taxes on tobacco products and cigarette papers and tubes, and establishes a comprehensive civil and criminal framework to protect the revenue. The Secretary of the Treasury administers these provisions and has delegated this authority to TTB, which collected over $14 billion in tobacco excise taxes in FY 2013. TTB's tax authority also extends to alcohol products and firearms and ammunition, which combined resulted in nearly $9 billion in collections last year.[1] In total, under its IRC authority, TTB collected approximately $23 billion in excise taxes in FY 2013, making TTB the third largest tax collection agency in the U.S. government.

With regard to tobacco, the IRC and its implementing regulations establish qualification criteria to engage in businesses relating to manufacturing, importing, or exporting tobacco products, and manufacturing or importing processed tobacco, and require that persons obtain permits to engage in these activities.[2] Tobacco product retailers, wholesalers, and distributors of tobacco products

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[1]TTB administers the provisions of the IRC relating to distilled spirits, wine, and beer (26 U.S.C. Chapter 51), firearms and ammunition excise taxes (26 U.S.C. sections 4181, 4182, and related portions of chapter 32), and the general rules of tax procedure with respect to these commodities (including related criminal provisions at 26 U.S.C. Chapters 68 and 75). In addition, TTB administers the Federal Alcohol Administration Act (27 U.S.C. chapter 8, subchapter I), which covers basic permits, unfair trade practices, and labeling and advertising of alcohol beverages; the Alcoholic Beverage Labeling Act of 1988 (27 U.S.C. chapter 8, subchapter II), which requires a specific "Government Warning" statement on alcohol beverage labels; and the Webb-Kenyon Act (27 U.S.C. sections 122-122b), which prohibits the shipment of liquor into a state in violation of state law.

[2]Under the IRC, tobacco products include cigars, cigarettes, smokeless tobacco (chewing tobacco and snuff), pipe tobacco, and roll-your-own tobacco. TTB regulations define processed tobacco to mean any tobacco that has

and processed tobacco are not required under the IRC to obtain a TTB permit, and TTB has only limited jurisdiction over these entities.

Under the IRC, manufacturers of tobacco products and export warehouse proprietors must file a bond that relates to the tax liability for the tobacco products on the premises covered by the permit. The IRC and implementing regulations also include recordkeeping and reporting requirements designed to ensure that TTB can verify that the tax on tobacco products is paid or determined or that adequate documentation exists to confirm that a tax exemption applies.

The federal excise tax on tobacco products is imposed upon the manufacture and importation of tobacco products. The tax is determined when the tobacco product is "removed" from the manufacturer's premises or released from customs custody. TTB collects the federal excise tax on tobacco products removed from the facilities of domestic manufacturers for consumption within the United States. U.S. Customs and Border Protection (CBP) collects federal excise tax on imported tobacco products, along with applicable duties. There are several exemptions from the tax, including when tobacco products are transferred to the bonded premises of a manufacturer or when products are shipped for export. Processed tobacco is not subject to federal excise tax.

To enforce these provisions, subtitles E and F of the IRC provide TTB with certain enforced collection options (such as liens and levies), civil and criminal penalties, permit suspension and revocation procedures, and forfeiture provisions to ensure that the tax is collected.

TTB Enforcement Profile

TTB's tax enforcement strategy employs a three-pronged approach that involves the development and application of multiple investigative tools to detect and address excise tax fraud and tobacco diversion through: (1) building risk models to assimilate large amounts of data to identify high-risk activity; (2) applying advanced investigative techniques to uncover illicit trade and fraudulent activity; and (3) deploying teams with diverse skill sets for large, complex cases.

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undergone processing, but that does not include tobacco products. The processing of tobacco includes, but is not limited to, stemming (that is, removing the stem from the tobacco leaf), fermenting, threshing, cutting, or flavoring the tobacco, or otherwise combining the tobacco with non-tobacco ingredients. TTB also administers the federal excise tax on cigarette papers and tubes.

Over the last three years, TTB has expanded its use of these tools and techniques to deploy TTB's field personnel of approximately 65 auditors and 60 investigators to address identified areas of revenue risk.

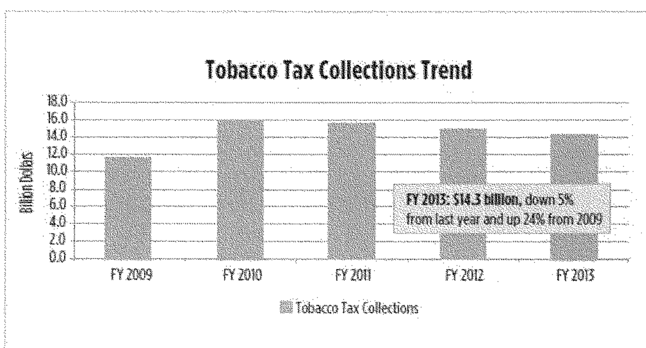
TTB's enforcement strategy leverages the expertise and skills of TTB's approximately 465 employees. TTB revenue and permit specialists evaluate permit applications and operational reports to ensure that only qualified persons obtain permits to operate in the tobacco industry and that they operate in compliance with the IRC. Prior to issuing new permits, TTB conducts an investigation on high risk tobacco processor, manufacturer, or importer applicants to verify the accuracy of permit application information and ensure that the qualification criteria are met. TTB has also developed risk models to identify potential diversion and fraudulent activity. Through the use of these models, in conjunction with other intelligence, TTB analysts identify diversion trends and schemes, and refer high-risk cases for further field work. TTB auditors and investigators then pursue leads suggesting unlawful operations and conduct investigations and audits based upon both risk and random factors. TTB also operates a tobacco laboratory, which analyzes products and develops analytical methods to ensure the appropriate tax classification of tobacco products and lends analytical support to audits and investigations. As these cases develop, if there are indications of fraud and other criminal activity, they are referred to TTB's special agents for investigation and potential referral to the Department of Justice for prosecution.

Children's Health Insurance Program Reauthorization Act of 2009

The Children's Health Insurance Program Reauthorization Act of 2009 (Pub. L. 111-3, "CHIPRA") was enacted on February 4, 2009. Among other things, CHIPRA increased the federal excise tax on all tobacco products; imposed a floor stocks tax upon all tobacco products held for sale on April 1, 2009 (except large cigars); and created a new permit requirement for those engaged in manufacturing or importing processed tobacco. The new tax rates, summarized in the below table, went into effect on April 1, 2009. Before CHIPRA, the tax rate on cigarettes was higher than the rates on roll-your-own tobacco, pipe tobacco, and small cigars; CHIPRA generally equalized the tax rate for cigarettes, roll-your-own tobacco, and small cigars. The tax rate for pipe tobacco was also increased, but to a significantly lower rate than roll-your-own tobacco. In addition, CHIPRA significantly increased the ad valorem tax rate for large cigars as well as the maximum tax rate.

Item	Current Rate	Pre-CHIPRA Rate
Cigarettes --		
Small Cigarettes (no more than three pounds per thousand)	$50.33 per thousand ($1.01 per pack)	$19.50 per thousand ($0.39 per pack)
Large Cigarettes (more than three pounds per thousand)	$105.69 per thousand	$40.95 per thousand
Cigars --		
Small Cigars (no more than three pounds per thousand)	$50.33 per thousand	$1.828 per thousand
Large Cigars (more than three pounds per thousand)	52.75 percent of price for which sold, not to exceed $402.60 per thousand	20.719 percent of price for which sold, not to exceed $48.75 per thousand
Roll-Your-Own Tobacco	$24.78 per pound	$1.0969 per pound
Pipe Tobacco	$2.8311 per pound	$1.0969 per pound
Snuff	$1.51 per pound	$0.585 per pound
Chewing Tobacco	$0.5033 per pound	$0.195 per pound
Cigarette Papers	$0.0315 for each 50 papers	$0.0122 for each 50 papers
Cigarette Tubes	$0.0630 for each 50 tubes	$0.0244 for each 50 tubes

As illustrated by the below graph, the CHIPRA tax changes have resulted in increased tobacco tax collections by TTB, although the amount of the increase has decreased steadily since FY 2010, the first full fiscal year following CHIPRA. Overall, however, tobacco tax collections remain higher than in FY 2009, the year during which CHIPRA was enacted.



Immediately following the passage of CHIPRA, TTB administered the floor stocks tax, which is a one-time excise tax placed upon products subject to a tax increase. The floor stocks tax is equal to the difference between the new tax rate and the previous rate and is imposed on products that have been removed subject to tax from a manufacturer's premises or upon release from customs custody but that have not yet been sold at retail by wholesalers and retailers. TTB also identified tobacco product wholesalers and retailers who did not file and/or pay floor stocks tax or significantly underpaid this tax, and followed up with audits and investigations to ensure that all taxes due were properly paid. From FY 2009 through FY 2013, TTB collected more than $1.2 billion in floor stocks tax.

In addition, CHIPRA imposed new permit requirements for manufacturers and importers of processed tobacco, which is generally tobacco that has been processed for use by manufacturers of tobacco products to make tobacco products. As such, it is not subject to tax. There are currently 30 TTB-permitted manufacturers of processed tobacco and 170 permitted importers of processed tobacco. TTB required through regulation that manufacturers and importers of processed tobacco notify TTB of any sales of processed tobacco to non-permittees to provide insight into the movement of this untaxed tobacco. In FY 2013, approximately 185 million (23 percent) of the roughly 831 million pounds of processed tobacco removals reported to TTB (excluding exports) were shipped to entities that do not hold a federal permit with TTB. Although some of these removals represent sales to brokers, who may ultimately sell processed tobacco to a TTB-permitted manufacturer of tobacco products, others removals may be ultimately destined for illicit production. TTB analyzes this information, in conjunction with other intelligence, to select and prioritize its audits and investigations. As a result of these enforcement efforts, TTB has identified through its investigations to date approximately $180 million in unpaid federal excise taxes; some of these cases have resulted in referrals for criminal investigation.[3]

[3]The Administration's FY 2014 and FY 2015 Budgets proposed to clarify that roll-your-own tobacco includes any processed tobacco that is removed or transferred for delivery to anyone without a proper permit, but does not include export shipments of processed tobacco. This provision would provide TTB with authority to collect tax on all processed tobacco when it is removed by the manufacturer or importer for delivery to any non-permitted domestic entity.

Tobacco Industry Trends Post-CHIPRA

The tax rate changes and resulting tax differentials enacted through CHIPRA created new incentives for manufacturers, importers, and consumers of certain tobacco products. These trends, and TTB's actions in response to each of them, are detailed below.

Cigars and cigarettes: Prior to CHIPRA, there was a significant tax differential between cigars and cigarettes (particularly between small cigars and small cigarettes). The tax on small cigars was $1.828 per 1,000 sticks, while the tax on small cigarettes was $19.50 per 1,000 sticks. At that time, TTB was working to establish an objective standard to distinguish between the two products for tax purposes and to minimize potential revenue losses from misclassification. To that end, in October 2006, TTB published in the Federal Register a notice proposing a set of standards to distinguish between cigars and cigarettes for tax purposes based on, among other characteristics, the filler tobacco and physical product features, such as the presence of an integrated filter (71 FR 62506). CHIPRA, however, equalized the tax on small cigars and small cigarettes, at $50.33 per 1,000 sticks. Since then, TTB's intelligence, audits, and investigations have not found evidence of widespread misclassification of cigarettes as cigars under the IRC.

Although the incentive for misclassification of cigarettes as cigars for federal excise tax purposes was removed by CHIPRA, other laws distinguish between cigars and cigarettes, with more stringent regulatory restrictions imposed upon cigarettes than cigars.[4] As such, we intend to complete the 2006 rulemaking to set forth objective, analytical standards for distinguishing between these products for federal excise tax purposes. Based on comments received and internal analysis, TTB found the originally proposed factors to be insufficient for this purpose; TTB has since identified a different analytical standard that we intend to propose to distinguish between cigar-like and cigarette-like tobaccos. TTB is currently finalizing the method for this standard and will resume the 2006 rulemaking project upon completion.

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[4]For example, the Jenkins Act, amended by the Prevent All Cigarette Trafficking Act, regulates the delivery and internet sales of cigarettes and prohibits their mailing through the U.S. Postal Service, but it does not apply to cigars. Similarly, the Contraband Cigarette Trafficking Act (CCTA), 18 U.S.C. chapter 114, makes it a federal felony for certain persons to traffic in contraband cigarettes; however, the CCTA does not apply to cigars. The Bureau of Alcohol, Tobacco, Firearms and Explosives under the Department of Justice has primary jurisdiction for CCTA and Jenkins Act enforcement.

Small cigars and large cigars: TTB has, however, seen a notable shift in the cigar market since CHIPRA. Although CHIPRA substantially raised the tax rates imposed on both small cigars and large cigars, it also created an incentive to shift production to the large cigar category. The tax on large cigars is based on a percentage of the sale price from the manufacturer or importer, up to a maximum amount. Depending on pricing, the ad valorem excise tax on a large cigar can be significantly lower than the excise tax on a small cigar. Consequently, manufacturers may legitimately add weight to small cigars to qualify them for the large cigar tax rate, and then recognize net tax savings. In some instances, only minimal changes may be needed to add additional weight to a product so that it meets the definition of a large cigar, such as adding a small amount of tobacco.

Following CHIPRA, removals of domestic small cigars have decreased significantly, while there has been a dramatic increase in large cigar removals. In the 12 months preceding CHIPRA, of all cigars removed for sale in the United States by domestic manufacturers, 52 percent were small cigars and 48 percent were large cigars. During the post-CHIPRA period (from April 2009 through calendar year 2013), domestic large cigar removals increased to 93 percent of all cigars removed for sale, with domestic small cigar removals falling to 7 percent. Of domestic large cigar removals in the three years following CHIPRA, over 45 percent were made by companies that had switched the majority of their production from small to large cigars.

Large cigar ad valorem tax rate: Large cigars are the only tobacco product for which the excise tax is based on the manufacturer or importer's sale price; all other tobacco products are taxed at a flat rate based either on the number of units or the weight of the product. As noted above, the ad valorem tax on large cigars can result in a significantly lower tax on a large cigar than on a small cigar or cigarette, depending on the sale price of the large cigar. Since CHIPRA, which increased the maximum tax rate on large cigars to $402.60 per thousand (from $48.75 per thousand), the majority of large cigar removals by manufacturers and importers are taxed based on the sale price, minus allowable exclusions, instead of paying tax at the maximum tax rate. Before CHIPRA, 38 percent of domestic large cigars were sold below the maximum rate, whereas currently over 99 percent of domestic large cigars are sold below the maximum rate. This incentive to achieve the lowest possible sales price is reflected in the overall decrease in the average taxable sale price since CHIPRA.

Large cigar manufacturers may be lowering their taxable sale price in a number of ways. One common scenario is to "layer" their sales transactions. In some of these cases, manufacturers or importers insert an additional transaction with an intermediary into their distribution chain before the sale to a wholesaler or distributor. The transaction with the intermediary is at a low price. The manufacturer or importer and the intermediary sometimes establish this low price based on a special arrangement between them. Evidence of that special arrangement can be extremely difficult to obtain. The manufacturer or importer pays the ad valorem tax based on the low price to the intermediary, who resells the already taxed cigars to wholesalers or distributors at a much higher price. Although TTB has authority under the IRC to calculate the tax for these types of transactions based on a constructive sale price instead of the permitted taxpayer's actual sale price, TTB must establish that the large cigars were sold by the manufacturer or importer through other than an arm's length transaction at less than a fair market price. Such determinations can be complicated and resource-intensive, as the activity at issue can range from legal tax avoidance to illegal tax evasion, requiring a case-specific analysis of these transactions, which may include non-permitted foreign entities.

In addition, TTB has found that some manufacturers and importers of large cigars who had formerly been paying tax at the lower, pre-CHIPRA maximum rate are now more frequently taking unlawful exclusions from the taxable sale price.[5] Auditing unlawful exclusions is also resource-intensive, complex, and increasingly results in litigation. Post-CHIPRA, the average tax collected per stick for domestic cigar removals has decreased almost 40 percent, from 7.21 cents per stick in FY 2010 to 4.4 cents per stick in FY 2014. The average post-CHIPRA tax collected per stick for imported large cigars has also decreased, from 10.5 cents per stick in FY 2010 to 6.67 cents per stick in FY 2014. TTB is actively pursuing audits and investigations related to large cigar pricing, with several civil cases pending in this area.

Other factors contributing to a decrease in the average post-CHIPRA large cigar tax rate are the entry of low-priced, smaller cigars that have added weight to fit into the large cigar tax category (as discussed in the preceding section) as well as increased overseas production, which may face lower production costs as compared to domestic production.

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[5] Allowable exclusions are limited to expenses incurred in connection with the delivery of cigars to a purchaser, such as transportation, delivery, and insurance.

Pipe tobacco and roll-your-own tobacco: TTB has also seen a significant shift in the removals of pipe tobacco and roll-your-own tobacco post-CHIPRA. Under the IRC, pipe tobacco is 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. Roll-your-own tobacco is defined as 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 or cigars, or for use as wrappers of cigars or cigarettes. TTB's classification determination under the IRC depends on these factors at the point when a product is removed by the manufacturer or importer; subsequent actions by wholesalers, distributors, or retailers characterizing potential uses of these products are generally beyond TTB's jurisdiction.

Before CHIPRA, the tax rates on pipe tobacco and roll-your-own tobacco were the same ($1.0969 per pound). CHIPRA increased the tax on pipe tobacco to $2.8311 per pound, while the tax on roll-your-own tobacco was increased to $24.78 per pound to make it generally equivalent to the cigarette tax. Because the two products can be similar (and even interchangeable), and because the tax on roll-your-own tobacco was significantly increased, a portion of the roll-your-own tobacco market has switched to pipe tobacco, resulting in a dramatic shift in the volume of pipe tobacco and roll-your-own tobacco reported as removed by domestic manufacturers. In the 12 months preceding CHIPRA, roll-your-own tobacco accounted for 86 percent of the combined roll-your-own and pipe tobacco market, with pipe tobacco representing the remaining 14 percent. Since CHIPRA (from April 2009 through calendar year 2013), there has been a near-complete reversal in these figures, with pipe tobacco accounting for 85 percent of combined roll-your-own and pipe tobacco removals and roll-your-own tobacco falling to 15 percent. TTB believes that this increase in pipe tobacco removals is partly due to increased consumer demand for pipe tobacco based on the price differential between pipe and roll-your-own tobacco (for use in a pipe or in a personal cigarette-making machine used at home), but it is exacerbated by the use of pipe tobacco in cigarette-making machines made available for commercial purposes (discussed in the following section). The growth in the hookah tobacco market, which is classified as pipe tobacco for IRC purposes, may also be a contributor.

In response to this shift, TTB published an advanced notice of proposed rulemaking in the Federal Register in July 2010 regarding potential physical characteristics of roll-your-own and pipe tobacco that could be used to set an objective standard to differentiate between the products (75 FR 42659). The comment period was re-opened in 2011 to allow public comments on an additional proposal received from an industry member. Not only is it difficult to establish objective physical standards for differentiating between the two products, given the similarities and the wide variety among these products, it is also difficult to identify factors that differentiate pipe tobacco from roll-your-own tobacco for tax classification purposes, given the current statutory standards, as reflected by the comments received in response to the rulemaking.

Cigarette-making machines: The CHIPRA tax change coincided with technological advances in cigarette-making machines, some of which could make cigarettes from either pipe tobacco or roll-your-own tobacco at a much quicker rate, taking only eight minutes to "roll" or "fill" a carton (200 cigarettes) as compared to the three hours needed to "fill" a carton using older model machines. TTB believes that the CHIPRA increases to the tax on cigarettes and roll-your-own tobacco and the availability of a lower taxed alternative in the form of pipe tobacco resulted in an increase in the popularity of these machines. Some tobacco retailers and other machine operators attempted to rely on the "personal use" exemption to the definition of "manufacturer of tobacco products" to claim that the machines were being operated to produce products solely for personal consumption or use. The retailers sold cigarettes produced by cigarette-making machines at prices ranging from $16.02 to $25.50 per carton when the average price of a taxpaid, factory-made carton of cigarettes was about $50 (excluding local taxes).

In response, on September 30, 2010, TTB issued Ruling 2010-4, Cigarette-Making Machines in Retail Establishments, which made clear that "the proprietor of a retail establishment who is in the business of making cigarettes for others, or who facilitates the making of cigarettes by or for others by providing the use of a commercial cigarette-making machine at its premises is engaged in the business of a tobacco products manufacturer and must qualify for and obtain a permit from TTB to engage in such business." Beginning in November 2010, however, as part of a case filed by a cigarette-making machine company, a court restrained TTB from enforcing this ruling and issued an injunction in December 2010. TTB could not issue permits to retailers or other machine operators while this injunction was in place. In 2012, Congress passed a law, the Moving Ahead for Progress in the 21st Century Act, P.L. 112-141 (signed July 6, 2012) ("MAP-21"), that allowed TTB to take action by amending the definition of "manufacturer of tobacco products" at 26 U.S.C. 5702(d) to specifically include "any person who for commercial purposes makes available for consumer use . . . a machine capable of making cigarettes, cigars, or other tobacco products," which clarified that anyone making the machine available for commercial purposes must first obtain a permit to manufacture tobacco products from TTB and is liable for the resulting tax. The law became effective in July 2012, and the injunction was vacated shortly thereafter based on the clarification provided by MAP-21. In August 2012, TTB began processing permit applications for cigarette-making machine operators and actively enforcing the law against unpermitted machine operators.

TTB does not have authority to regulate the manufacture or distribution of these machines, so TTB cannot quantify the total number of cigarette-making machines currently in use, but TTB has obtained information from state authorities and other sources regarding the locations of cigarette-making machines. Based on this information, TTB has issued warning letters to 1,467 potential operators of cigarette-making machines since October 2012 to notify them of the civil and criminal liabilities associated with operating a cigarette-making machine for commercial purposes without obtaining a TTB permit and paying tobacco excise taxes.

TTB has also found that some cigarette-making machine operators claim to be a type of "social club" that has been established to make cigarette-making machines available to their "members." These clubs do not have a TTB permit; however, some of them are registered with a state as "non-profit" or with IRS as "tax exempt" for income tax (not excise tax) purposes. The "social clubs" use this status to contend that they have a "noncommercial" purpose and are therefore exempt from federal excise tax. TTB issued public guidance in October 2012 to make clear that the non-profit status of the person or clubs making the machines available is not relevant in evaluating whether their purposes are "commercial." Thus far, TTB has not concluded that any such operations are in fact exempt from excise tax liability or other IRC obligations, which TTB has reiterated in public guidance documents published in August 2013 and May 2014. Since 2013, TTB has initiated over 70 investigations involving these machines, the vast majority of which have involved "social clubs," and has identified total tax liabilities of nearly $4 million to date. TTB continues to investigate cigarette-making machine locations, including "social clubs," with additional planned investigations for FY 2015.

Tobacco Diversion

In addition to the above issues, which generally involve tax avoidance by permitted industry members and others seeking to obtain a lower tax rate through the IRC framework, the 150 percent increase in the federal excise tax on cigarettes imposed by CHIPRA increased the incentive to evade federal taxes through tobacco diversion. Tobacco diversion refers broadly to the movement of tobacco products into domestic commerce without the payment of taxes. Accurately estimating tax losses resulting from tobacco diversion has inherent challenges, both because of the clandestine nature of the activity and the degree of underreporting in tobacco consumption data used to generate revenue loss estimates, as noted in the Department of the Treasury's 2010 Report to Congress. Common diversion schemes include the following:

- Tobacco products are removed from the manufacturer's premises in excess of the quantity reported to TTB, thus evading the tax on unreported quantities.
- Tobacco products are removed from the manufacturer's premises for export (which is a removal not subject to federal excise tax), and subsequently are diverted into domestic commerce before export, thus evading tax payment.
- Tobacco products are removed from the manufacturer's premises for export without tax, exported, and then smuggled back into the United States without the required importation entry and associated tax payment.
- Tobacco products are smuggled from abroad into the United States, disguised and declared as something other than as tobacco products, or are declared as a smaller quantity than actually imported, thus evading the applicable tax.
- Tobacco products are produced by a manufacturer operating without a permit and are removed for domestic consumption without the payment of applicable taxes.

TTB has seen each of these scenarios and addressed them through initiating criminal or civil proceedings, pursuing administrative remedies against TTB permittees, or working with state or other federal agencies to address unlawful conduct and collect the tax.

A vital component of our enforcement strategy, TTB's criminal enforcement program is critical to the bureau's ability to effectively curtail current illicit operations and deter others from engaging in diversion activity. Although still in its early stages, TTB's criminal enforcement program has exhibited notable results in the less than four full years of operations since the program was initiated in FY 2011.[6] With only a small cadre of special agents, obtained through an interagency agreement with the Internal Revenue Service Criminal Investigation Division, TTB has opened a total of 72 cases, with identified liabilities of over $345 million in estimated alcohol and tobacco excise taxes and approximately $117 million in criminal seizures. To date, 70 of 72 cases presented to the U.S. Attorney's Office have been accepted for further investigation – demonstrating both the merit and magnitude of these cases – and TTB has maintained a 100 percent conviction rate on cases fully resolved through the legal system. TTB's criminal enforcement program is also building key relationships with other federal and state law enforcement agencies, generating referrals for additional cases and opportunities for partnering in future cases and investigations.

In addition, specifically with regard to diversion risk associated with the importation and exportation of tobacco products, TTB has been working with CBP on cooperative enforcement efforts, including the development and implementation of the International Trade Data System (ITDS). The purpose of ITDS is to provide a "single window" through which importers and exporters will submit electronically all information necessary to comply with all other government agencies' requirements for the clearance of imports and exports. This cooperative system and the transactional trade data that it will provide are expected to factor prominently in TTB's tax enforcement strategy going forward. In addition to more timely and targeted information on imports and exports for TTB enforcement purposes, TTB expects that this effort will improve communication and coordination between CBP, TTB, and other participating agencies on tax and trade issues. TTB plans to be fully integrated into ITDS by November 2015, well in advance of the December 31, 2016 deadline for government-wide utilization of ITDS, as mandated by Executive Order 13659, entitled "Streamlining the Export/Import Process for America's Businesses."

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[6]Pursuant to the FY 2010 Consolidated Appropriations Act, TTB was appropriated $3 million, expendable over two years, to hire, train, and equip special agents to enforce its criminal jurisdiction. Since FY 2012, TTB has been appropriated $2 million annually to continue hiring special agents, which are now an important component of TTB's tobacco enforcement program.

Conclusion

I sincerely appreciate the opportunity to testify before the Committee today. I am proud of this bureau and what we have been able to accomplish in the 11 years since we were established in 2003. Despite our small size, we have worked to maximize the reach of our resources through the use of innovation, analytics, and partnering with other agencies to effectively exercise our jurisdiction over our regulated industries, collecting roughly $23 billion in excise tax revenue in FY 2013, which represents a return of approximately $450 for every dollar invested in TTB's revenue collection activities. As outlined above, tobacco-related enforcement issues continue to present distinct challenges for TTB and pose a risk to federal revenue post-CHIPRA, and these issues will likely exist as long as incentives remain under the IRC for manufacturers to reclassify products or restructure transactions to achieve a lower tax rate. Similarly, given the increased financial incentives for unlawful diversion following tobacco tax rate increases, illicit schemes to evade federal excise taxes will continue to evolve and require an ongoing and dedicated enforcement presence to address them. We are committed to using every tool available to detect and respond to illegal activity, including administrative, civil, and criminal remedies as well as coordination with other federal, state, and local authorities. I am honored to lead the fine women and men of TTB and proud of their dedication and resourcefulness in tackling these difficult challenges. I would be happy to discuss our tobacco tax enforcement activities and answer any questions you may have.

Questions for the Record for John Manfreda, Administrator of the Alcohol, Tobacco, and Trade Bureau (TTB), U.S. Department of the Treasury
Senate Committee on Finance
"Tobacco: Taxes Owed, Avoided, and Evaded"
Hearing held July 29, 2014

Ranking Member Orrin Hatch

1. **Mr. Manfreda, in this hearing we heard that there is a case to be made that roll-your-own tobacco is being marketed as pipe tobacco in order to take advantage of the lower tax rate for pipe tobacco. The GAO written testimony notes that a representative of a tobacco company noted that there was no real difference between their roll-your-own tobacco and pipe tobacco.**

   The written testimony of Mr. Bernstein, President and CEO of Liggett Vector Brands, contains examples of what is labelled as pipe tobacco being sold with cigarette papers and tubes, and rolling machines. In some examples, it appears that packages have been altered with stickers. Could you walk us through how a TTB investigation would consider these factors?

   Part of the purpose of this hearing is to gauge the ability of the tax code to accomplish its objective. Do you think TTB rulemaking has the existing authority to allow for differentiation between roll-your-own and pipe tobacco, or is the statute at issue, as suggested by GAO? I understand that you note in your testimony that funding of TTB revenue collection activities generates a positive return, but I think that if we can't definitively tell roll-your-own from pipe tobacco, then it doesn't matter how much we spend on enforcement.

Answer:

Any TTB tax classification determination must be grounded in the statutory definitions. By way of background, the Internal Revenue Code (IRC) at 26 U.S.C. 5702(n) defines "pipe tobacco" as 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. Under 26 U.S.C. 5702(o), "roll-your-own tobacco" is 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 or cigars, or for use as wrappers thereof. These definitions thus require consideration of the uses for which the tobacco is suitable and the likelihood of the tobacco being offered to or purchased by consumers for a particular use based solely on the tobacco's appearance, type, packaging, and labeling, and as a result do not set forth objective standards by which to distinguish between the products.

Further, the IRC definitions apply when the product is subject to Federal excise tax, generally when it is removed from a factory or released from customs custody.[1] As a result, actions taken

[1] TTB does not have authority under the IRC over wholesalers, distributors, or retailers of tobacco products, except in very limited circumstances. Such circumstances include floor stocks tax provisions similar to those set forth in CHIPRA and provisions prohibiting any person from purchasing, receiving, possessing, offering for sale, or selling or otherwise disposing of, after removal, any tobacco products, not put up in packages as required under the IRC at

by a wholesaler or retailer, such as marketing or product placement, generally are not within the scope of the IRC definitions.

Your question also touches on how TTB enforces its existing regulations, which, because of the lack of objective criteria to distinguish between the products based on "appearance" or "type," determine the suitability and likelihood that products will be offered to consumers as pipe tobacco or as roll-your-own tobacco based on the manufacturer's "packaging" and "labeling" statutory criteria.[2] With regard to the scenario where products that are labeled as "pipe tobacco" are sold along with cigarette papers and tubes, TTB must first consider whether the activity relates to the "packaging" or "labeling" of the product *when the product was removed by the manufacturer or importer subject to federal excise tax*. If a manufacturer includes cigarette papers or tubes in a package bearing a "pipe tobacco" designation, TTB regulations state that this will suggest a use other than as pipe tobacco and the product will be deemed roll-your-own tobacco.[3] However, if a retailer positions taxpaid products on a shelf next to cigarette tubes, that fact is not relevant to the Federal excise tax determination.

Your question also refers to a scenario where a package has been altered by the application of a sticker, such as a sticker bearing the designation "pipe tobacco." TTB regulations require that the designation for federal tax purposes be imprinted on the consumer package or "securely affixed" to the consumer package when the product is removed from the factory by the manufacturer or released from customs custody, at which point it is subject to tax.[4] As a result, a sticker applied to a package by a manufacturer prior to tax payment is not by itself an indication that the product is misclassified.

You also ask about TTB's authority to further differentiate between the products through rulemaking. TTB has authority to establish regulatory standards to differentiate pipe tobacco from roll-your-own tobacco to the extent that any such differentiation is consistent with the statutory definitions. The lack of objective standards in the statutory definitions presents a challenge to TTB. Another challenge is that under the IRC, tobacco products theoretically may meet the definitions of both pipe tobacco and roll-your-own tobacco, if the products are suitable and likely to be used for both purposes.[5] In fact, some products historically have been presented

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26 U.S.C. 5723 or which are put up in packages not bearing the marks, labels, and notices, as required under that section (see 26 U.S.C. 5751).

[2] *See* 27 CFR 40.25a. The IRC provides that tobacco products generally cannot be removed from the packages in which they leave the domestic factory or customs custody until the product is provided to the consumer. *See* 26 U.S.C. 5751 (regarding the purchase, receipt, possession, or sale of products after removal).

[3] *See* 27 CFR 40.25a(b)(3)(ii).

[4] *See* 27 CFR 40.216a, 40.216b, 41.72a, 41.72b.

[5] This is in contrast with other IRC tobacco product definitions. For example, the IRC definitions of "cigar" and "cigarette" reference each other, setting forth the relationship between the two. Under 26 U.S.C. 5702(a), a cigar is

to consumers as suitable for both uses.[6] Although TTB has the authority to engage in rulemaking to differentiate between pipe tobacco and roll-your-own tobacco, any proposed regulatory standard would not likely remove the ability and incentive for industry members to manipulate characteristics of their products so that products may be classified as the lower taxed product (pipe tobacco) while remaining suitable for use as the higher taxed product (roll-your-own tobacco). Equalizing the tax imposed on the two products would eliminate that incentive, as GAO observed in its 2012 Report, "Large Disparities in Rates for Smoking Products Trigger Significant Market Shifts to Avoid Higher Taxes Tax Rates."[7] When commenting on the 2012 GAO Report, TTB generally agreed that the introduction of large tax disparities between similar products has contributed to the substitution of higher-taxed products with lower-taxed products.[8] TTB also agrees with the testimony provided by GAO to the Senate Finance Committee on July 29, 2014, that "roll-your-own and pipe tobacco are similar and, in some cases, may be substitutable products, and the IRC lacks specificity on how they should be distinguished based on physical characteristics," that "the lack of consensus on which characteristics or criteria truly define and differentiate roll-your-own from pipe tobacco reveals the complexity and difficulty of developing standards to distinguish the products from each other," and that "there is the concern that products could easily be manipulated to negate any newly established standards."[9]

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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)), while under 26 U.S.C. 5702(b) a cigarette is (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco, and (2) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in paragraph (1). It is therefore not possible for a product to be classified under the IRC as both a cigar and a cigarette.

[6] For example, images of the packaging of "Sir Walter Raleigh," "Prince Albert," and "Half and Half" brand products show that "Sir Walter Raleigh" packaging has, in the past, included the prominent statement "Smoking Tobacco for Pipe and Cigarette"; "Prince Albert" packaging included the statement "Tobacco for Pipe and Cigarette Smoking"; and "Half and Half" packaging included the statement "For Pipe and Cigarettes." At one time, "Half and Half" was also marketed in the form of a "pipe tobacco filled cigarette." *See, e.g.*, Legacy Tobacco Documents Library at http://legacy-dc.ucsf.edu/ (University of California, San Francisco) and www.trinketsandtrash.org (associated with the Rutgers School of Public Health, and described on the site as "a surveillance system and archive that monitors, collects, and documents current and historic tobacco products and tobacco industry marketing materials and tactics…for research and educational purposes").

These historic examples indicate that products have been suitable for and actually offered to consumers for multiple uses prior to the effective date of the Children's Health Insurance Reauthorization Act of 2009 (CHIPRA). Any information about these brands comes solely from publicly available documents that are available online. TTB does not maintain information about historical product characteristics or packaging and would have no information on tobacco product physical characteristics from which to compare current product specifications to prior product specifications.

[7] *See* GAO-12-475, p. 43 (Matter for Congressional Consideration).

[8] *See* GAO-12-475, p. 55 (Appendix IV: Comments from the Department of the Treasury).

[9] *See* GAO-14-811T, p. 21.

Finally, we note that TTB has made significant progress in its tobacco enforcement activities in recent years, particularly through the establishment of its criminal enforcement program, through which TTB has been effectively identifying illegal activity and pursuing the appropriate remedies, including collecting the taxes due. Enforcement also serves as a deterrent against tobacco diversion and other tax evasion activities. However, TTB's criminal enforcement efforts must focus on tax evasion, which is illegal, not tax avoidance, which is legal. To the extent that federal revenue collections have been affected by tax avoidance behavior incentivized by differing tax rates on similar tobacco products, TTB would not expect these trends to change significantly following rulemaking.

2. **Mr. Manfreda, in your written testimony you noted that "the 150 percent increase in the federal excise tax on cigarettes imposed by CHIPRA increased the incentive to evade federal taxes through tobacco diversion." Please describe in more detail what other behaviors you are witnessing.**

Answer:

TTB is aware of a variety of tobacco diversion schemes that have been employed by illicit operators to evade federal excise taxes since the CHIPRA tobacco tax rate increases went into effect in April 2009. A number of those schemes are described in the Department of the Treasury's February 2010 "Report to Congress on Federal Tax Receipts Lost Due to Illicit Trade and Recommendations for Increased Enforcement" and the March 2011 GAO report entitled "Illicit Tobacco: Various Schemes are Used to Evade Taxes and Fees" (GAO-11-313).

As outlined in those documents, tobacco diversion schemes include the following behaviors to evade the payment of federal excise taxes:

- Tobacco products are produced by a manufacturer in the United States illegally operating without a TTB-issued permit, and those products are then removed for domestic consumption without the payment of applicable taxes.
- Tobacco products are removed from a domestic manufacturer's premises in excess of the quantity reported to TTB, thus evading the tax on the unreported quantity of products removed.
- Tobacco products are removed from the manufacturer's premises for export (which is a removal not subject to Federal excise tax), and either the manufacturer or an export warehouse proprietor diverts the products for sale in domestic commerce before export, thus illegally avoiding tax payment.
- Tobacco products are removed from the manufacturer's premises without tax payment for export, are actually exported, but then are smuggled back into the United States without the required importation entry and associated tax payment.
- Tobacco products are smuggled from abroad into the United States, disguised and declared as something other than as tobacco products, or are declared as a smaller quantity than actually imported, thus illegally evading the applicable tax payment requirements.

- Tobacco products are sold by mail order, phone, or over the Internet from domestic and foreign vendors and are delivered directly to the consumer without the payment of applicable taxes.

Further detail about each of the above schemes, as well as information about additional schemes intended to evade state and local excise taxes and Tobacco Master Settlement Agreement escrow payments, is available in the 2011 GAO report referenced above.

3. **Mr. Manfreda, to what extent does the jurisdiction of the Alcohol and Tobacco Tax and Trade Bureau (TTB) overlap with the Bureau of Alcohol, Tobacco, Firearms, and Explosives (ATF). In a report published in June 2014, GAO noted that ATF "deemphasized alcohol and tobacco investigations that do not involve violent crime." What impact have ATF priorities had on the ability of TTB to carry out its mission? How often does TTB work with ATF on cases involving tobacco, and how often does either agency become aware of a potential issue from the other agency?**

Answer:

TTB enforces Chapter 52 of the IRC, which imposes the federal excise tax on tobacco products and cigarette papers and tubes and special occupational tax on certain tobacco-related industry members. Chapter 52 also sets forth permit, bond, recordkeeping, reporting, and inventory requirements for certain industry members and authorizes TTB to prescribe certain tobacco packaging and labeling requirements. The Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) has primary jurisdiction over the Contraband Cigarette Trafficking Act (CCTA), [10] which primarily addresses the interstate smuggling of cigarettes to avoid certain state taxes, and the Jenkins Act (as amended by the Prevent All Cigarette Trafficking Act (PACT Act)), [11] which generally regulates the delivery and Internet sales of cigarettes and prohibits their being mailed through the U.S. Postal Service. TTB may exercise ancillary jurisdiction under these laws where appropriate – and TTB has been involved in multiple cases that have identified both CCTA violations and Internet sales where illicit manufacturers, importers, and cigarette distributors evade both federal excise taxes and state excise taxes – but TTB does not have primary jurisdiction over the CCTA or the Jenkins Act.

ATF is one of the many law enforcement partners with which TTB routinely interacts in the form of intelligence sharing, case referrals, and joint investigations. Quantifying the frequency of this interaction is difficult because it consists of both formal contact between TTB and ATF on specific matters as well as informal information exchange between intelligence analysts, investigators, and agents.

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[10] Pub. L. No. 95-575.

[11] Pub. L. No. 81-363; Pub. L. No. 111-154; *see also* Pub. L. No. 109-177 (additional amendments).

Notably, since receiving two-year funding in FY 2010 to operate its own criminal enforcement program, TTB has been able to independently pursue cases involving tax evasion and other criminal activity. The bureau has subsequently received $2 million in annual funding for FY 2012 through FY 2014 to continue the criminal enforcement program.

4. **Mr. Manfreda, in your testimony you note some of the diversion schemes you encounter, such as tobacco smuggling and products being made by an unlicensed manufacturer. Mr. Manfreda and Dr. Gootnick, how many unlicensed manufacturers do you estimate are in operation, and what challenges does TTB face in closing them down?**

Answer:

As noted in my testimony, and as previously stated in the Department of the Treasury's 2010 "Report to Congress on Federal Tax Receipts Lost Due to the Illicit Trade in Tobacco Products" and accompanying study, accurately measuring the amount of tobacco diversion and the resulting federal revenue loss is difficult because these activities are, by definition, clandestine in nature. TTB has conducted 169 investigations into illegal manufacturing operations, including over 80 investigations into unpermitted cigarette-making machine operators, since FY2013. However, TTB is unable to estimate the number and impact of illicit tobacco operations that have not yet been detected. Further, as noted in the 2011 GAO report entitled "Illicit Tobacco: Various Schemes Are Used to Evade Taxes and Fees," illicit tobacco operations are constantly evolving in response to many factors, including tobacco taxes, regulations, and enforcement activities,[12] so addressing these issues requires a dedicated enforcement presence to curtail and deter illicit activities.

One important challenge is that there is no legal barrier to illicit manufacturers obtaining processed tobacco for use in making their products illegally. Processed tobacco is generally tobacco that has been processed for use, by a manufacturer of tobacco products, in the manufacture of such products. A common example is "cut rag" tobacco, which may be used without any further manipulation by a manufacturer of tobacco products as the filler tobacco in cigarettes. The IRC provides TTB authority over manufacturers and importers of processed tobacco. TTB requires that those manufacturers and importers submit reports showing to whom they sell and/or deliver the processed tobacco. However, under the IRC, those entities are not required to sell or deliver processed tobacco to a TTB-permitted manufacturer of tobacco products. As a result, untaxed processed tobacco may subsequently be legally sold to illegal (unlicensed) manufacturers, typically through unpermitted intermediaries over whom TTB has no authority. Given the risk of processed tobacco being used in illicit manufacturing operations, TTB has focused on tracking the distribution of processed tobacco to subsequent purchasers, although these cases are time and resource-intensive. Since April 2011, TTB has conducted 26 forward traces of processed tobacco, identifying approximately $180 million in potential unpaid

[12] *See* GAO-11-313, p. 16.

federal excise tax liability. These cases are ongoing. As noted in my testimony, to help address this enforcement challenge, the Administration's FY 2014 and FY 2015 budgets proposed to clarify that roll-your-own tobacco includes any processed tobacco that is removed or transferred for delivery to anyone without a proper permit, but does not include export shipments of processed tobacco. This provision would provide TTB with authority to collect tax on all processed tobacco when it is removed by the manufacturer or importer for delivery to any non-permitted domestic entity.

5. **I am especially interested in any estimate you can place on the size of the black market in tobacco products. It seems to me that in addition to examining some behaviors that are being discussed as either evasion or avoidance, we should also focus on behaviors that are unquestionably evasion. What specific black market behaviors that you believe constitute evasion do you think have the greatest impact on tax collection?**

Answer:

As noted previously, estimating the extent of illegal activity is extremely difficult, as that activity is by definition intended to avoid detection. Treasury addressed the difficulties and limitations of such estimates in the 2010 "Report to Congress on Federal Tax Receipts Lost Due to the Illicit Trade in Tobacco Products" and accompanying study. Further, as also explained in response to question 4, the use of untaxed processed tobacco in illicit manufacturing operations contributes to black market activity and adversely affects tobacco tax collections, with approximately $180 million in potential unpaid federal excise tax liability identified in 26 investigations since April 2011.

In addition, illegal activity involving tobacco products often crosses a number of federal and state jurisdictions, so some black market activity, such as the smuggling of tobacco products across state lines to avoid payment of appropriate state taxes, is not within TTB's primary jurisdiction. TTB regularly shares information with and engages in joint actions with other agencies, such as ATF, U.S. Immigration and Customs Enforcement (ICE), Homeland Security Investigations (HSI), and U.S. Customs and Border Protection (CBP), and those agencies also take enforcement actions and lead both interdiction efforts and tobacco smuggling investigations within their specific jurisdictions. For example, CBP regulates customs bonded warehouses (CBWs) through which exports and imports may take place, while TTB regulates export warehouses (EWs) through which tobacco products may be exported or may be removed without payment of tax for use as ship supplies. ICE /HSI is responsible for illicit tobacco investigations addressing the smuggling of both counterfeit and genuine cigarettes across U.S. borders.

TTB has found through its investigations that EWs are a particular risk for tax evasion, especially when used by ship chandlers to provide ship supplies "for consumption beyond the internal revenue laws of the United States," which is an IRC tax exempt removal under 26 U.S.C. 5704(b). During TTB investigations, we have found EWs functioning as retail outlets where untaxed cigarettes are sold but not delivered, as required, to vessels. As a result, TTB has focused resources in this area and has increased coordination and cooperation with CBP as well. TTB has conducted 12 EW investigations since FY 2012, with approximately $8 million in federal excise tax liabilities identified to date. We intend to continue expanding our collaboration with CBP in FY 2015, and we expect that TTB's planned full integration into the International Trade Data System in late 2015 will further enhance the ongoing communication and coordination between CBP, TTB, and other participating agencies on tax and illicit trade issues.

Senator Mark Warner

Mr. Manfreda, your bureau's FY2015 budget submission, you talk explicitly about your role in combating illicit activity, noting: "Failure to address illicit trade not only deprives governments of revenue, but also gives non-compliant actors an unfair competitive advantage over their lawful counterparts." Illicit trade includes those who are operating outside the rules, but also those who seem to be skirting the letter or intent of the laws and regulations.

In this budget justification you say that you will "Invest resources in program activities that provide the greatest assurance that these industries are operating in compliance with tax and regulatory requirements, in the interest of collecting the excise taxes due and ensuring fair and lawful market activity." My understanding, if I'm reading the submission right, is that you're proposing a slow, but steady increase in some funds to combat that illicit work, which net savings from these investments of about $92 million over 10 years.

1. **Can you talk a bit about how you came up with your justification for this enforcement and why you think that is adequate knowing what we've heard today about current businesses practices and illicit trade?**

Answer:

As noted in my testimony, the tax enforcement challenges that TTB faces are substantial and complex. To help address these challenges, the Administration requested additional funding in FY 2015 to augment TTB's current tax enforcement staff of approximately 150 investigators, auditors, and agents. Specifically, the President's Budget requests an initial investment of $5 million in FY 2015 through a program integrity cap adjustment to increase TTB enforcement initiatives targeting the illicit trade of alcohol and tobacco products. As these initiatives must be sustained over time to maximize taxpayer returns, the proposal also calls for an annual investment of approximately $5 million to support additional TTB enforcement initiatives through FY 2019. If enacted, the FY 2015 investment would increase TTB's enforcement staff by nearly 25 percent (or 35 FTE) in the first year. After 5 years of investment, this infusion of an additional 35 FTE each year would effectively double TTB's enforcement presence. The staffing plan provides for the enforcement, intelligence, and support personnel that are necessary to identify, investigate, and effectively prosecute criminal diversion cases. TTB has used this mix of skills in its investigations since launching its criminal enforcement program in 2011, and the proposed incremental increases in resources will allow for periodic assessments of program performance and the opportunity for additional investments based on enforcement results.

2. **As well, could you talk about what challenges do you have enforcing the 2012 amendment in MAP21 which brought Roll-Your-Own tobacco machines under the**

definition of a tobacco product manufacturer? And how much delinquent FET have you collected from RYO machines in violation of the 2012 law?

Enforcing the 2012 amendment in MAP-21 is challenging largely due to the number of potential locations and the resources that are required to establish, assess, and collect tax on cigarette-making machine (CMM) locations. In addition, TTB personnel must be physically present to verify that machines are being made available for commercial purposes and to gather information used to establish the amount of tax liability. Also, many entities continue to operate under the mistaken belief that their activities are exempt from tax and other IRC obligations because they are set up as a "social club" or "non-profit."

In the more than 80 investigations initiated to date, TTB has identified almost $4 million in outstanding federal tax liability, with an average of roughly $50,000 per investigation. As investigations are completed, TTB collects the liability through the tax assessment process under the Internal Revenue Code. Tax assessments take time because TTB must protect the rights of the taxpayer and ensure fair collection procedures. In addition, many subjects of TTB's CMM investigations are small businesses that may ultimately lack the ability to pay. The amount of tax collected thus far in connection with these efforts constitutes "return information" that is prohibited from public disclosure pursuant to 26 U.S.C. 6103.

To date, TTB's CMM enforcement program has had a deterrent effect on CMM owners and operators, with some operators discontinuing operations as a result of TTB's enforcement actions. TTB has publicized the status of its enforcement efforts as much as possible to increase that deterrent effect and to correct any misperceptions about the impact of the 2012 amendment. For example, in its May 12, 2014 Announcement, "Ongoing Enforcement in Connection with Cigarette-Making Machines," TTB emphasized that "every operation reviewed [has been] subject to excise tax liability and other IRC obligations, including those operations where machines were available to members of a 'social club' or 'non-profit.'"[13] Although it is difficult to quantify deterrent effect, TTB investigators are with increasing frequency encountering locations that have discontinued offering CMMs due to either previous interaction with TTB investigators or awareness of TTB's enforcement efforts. As investigations continue to culminate in assessment and collection, TTB expects that public awareness and the impact of its enforcement will increase.

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[13] Available at http://www.ttb.gov/announcements/ttb-announcement-ongoing-enforcement-in-connection-with-cigarette-making-machines.pdf.

Senator Mike Enzi

1. **Collection of tax revenue is among the primary responsibilities at the TTB. However, due in part to the illicit trade of tobacco products – such as the smuggling of cigarettes and other products across state lines to avoid tax differentials – millions of dollars in tobacco tax revenue goes uncollected each year. The TTB is also responsible for regulating and taxing the alcohol industry. It is my understanding that in light of each state's individual authority to set state laws dealing with the regulation and distribution of alcohol products within their respective borders, the three-tier system of alcohol distribution has been well-established in most all states. And, as part of that three-tier system, in the majority of states, the distribution tier has a shared responsibility for the collection of alcohol tax revenue resulting in a more accountable chain of custody for the product. In your opinion, do the same issues of efficient tax collection and accountability in alcohol occur in tobacco? If not, can you further explain the differences between the two industries, the methods by which the taxes are collected and how the products are traced?**

   (Please see articles attached.)

Answer:

One of TTB's primary responsibilities is the collection of the federal excise taxes imposed by Chapters 51 (Distilled Spirits, Wine and Beer) and 52 (Tobacco products and cigarette papers and tubes) of the IRC. The alcohol and tobacco industries are subject to regulation and taxation by federal, state, and, in some cases, local governments. The three-tiered system of alcohol distribution discussed in the articles is a function of state, not federal, law.[14] As a result, each state determines the structure of its distribution system with some states controlling one or more aspects of it. Federal excise taxes on alcohol and tobacco products are generally imposed at the producer/manufacturer or importer level.[15] Businesses in the distribution or retail tiers do not routinely bear or share responsibility for federal excise tax payment.[16]

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[14] *See, e.g., California Retail Liquor Dealers Association v. Midcal Aluminum, Inc.*, 445 U.S. 97, 110 (1980) (explaining that the Twenty-first Amendment confers on the States "virtually complete control over . . . how to structure the liquor distribution system").

[15] *See* 26 U.S.C. 5005(a) (imposing liability on the distiller or importer of distilled spirits), 5043(a) (imposing liability on the proprietor of a bonded wine cellar or the wine importer), 5051(a) (imposing tax on beer brewed or produced or imported), 5703(a)(1) (imposing liability on the manufacturer or importer of tobacco products).

[16] When Congress increases the tax rates for either alcohol or tobacco products, retailers and wholesalers are generally required to pay a "floor stocks tax" based on the products in inventory on the effective date of the tax increase. *See, e.g.*, Pub. L. No. 111-3, sec. 701(h). This requirement serves to equalize the tax for products that were removed from the manufacturer's or importer's bond prior to the tax increase.

Other than floor stocks tax, distributors or wholesalers who are not also producers/manufacturers or importers do not pay federal excise tax except indirectly as part of the purchase price from the taxpayer. At one time, certain alcohol distributors were required to pay a special (occupational) tax each year, but that requirement was permanently

Because both alcohol and tobacco excise tax are collected from the producer/manufacturer or importer, there are many similarities between TTB's administration of federal excise taxes under IRC Chapters 51 and 52. For example, tax on domestic products is determined upon removal from bond and generally collected upon the basis of a semi-monthly return.[17] Entry into both the alcohol and tobacco industries is conditioned upon obtaining a permit or filing a brewer's notice,[18] and TTB requires domestic producers and manufacturers to file bonds to protect the revenue.[19] For both commodities, TTB shares tax information with state taxing authorities to enhance TTB and state tax administration efforts.

We note that other federal laws are aimed at preventing the interstate smuggling of tobacco products: the CCTA,[20] which is enforced by ATF; the Jenkins Act,[21] which is enforced by the Federal Bureau of Investigation; the PACT Act,[22] which is enforced by ATF and the United States Postal Service; and certain provisions of the Family Smoking Prevention and Tobacco Control Act,[23] which is enforced by the Food and Drug Administration.

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repealed effective July 1, 2008. *See* Pub. L. No. 109-59, sec. 11125. TTB does issue permits to alcohol wholesalers, *see* 27 U.S.C. 203-204, but those wholesalers are not required to file regular monthly reports or excise tax returns, *see* 27 CFR part 31.

[17] *See* 26 U.S.C. 5006(a)(1) (determination of tax on distilled spirits), 5041(a) (imposition of tax on wine), 5054(a)(1) (determination of tax on beer), 5061 (method of collecting alcohol excise tax), 5703(b) (method of payment of tax on tobacco products and time for payment). Some alcohol producers may qualify to file returns and pay excise taxes less frequently, depending on their production. *See* 26 U.S.C. 5061(d)(4). Responsibility for assessing and collecting the excise taxes due on imported alcohol and tobacco products under Chapters 51 and 52 of the Internal Revenue Code are among the "Customs revenue functions" vested by statute with the Secretary of Treasury (6 U.S.C. 212) and delegated to the Secretary of Homeland Security under Treasury Order 100-16 (68 FR 28322, dated May 23, 2003).

[18] 27 U.S.C. 203-204 (distillers, wine producers, and alcohol importers); 26 U.S.C. 5171 (distillers), and 5401(a) (brewers); 26 U.S.C. 5713 (manufacturers and importers of tobacco products).

[19] 26 U.S.C. 5173 (distilled spirits plants, 5354 (bonded wine cellars), 5401(b) (brewers), 5711 (manufacturers of tobacco products).

[20] Pub. L. No. 95-575.

[21] Pub. L. No. 81-363.

[22] Pub. L. No. 111-154.

[23] Pub. L. No. 111-31.

Testimony of

Rocky Patel

Owner, Rocky Patel Premium Cigars, Inc.

before the

United States Senate Committee on Finance

Tobacco: Taxes Owed, Avoided, and Evaded

July 29, 2014

Introduction

Chairman Wyden, Ranking Member Hatch, and Members of the Committee:
My name is Rocky Patel, and I am the owner and CEO of Rocky Patel Premium Cigars Inc. Founded in Naples, Florida, Rocky Patel Premium cigars are globally known for their premium quality aged tobaccos. Our cigars are the product of a belief that a premium cigar should be the result of artisan craftsmanship, strict quality control, and the use of the finest, aged tobaccos. In fact, over three hundred different hands touch the tobacco used in our product from the time a seedling is planted in the ground to the time a Rocky Patel premium cigar is placed in a box for final shipment; a process that takes 4-5 years Today, we produce more than twenty million cigars annually while maintaining the utmost dedication to producing and offering high-quality premium cigars.

I would like to thank you for this opportunity to participate in today's important hearing. I have been asked to provide an overview of the premium cigar industry and tobacco excise taxes currently applicable to premium cigars under the U.S. Internal Revenue Code. I will also be discussing issues relating to premium cigar tax compliance, as addressed in the GAO report, *Large Disparities in Rates for Smoking Products Trigger Significant Market Shifts to Avoid Higher Taxes*[1], and potential ways to work together on these issues. I will be pleased to do so.

Background on the Premium Cigar Industry

Premium cigars are not defined under the Internal Revenue Code, but they are typically considered to be high grade tobacco products wrapped in one hundred percent leaf tobacco with one hundred percent tobacco filler, containing no filter, tip or non-tobacco mouthpiece, and weighing in at least at 6 pounds per 1,000 count. The closest approximation to a premium cigar in the Internal Revenue Code is the "large" cigar, which is a cigar that weighs at least 3 pounds per 1,000 count. Besides weight, the Internal Revenue Code does not have additional requirements for a cigar to be considered a large cigar. As a result, there are physical weight differences between what is considered a large cigar under the Internal Revenue Code and what we consider a premium cigar for large cigars that weigh between 3 and 6 pounds per 1,000 count.

In addition to its distinctive physical characteristics, premium cigars are also unique in their culture, business model, and consumer base. The premium cigar culture is distinctive and is rooted in the social and leisurely nature of premium cigar consumption. The typical cigar shop is a small, family owned brick-and-mortar store that directly distributes its products and is the modern day equivalent of a general store or barbershop, where men and women of all demographics who share

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[1] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-475, TOBACCO TAXES: LARGE DISPARITIES FOR SMOKING PRODUCTS TRIGGER SIGNIFICANT MARKET SHIFTS TO AVOID HIGHER TAXES (2012).

a passion for premium cigars can enjoy each other's company, share common interests, and discuss the issues of the day in a relaxed, comfortable environment.

Importantly, premium cigar stores are a destination-only retail sales venue. The majority of customers at premium cigar stores do not come from "off the street" type traffic. Consumers generally do not enter premium cigar stores without first knowing that premium cigars are sold there. Consider that not only is selling tobacco to minors forbidden in every jurisdiction in the United States where a cigar shop exists, but many shops mandate you be 18 years old just to enter the premises. Moreover, premium cigars are enjoyed in moderation, with the majority of premium cigar smokers smoking less than 1 cigar per day.

In sum, premium cigars occupy a unique niche within the overall cigar and tobacco market, serving an adult consumer base with a complex palate and appreciation for high quality tobacco products.

Background on Premium Cigar Taxes

Congress has taxed tobacco products since its inception as a means to raise revenue and to discourage consumption. Since the 1970s, cigars have been classified as either small or large, based upon their weight, and taxed differently based on this classification. Large cigars are defined as weighing more than 3 pounds per thousand; all cigars that weigh less than 3 pounds per thousand are considered "small" cigars.[2] Premium cigars are lumped into the large cigar category under the Internal Revenue Code.

In February 2009, the enactment of the Children's Health Insurance Program Reauthorization Act[3] ("CHIPRA") fundamentally transformed tobacco taxation by significantly raising the federal excise taxes ("FET") on both small and large cigars, along with other tobacco products, including cigarettes, pipe tobacco, and roll-your-own ("RYO") tobacco.

Before CHIPRA, premium and large cigars were taxed at the larger amount of either 20.719 percent per each cigar or not more than 4.875 cents per cigar. After CHIPRA, taxes on premium and large cigars rose to the larger amount of either 52.75 percent per each cigar or not more than 40.26 cents per cigar. This resulted in as much as a 726 percent tax increase on premium and large cigars per thousand "sticks." This represents one of the highest increases in the history of the IRS tax code. By comparison, taxes on small and large cigarettes increased by approximately 158% per thousand sticks after CHIPRA.

These increases have had a significant impact on the premium cigar community. While manufacturers or importers of premium cigars usually pay the applicable FET, the tax is passed on to premium cigar retailers when purchasing inventory. In

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[2] *See* 26 U.S.C. § 5701(a).
[3] Pub. L. No. 111-3, 123 Stat. 8.

addition to paying a price that includes the cost of the FET, premium cigar retailers must also pay a state "Other Tobacco Product," or OTP, tax. Such taxes can go as high as 95% of the wholesale price. OTP taxes are generally based on the price for which the cigars are sold by the manufacturer or importer to the retailer, which includes the FET.[4] In effect, this means that a premium cigar retailer pays a "tax on a tax" as a basic cost of doing business. Paying both FET and OTP taxes has a significant impact on the premium cigar retailer, requiring a significant up-front investment that retailers must carry in inventory until, and if, the cigars are sold.

As a result, premium cigar retailers must carefully plan their purchases and strictly control their inventories. The cost of insuring the cigars is also artificially inflated as a result for both the wholesaling importer as well as the retailer.

Premium cigar retailers are generally required to remit applicable tobacco taxes to state governments once a month, placing a constant strain on cash flow. Moreover, remitting taxes once a month means that most premium cigar retailers have had to adopt costly accounting and inventory systems to keep track of taxes that are due to the federal and state governments. Consequently, premium cigar retailers face a costly and challenging business environment well before they sell their first cigar.

While excise tax costs are eventually passed down to the consumer, it should be stressed that the up-front timing of FET and OTP taxes makes a premium cigar less attractive as a product, hurting the bottom line of the premium cigar retailer. This is particularly true because premium cigars are luxury items that are often foregone during economic downturns.

Consequently, as the Committee considers the concerns raised by the GAO Report, we encourage you to consider the significant tax burden resulting from FET and state OTP excise taxes on the premium cigar industry, and how these taxes impact the primarily small, family-owned businesses that sell these products. As discussed further in my testimony, we believe that creating a new definition of premium cigar under the Internal Revenue Code and replacing the current ad valorem tax with a flat tax would allow the regulators to focus their resources on incidences of tax avoidance while also reducing the tax burden on small businesses.

Avoidance of Tobacco Excise Taxes

The GAO report highlighted an important tax avoidance issue that reduces federal tax revenue and tarnishes the reputation of the premium cigar industry: the migration of small cigars to large cigars by manufacturers that are seeking the benefit of a lower tax rate. After the enactment of CHIPRA, price sensitive manufacturers and consumers began substituting higher-taxed products with lower-taxed products. On the margins, some participants in the tobacco industry

[4] *See* Large Cigar Taxes on and after January 1991, Industry Circular 91-3, Department of the Treasury, Alcohol and Tobacco Tax and Trade Bureau (March 19, 1991).

took steps to avoid taxes by reclassifying or repackaging their products as lower-taxed goods.

The premium cigar industry understands Congress' concerns about these practices and desire to address these issues. However, we believe that any measures adopted, whether through legislation or administrative action, should respond to particular problems posed by specific tobacco products. Such actions should also recognize substantial differences in revenue lost due to these practices and how limited resources at the regulatory level can be used most productively. As compared to all other tobacco products, cigars, both large and small, represented less than 4% of federal excise tax revenue from all tobacco products in 2012.[5] This suggests that public policies adopted in response to the compliance issues identified in the GAO report should focus on key sources of revenue loss and not be so broad as to cover tobacco products that are not the source or cause of tax avoidance.

Moreover, we believe that tax compliance can be achieved without additional tax increases on premium cigars. Instead, we believe that steps can be taken at the administrative or legislative level to clarify differences in tobacco products, including the specific qualities of premium cigars, and to address the incidence of taxation, that will increase simplicity, provide certainty, and improve compliance.

Certain tobacco manufacturers have taken steps to make "small" cigars qualify as "large" cigars, despite several differences in characteristics, quality, distribution and marketing, and the targeted consumer. As the GAO reported, some small cigar manufacturers added an incremental amount of tobacco to make their products slightly heavier. Other manufacturers have used non-tobacco filler or stuffing to increase the weight of a small cigar.

As noted previously, the premium cigar industry takes great pride in quality cigars that are symbols of good taste, passion, and high craft and believes that cigars should be classified by more than just weight. Important qualities that distinguish premium cigars from other tobacco products include one hundred percent tobacco binder, and filler, a lack of a filter or non-tobacco tip, and a wrapper that is made from one hundred percent leaf tobacco. Small cigar and other machine made tobacco manufacturers that avoid taxes by taking actions to reclassify their products as large cigars are producing and marketing cigars that have no relationship to premium cigars or the premium cigar industry.

In fact, this type of activity hurts the image of the premium cigar industry by association - implying that all cigar manufacturers, including premium cigar manufacturers, value tax savings over the quality of their product. The exact opposite is true, as our entire business model relies upon providing a high quality product and superior experience to our consumer base.

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[5] IRS, Statistics of Income Division, Historical Table 20, *available at* http://www.irs.gov/uac/SOI-Tax-Stats-Historical-Table-20

The premium cigar industry would like to work with Congress and regulators on this issue. One constructive approach would be to define "premium cigar" in the Internal Revenue Code, which would distinguish between non-premium, "lighter" large cigars and premium cigars. This would allow Congress and the regulators to appropriately focus on tax avoidance issues occurring on the border between small and large cigar classifications

For purposes of the Internal Revenue Code, we urge you to consider specifying that premium cigars should be defined according to several unique factors, including the fact that premium cigars are unfiltered products that are wrapped in leaf tobacco and weigh more than 6 pounds for every 1,000 cigars. Although weight is a part of this definition, the 6 pound mark is significantly more than the 3 pound weight threshold that currently defines a large cigar; further, the weight requirement is combined with other distinguishing characteristics, making it impossible to game the definition based on weight alone. We believe adding a new definition of premium cigars under the Internal Revenue Code along these lines would more accurately reflect the distinctions between premium and non-premium cigars while also reducing incidences of tax avoidance.

We also support a flat tax for premium cigars. As noted previously, large cigars are currently taxed at the higher amount of either 52.75 percent per each cigar or not more than 40.26 cents per cigar. We believe that a flat tax applied to premium cigars could and should be lower than the current rate applied to large cigars to more appropriately calibrate the relative difference between the tax rates on premium cigars and small cigars. A flat tax would have the added benefit of simplicity and certainty, reducing the compliance burden on the premium cigar industry and reducing the enforcement burden on the Alcohol and Tobacco Tax and Trade Bureau, or the TTB.

Conclusion

Whatever actions that are taken to address these issues should be consistent with sound tax policy and not be driven by the need to raise revenues. Any increase in premium cigar excise taxes disproportionately hurts small businesses that are carrying a considerable amount of excise taxes already paid in an inventory that hasn't yet been sold. For many retailers, higher tobacco excise taxes on premium cigars may make the difference between surviving or shutting their doors. While the concerns in the GAO report should be addressed promptly, we urge the Committee and Treasury to consider the source of such problems when determining appropriate remedies.

In closing, I want to thank you for the opportunity to provide an overview of the tobacco excise taxes applicable to the premium cigar industry and proposed solutions to these problems. The premium cigar industry stands with Congress and recognizes the importance of limiting opportunities and discouraging efforts to circumvent federal excise taxes, not only from the standpoint of lost federal tax revenue, but also as a responsibility to protect the quality of premium cigars and reputation of the premium cigar industry.

Questions for the Record
"Tobacco: Taxes Owed, Avoided, and Evaded"
Hearing Date: July 29, 2014
Questions for Mr. Rocky Patel

Ranking Member Orrin Hatch

1. *Mr. Patel, in his written testimony, Dr. Gootnick notes that "according to Treasury officials, some large cigar manufacturers and importers began to restructure their market transactions to lower the sale price for large cigars to obtain the tax savings of a lower ad valorem rate, creating enforcement challenges." How large of an issue do you think this is, and how would you suggest this issue be addressed if it needs addressing?*

Answer: The premium cigar industry recognizes that layering and structuring sales transactions may be used to lower the sales price of their product and obtain the tax savings of a lower ad valorem rate. However, we believe that the problems and potentially lost revenue associated with these transactions are outweighed by the much more significant issue of the migration of certain small cigars to large cigars to benefit from the lower tax rate currently applied to large cigars under the Internal Revenue Code (the "Code"). These issues could, in part, be addressed by creating a new definition of premium cigar (discussed below) and applying an appropriately calibrated flat tax to such products. We take each of these issues in turn.

Layering and Structuring Transactions

Under judicial precedent[1] and guidance from Treasury and U.S. Customs and Border Protection[2], or CBP, an importer can structure an import transaction such that the "first sale" of a product must be used as the sales price for a tobacco product for purposes of the federal excise tax. A taxpayer may only utilize the first sale rule if four requirements are met: first, the sale must be a bona fide sale in accordance with CBP requirements; second, the goods must be clearly destined for the U.S. at the time of sale; third, the sales price must be at arm's length in accordance with CBP requirements; and, fourth, there must be a documentation and recordkeeping trail. In Industry Circular 91-3, the Alcohol and Tobacco Tax and Trade Bureau ("TTB") opined on the "first sale" rule and noted that changes in federal law required that the tax on large cigars be based on the price for which the cigars are sold by the manufacturer or importer (i.e., the actual sale price).

Since then, the "first sale" practice has been specifically reviewed by the Alcohol and Tobacco Tax and Trade Bureau ("TTB") and has been deemed appropriate under certain circumstances.[3] Moreover, the GAO report noted that Treasury has been approached to review the legality of these transactions since there is a lack of clear guidance on what types

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[1] *See E.C. McAfee Co. v. U.S.*, 842 F.2d 314 (Fed. Cir. 1988), *Nissho Iwai American Corp. v. U.S.*, 982 F.2d 505 (Fed. Cir. 1992).
[2] T.D. 96-87, 31 Cust. B. & Dec. No.1; 30 Cust. B. & Dec. No. 52 (1997)
[3] *See* Importation of Tobacco Products and Calculating the Tax on Imported Large Cigars, Industry Circular 2011-03, Department of the Treasury, Alcohol and Tobacco Tax and Trade Bureau (April 26, 2011).

of transactions would qualify for "first sale" treatment. In particular, the GAO report cited concerns that large cigar pricing trends were being driven by these "structuring" or "layering" transactions and resulting in federal tax revenue loss. Treasury is examining importer and manufacturer pricing arrangements and taking action on a case by case basis.

The TTB has the authority to examine the first sale practice and, in cases where first sale treatment is being inappropriately claimed, take additional action as necessary. However, as discussed below, replacing the current ad valorem tax model for premium cigars with a "flat" tax would eliminate the incentive to enter into first sale transactions. Importantly, however, we note that the federal tax revenue loss associated with layering and structuring transactions is far outweighed by the much larger issue of the migration of small cigars to large cigars, which is addressed below.

Migration of Small Cigars to Large Cigars

We believe that it is more important that TTB and Congress focus on the inappropriate migration of small cigars to large cigars. As GAO's testimony to the Committee notes, total annual sales of large cigars have grown from 5.8 billion units in fiscal year 2008 to 12.4 billion units in fiscal year 2013, an increase of about 115 percent.[4] The overwhelming share of this growth is due to consumption of cigars that have migrated from the small to large category, not from an increase in consumer consumption of large and premium cigars.

In addressing this issue, we strongly believe that differentiating premium cigars from small and large cigars is an integral part of eliminating inappropriate category migration by certain small cigar manufacturers and importers. Such differentiation will allow Congress and TTB to appropriately focus on migration issues occurring on the border between small and large cigar classifications without penalizing the premium cigar market, which differs substantially from the small and inexpensive large cigar markets in terms of physical product, patterns of consumption, consumer base, and culture.

For purposes of the Code, we urge you to define a premium cigar to mean a cigar that: (1) is wrapped in one hundred percent whole leaf tobacco; (2) contains a one hundred percent leaf tobacco binder; (3) contains primarily long filler tobacco; (4) is made by combining manually the wrapper, filler, and binder; (5) has no filter, tip, or non-tobacco mouthpiece; (6) does not have a characterizing flavor other than all natural tobacco; and (7) weighs more than six pounds per one thousand units. Although weight is a distinguishing factor, the 6 pound mark is significantly more than the 3 pound weight threshold that currently defines a large cigar; further, the weight requirement is combined with other distinguishing characteristics, making it impossible to characterize a cigar as a premium cigar based on weight alone.

We believe that adding these elements into a new definition of premium cigars in the Code would more accurately reflect the distinctions between premium and non-premium cigars while also reducing incidences of inappropriate migration.

[4] *Tobacco Taxes - Disparities in Rates for Similar Smoking Products Continue to Drive Market Shifts to Lower-Taxed Options*, 113th Cong. 12 (2014) (statement of David Gootnick, Director, International Affairs and Trade).

We also support a flat tax for premium cigars. As you know, large cigars are currently taxed at the higher amount of either 52.75 percent per each cigar or not more than 40.26 cents per cigar. We believe that a flat tax applied to premium cigars could and should be lower than the current rate applied to large cigars to more appropriately calibrate the distinctions between premium cigars, large cigars, and small cigars. A flat tax would have the added benefit of simplicity and certainty, reducing the compliance burden on the premium cigar industry and reducing the enforcement burden on the TTB. There would also be no incentive to engage in a first sale transaction if ad valorem pricing were replaced with a flat tax, as there would be no opportunity to obtain tax savings by lowering the sales price of the imported product.

In addition, we emphasize the importance of addressing this issue from a reputational standpoint. The premium cigar industry takes great pride in quality cigars that are symbols of good taste, passion, and high craft and believes that cigars should be classified by more than just weight. Small cigar and other machine-made tobacco manufacturers that avoid taxes by taking actions to reclassify their products as large cigars are producing and marketing cigars that have no relationship to premium cigars or the premium cigar industry. In fact, this type of activity hurts the image of the premium cigar industry by association - implying that all cigar manufacturers, including premium cigar manufacturers, value tax savings over the quality of their product. The exact opposite is true, as our entire business model relies upon providing a high quality product and superior experience to our consumer base.

Again, we appreciate the opportunity to testify before the Senate Finance Committee and provide our input on the taxation of the cigar industry. We recognize the importance of examining sources of lost federal tax revenue and discouraging efforts to inappropriately reclassifying products in order to obtain the benefit of a lower rate. We also view this as a responsibility of our industry to protect the quality of premium cigars and the reputation of the premium cigar industry. We look forward to working with Congress and TTB on this issue.

Testimony of Michael Tynan, Policy Officer
Oregon Health Authority, Public Health Division

Before the United States Senate Committee on Finance

July 29, 2014

Thank you Chairman Wyden, Ranking Member Hatch and members of the Committee. My name is Michael Tynan and I am the Policy Officer for the Public Health Division in the Oregon Health Authority. In that role I work on public health policy issues that aim to reduce the cause of death, disease and injury to Oregonians. Previous to that, I was at the Centers for Disease Control and Prevention (CDC) where I worked at CDC's Office on Smoking and Health. I have been invited here today to talk to you about studies I have published on changes that have happened since the Federal tobacco excise tax increased in 2009.

I am not here to speak for or against any piece of legislation. My full testimony, along with copies of the studies I reference, have also been submitted for the record.

Background

Tobacco use is the leading cause of death and disease in the United States. Each year, more than 480,000 people die from smoking and exposure to secondhand smoke. Smoking leads to cancer, heart disease and chronic lung disease and costs the United States at least $293 billion in medical costs and lost productivity annually. According to CDC, an estimated 18.1% (42.1 million) of U.S. adults are current cigarette smokers. Overall smoking prevalence has declined from 20.9% in 2005 to 18.1% in 2012, and CDC reports that this is encouraging and likely reflects the success of tobacco control efforts across the country.

This January marked the 50th anniversary of Surgeon General Luther Terry's landmark report on Smoking and Health. Since that report's publication, the public health community and Americans have learned a lot about the impact smoking has on individual and population health.

In addition to learning about the impact of tobacco use on human health, we have also learned a lot about the tobacco industry. In a 2006 Federal racketeering case against the tobacco industry, a Federal judge ruled that the tobacco industry had engaged in a decades-long enterprise that conspired to hide the dangers of smoking and impact on human health.

The good news is we know how to end the tobacco use problem in this country. There are key evidence-based interventions that have been proven to lead tobacco-users to quit, prevent youth from starting to use tobacco and reduce consumption among tobacco users. These interventions include increasing tobacco taxes, implementing comprehensive smoke-free laws, warning about the dangers of tobacco use with media campaigns, and increasing access to evidence-based cessation services.

Of this list of interventions, increasing the price of tobacco is one of the most effective tobacco prevention tools available for public health. And that is what I am here to talk to you about today.

Federal Cigarette Tax – 2009

Excise taxes are the most direct way for governments to increase the price of tobacco products. Every 10% increase in the price of cigarettes results in a 4% decline in consumption, and can have an even greater impact on youth and other price sensitive populations. Simply put, as cigarette and tobacco prices increase, people smoke less. Every state and the Federal government implements a tax on tobacco, with state cigarette taxes ranging from 17 cents per pack in Missouri to $4.35 per pack in New York State. The national average state excise tax for cigarettes is $1.54 per pack.

The Federal excise tax for tobacco products was increased on April 1, 2009. While the tax on most products (cigarettes, snuff and pipe tobacco) was increased by the same percentage, (see table) the tax on small cigars and roll-your-own tobacco increased by a greater amount to make those rates equivalent to the tax on cigarettes.

Federal Tobacco Tax Rates

Product	Tax prior to April 1, 2009	Tax as of April 1, 2009
Cigarettes	$0.39 per pack of 20	$1.01 per pack of 20
Small Cigars	$0.04 per every 20	$1.01 per every 20
Large Cigars	20.72% of sales price	52.75% of sales price
Snuff	$0.59 per pound	$1.51 per pound
Pipe Tobacco	$1.01 per pound	$2.83 per pound
Roll-Your-Own Tobacco	$1.01 per pound	$24.78 per pound

The issue we are discussing today is an unfortunate consequence of tax inequity between pipe tobacco and large cigars and other combustible products. As outlined in a Morbidity Mortality Weekly Report (MMWR) I authored with my CDC colleagues Gabbi Promoff, Tim McAfee and Terry Pechacek, the consumption of pipe tobacco and large cigars increased substantially after the federal tobacco excise tax was increased in 2009. (http://www.cdc.gov/mmwr/preview/mmwrhtml/mm6130a1.htm)

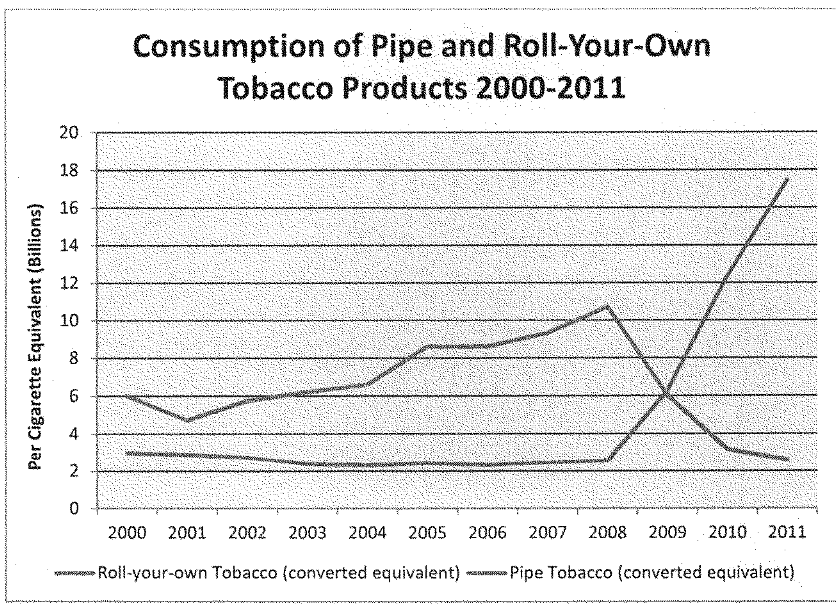
That MMWR attributed these changes to tax disparities created by the 2009 Federal tobacco tax increase that made 1) pipe tobacco less expensive than roll-your-own tobacco and manufactured cigarettes, and 2) large cigars less heavily taxed than small cigars and manufactured cigarettes.

Pipe and Roll-Your-Own Tobacco Consumption

Pipe tobacco and roll-your-own tobacco are typically classified for tax purposes based on the labeling, rather than physical characteristics (e.g. cut of loose tobacco, moisture profile).

Prior to the 2009 increase, the Federal tax on pipe and roll-your-own tobacco were the same. However, the 2009 tobacco tax changes resulted in the tax for roll-your-own tobacco being $21.95 per pound more than the tax on pipe tobacco.

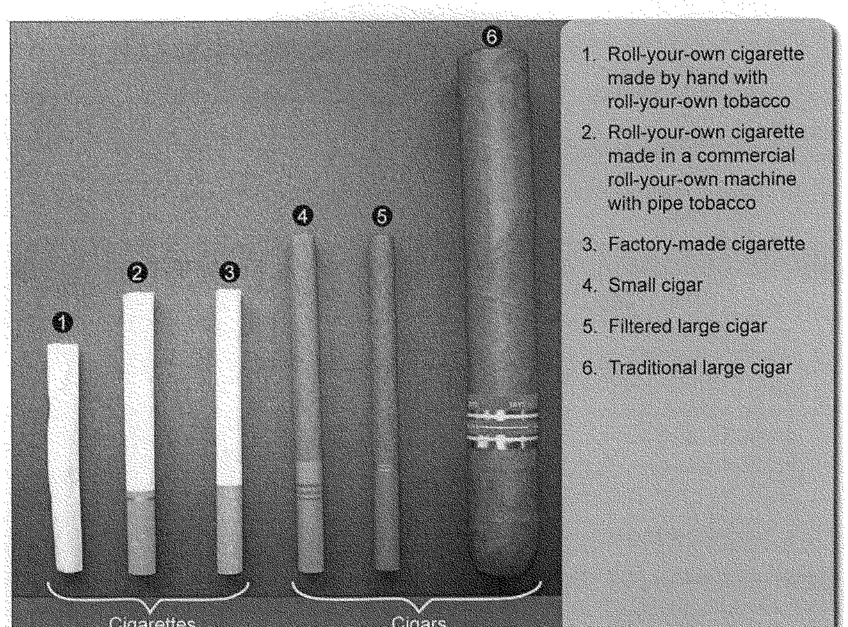
After the tax changes became effective, manufacturers began to re-label roll-your-own tobacco as pipe tobacco, making these products available to consumers at a lower price. Changes in consumption for pipe and roll-your-own tobacco were fully outlined in the MMWR, and are represented by the figure below, which calculates pipe and roll-your-own consumption based on Federal excise tax receipts.



Large and Small Cigar Consumption

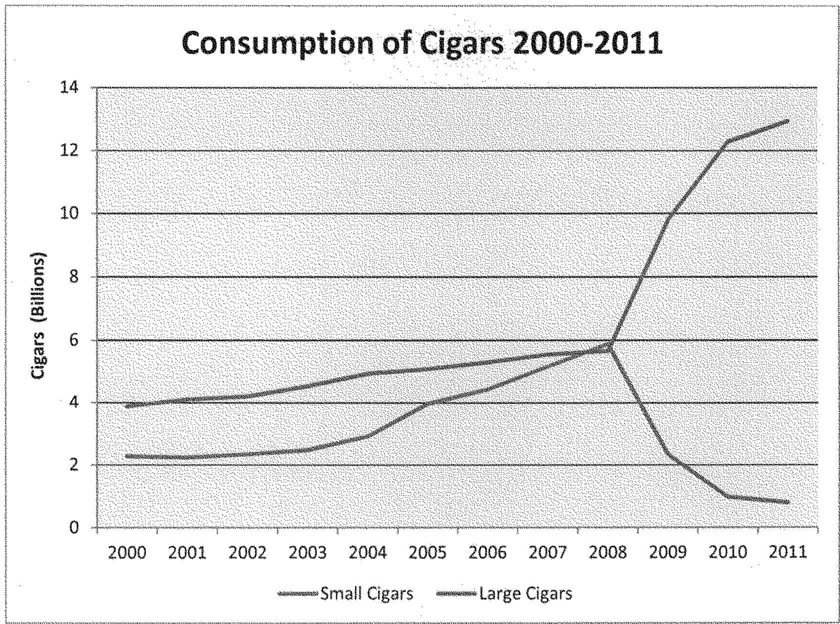
Cigars are primarily differentiated from cigarettes based on their wrapper, with cigarettes typically being wrapped in white paper and cigars being wrapped in brown tobacco leaf. Small cigars and large cigars are differentiated in the tax code based on their weight per thousand, with small cigars weighing 3 pounds or less per thousand.

For cigars, manufacturers were able to increase the per-unit weight of certain small cigars to take advantage of a lower tax when classified as large cigars. This is because large cigars are taxed based on product price, while small cigars are taxed per cigar. As a result of relatively minor increases in per-cigar weight, the new "large cigar" can appear almost identical to a "small cigar," which can resembles a typical cigarette.



Source: Government Accountability Office. Tobacco taxes: large disparities in rates for smoking products trigger significant market shifts to avoid higher taxes. Report 12-475.

Changes in consumption for cigars were fully outlined in the MMWR, and are represented by the figure below, which calculates cigar consumption based on Federal excise tax receipts.



Use of Automated Rolling Machines in Retail Stores

Tobacco retailers in some states began offering customers the use of automated cigarette rolling machines that could produce the equivalent of one carton of traditional cigarettes in approximately 8 minutes. By using tobacco labeled as pipe tobacco, cigarettes produced by these machines were much less expensive than factory-made cigarettes or cigarettes actually made from tobacco labeled as roll-your-own.

In a 2012 report published by the Government Accountability Office, researchers were able to use one of these machines to make 200 cigarettes using tobacco labeled as pipe tobacco for $25. As a comparison, GAO reported that a carton of 200 discount cigarettes would cost $51.50 and a carton of 200 brand-name cigarettes would cost $69.50. (http://www.gao.gov/assets/600/590192.pdf).

Today, it is still possible to purchase a one pound bag of pipe tobacco online for about $10 to use for roll-your-own purposes. Considering that 0.0325 oz (0.9 g) of tobacco is needed to produce each cigarette, one pound of tobacco will produce 492 cigarettes (approximately two and half cartons). As a comparison, a single carton of 200 brand-name cigarettes costs approximately $45 in Oregon.

First Study on the Impact on Federal Revenue

Using data from Federal tax receipts, I published a study with my colleague Dr. Daniel Morris that quantified the impact that these changes in consumption for pipe and roll-your-own tobacco had on revenue at the Federal and state level. (http://www.plosone.org/article/info%3Adoi%2F10.1371%2Fjournal.pone.0036487)

That study, which was published in 2012, found that from April 2009 through August 2011, Federal excise tax collections were lowered by $985 million, and state excise tax and sales tax revenue declined by $374 million. (Note: The reason state tobacco tax revenue declined is because most states levy taxes on pipe and RYO tobacco as a percentage of the product's overall price; therefore a lower Federal excise tax ultimately reduces states' excise and sales tax collections for tobacco products as well.)

After this study and the GAO report were published, a provision was included in the 2012 Federal Highway Bill that prohibited retailers from offering automated roll-your-own machines unless they registered as a tobacco manufacturer with the Federal government. Because of the fees and regulatory oversight associated with becoming a tobacco manufacturer, this provision was expected to remove these machines from retail space.

Continued Impact on Federal Revenue after the Highway Bill provision

To evaluate the impact of the tobacco tax provisions in the Federal Highway Bill, Dr. Daniel Morris, Tara Weston and I replicated the previously discussed study with data through June 2013. (http://tobaccocontrol.bmj.com/content/early/2014/04/10/tobaccocontrol-2013-051531)

In this paper that was published in April 2014, we found that while the amount of roll-your-own tobacco taxed as pipe tobacco climbed steadily from April 2009 to June 2012, it leveled off following the July 2012 enactment of the Highway Bill.

Updating the lost revenue figure, our new study found that from April 2009 through June 2013, Federal excise tax collections were reduced by a total of $2.36 billion.

This study found that while the Federal Highway Bill did, at least temporarily, level off the increase in pipe tobacco consumption, pipe tobacco rates did not return to pre-2009 levels or show any rate of decline. Therefore the Highway Bill was not effective at correcting the market shift that occurred in response to the tax disparity. Even without access to commercial rolling machines, smokers are continuing to take advantage of the tax disparity.

Impact on Health

Tax structures that provide tobacco users with an opportunity to switch to other low-cost tobacco products not only result in lower government revenue from these products, but also blunt the public health impact that excise tax increases would otherwise have on public health – specifically in preventing youth initiation, reducing tobacco consumption and prompting quit attempts. In this instance, roll-your-own and manufactured cigarette smokers who may otherwise quit instead have been able to maintain their addiction by switching to lower priced products.

Additionally, Food and Drug Administration tobacco regulations that apply to cigarettes and roll-your-own tobacco **do not fully** apply to pipe tobacco or cigars. This means that tobacco products that have a pipe label and cigarette-like cigars can be sold in candy flavors and with misleading descriptors such as light, mild and low. This is concerning to the public health community because the practice has been banned for cigarettes and roll-your-own and because, as the Surgeon General found, flavored tobacco products are appealing to youth.

Smoke from pipe tobacco, roll-your-own tobacco and cigars contain the same toxic chemicals as cigarette smoke. The evidence that the increase in cigar and pipe tobacco use is the result of cigarette smokers having access to low-priced alternative products is a public health concern, because the morbidity and mortality effects of other forms of combustible tobacco are similar to those of cigarettes.

Potential Policy Tools

At least two policy approaches can address these tax and policy loopholes:

- Establish objective standards to classify tobacco products
- Achieve tax parity among all tobacco products

One approach is for Federal regulatory agencies to distinguish objective standards for roll-your-own and pipe tobacco, rather than allowing companies to self-classify if a product is pipe or roll-your-own based on the label. Standards are needed based on measurable, objective characteristics.

The other approach—which is more direct—involves tax parity. The 2009 tax increase created tax parity for cigarettes and roll-your-own to discourage switching between these products. The issue we are discussing today is an unfortunate consequence of tax inequity between pipe tobacco and large cigars and other combustible products. Tax parity for combustible tobacco products would expand the public health benefit of the 2009 Federal tobacco tax increase.

Without a solution, states and the Federal government will continue to lose revenue, and there will be a low-cost alternative product available that is attractive to smokers who may have otherwise quit.

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Fiscal and Policy Implications of Selling Pipe Tobacco for Roll-Your-Own Cigarettes in the United States

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Abstract

Background: The Federal excise tax was increased for tobacco products on April 1, 2009. While excise tax rates prior to the increase were the same for roll-your-own (RYO) and pipe tobacco, the tax on pipe tobacco was $21.95 per pound less than the tax on RYO tobacco after the increase. Subsequently, tobacco manufacturers began labeling loose tobacco as pipe tobacco and marketing these products to RYO consumers at a lower price. Retailers refer to these products as "dual purpose" or "dual use" pipe tobacco.

Methods: Data on tobacco tax collections comes from the Alcohol and Tobacco Tax and Trade Bureau. Joinpoint software was used to identify changes in sales trends. Estimates were generated for the amount of pipe tobacco sold for RYO use and for Federal and state tax revenue lost through August 2011.

Results: Approximately 45 million pounds of pipe tobacco has been sold for RYO use from April 2009 to August 2011, lowering state and Federal revenue by over $1.3 billion.

Conclusions: Marketing pipe tobacco as "dual purpose" and selling it for RYO use provides an opportunity to avoid paying higher cigarette prices. This blunts the public health impact excise tax increases would otherwise have on reducing tobacco use through higher prices. Selling pipe tobacco for RYO use decreases state and Federal revenue and also avoids regulations on flavored tobacco, banned descriptors, prohibitions on shipping, and reporting requirements.

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Competing Interests: The authors have read the journal's policy and have the following conflict: DM works for the Oregon Tobacco Prevention and Education Program and is paid in part with Measure 44 tobacco tax revenues. If the federal tobacco tax disparity between pipe and RYO tobacco were closed, tobacco-tax funded state programs like TPEP would see an increase in funding. This does not alter the authors' adherence to all the PLoS ONE policies on sharing data and materials.

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Introduction

Increasing the price of tobacco products is an evidence-based intervention that prevents initiation of tobacco use among adolescents and young adults, reduces consumption of tobacco, and increases quit attempts [1–4]. Excise taxes are the most direct way for governments to increase the price of tobacco products [2,4]. However, tobacco users may seek sources of lower priced tobacco products in response to a price increase instead of quitting tobacco use or reducing consumption, undermining the public health impact of the tax increase [5]. Strategies employed to avoid paying higher prices include, but are not limited to, crossing state borders to purchase products in states with a lower excise tax; purchasing no-to-low taxed products over the internet or at Native American reservations; purchasing no-to-low taxed products on the black market; switching to discount brands; or making roll-your-own (RYO) cigarettes [5–9]. Tobacco manufacturers have also reformulated or re-labeled products to capitalize on disparities between tax rates on different types of tobacco products and minimize the impact taxes have on product prices [10].

The Federal excise tax for tobacco products was increased on April 1, 2009 (Table 1) [11]. While the tax on cigarettes, snuff and pipe tobacco was increased by 158%, the tax on small cigars and RYO tobacco increased by a greater amount to make those rates equivalent to the tax levied on cigarettes [11]. Previously, the excise tax rates for RYO and pipe tobacco were the same, but after the increase, the tax on pipe tobacco was $21.95 per pound less than the tax on RYO tobacco [11].

After this tax disparity developed, RYO manufacturers began to label loose tobacco as pipe tobacco, making these products available to RYO consumers at a lower price [10,12]. As Morris showed, as soon as the tax rates changed, the amount of loose tobacco taxed as RYO declined dramatically, while the amount of loose tobacco taxed as pipe tobacco increased [10]. This practice was possible because, even though pipe tobacco and RYO tobacco traditionally have different physical characteristics (i.e. pipe tobacco is coarser and moister than RYO tobacco), for practical purposes the products are taxed and regulated according to the label on the packaging [12–14]. A lower price was realized

Table 1. Change in federal excise tax for all tobacco products, April 1, 2009.

Product	Tax Prior to April 1, 2009	Tax as of April 1, 2009
Cigarettes	$19.50 per 1,000	$50.33 per 1,000
Small Cigars	$1.83 per 1,000	$50.33 per 1,000
Large Cigars	20.72% of sales price, $0.05 maximum per cigar	52.75% of sales price, $0.4026 maximum per cigar
Snuff	$0.59 per pound	$1.51 per pound
Pipe Tobacco	$1.01 per pound	$2.83 per pound
Roll Your Own	$1.01 per pound	$24.78 per pound

doi:10.1371/journal.pone.0036487.t001

because the Federal excise tax is paid by manufacturers who pass the cost to consumers through the final retail price. Additionally, because most states levy ad valorem taxes on pipe and RYO tobacco (i.e. taxes as a percentage of the product's overall price) [15], a lower Federal tax ultimately reduces states' excise and sales tax collections for tobacco products as well.

Loose tobacco labeled as pipe tobacco is being offered to consumers for making cigarettes. For example, starter kits are being sold that include a table-top injector machine, a box of cigarette tubes, and a bag of loose tobacco labeled "pipe tobacco" [16]. In addition, tobacco retailers in some states are offering customers the use of commercial cigarette rolling machines that can produce the equivalent of one carton of traditional cigarettes (i.e. 200 cigarettes) in approximately 8 minutes [17]. By using loose tobacco labeled as pipe tobacco, cigarettes produced by these machines are less expensive than factory-made cigarettes or cigarettes made from tobacco labeled as RYO [18–21].

Sellers of make-your-own cigarettes supplies use a range of terms to describe their products, including "dual purpose tobacco", "dual use tobacco" or "multi-use tobacco." This terminology helps prevent taxation of loose tobacco at the RYO rates. One online retailer posted "*This dual purpose tobacco is a highly recommended low-cost alternative to the standard cigarette tobacco. 'Dual Purpose Tobacco' is also called 'Alternative Tobacco' and 'Pipe Cut Tobacco.' 'Pipe-cut' pipe tobacco is the same as cigarette tobacco, with exception to the leaf being cut a little wider. Dual purpose pipe-cut tobacco is a dry tobacco works well with all of our cigarette machines and cigarette tubes.*" [22]

This study quantifies the effect the Federal tax increase had on loose tobacco sales, and describes the policy and revenue implications of marketing pipe tobacco as "dual purpose" and selling it for RYO use, including estimating the total Federal and state revenue lost.

Methods

Data on quantities of tobacco taxed in the United States between January 2007 and August 2011 come from monthly reports published by the Department of Treasury's Alcohol and Tobacco Tax and Trade Bureau (TTB) [23]. TTB collects Federal excise taxes on tobacco products that are intended for sale in the United States. State-specific pipe and RYO tobacco excise tax rates, sales tax rates on tobacco products, and cigarette sales volumes are from the Tax Burden on Tobacco [15].

Microsoft Excel 2010 and Adobe Illustrator CS3 were used to graph data. We used Joinpoint software to describe changes in loose tobacco sales trends (pipe tobacco plus RYO). The National Cancer Institute publishes Joinpoint software as a tool for assessing public health trends [24]. Joinpoint fits a segmented regression model to trend data, identifying the points where the segments meet and the trend changes (the "joinpoints") [25]. We specified a linear model assuming constant variance in the dependent variable.

To calculate revenue loses, TTB data were used to estimate the amount of loose tobacco marketed as pipe tobacco and sold for RYO use since the April 2009 federal tax change. In the 12 months prior to the tax increase, an average 432,000 pounds of pipe tobacco were taxed per month; this number is the baseline for comparison. For each month from April 2009 through August 2011, the difference between the amount of pipe tobacco taxed and the baseline amount was assumed to indicate the quantity of pipe tobacco sold for RYO use. The sum of the monthly differences is the cumulative amount (Equation 1).

$$\text{National estimate for lbs. of pipe tobacco sold for RYO use} = \sum_{\text{April 2009}}^{\text{August 2011}} (\text{Taxed pipe tobacco} - \text{baseline taxed pipe tobacco}) \tag{1}$$

State-specific cigarette sales data are readily available, but few states report pipe tobacco sales data. To generate state-specific sales estimates for pipe tobacco sold for RYO use, we assumed that tobacco sales for RYO use were proportional to state cigarette sales [15]. We therefore used state cigarette sales data to establish the proportion of national cigarette sales that occurred in each state. These proportions were multiplied by the total estimated amount of pipe tobacco sold for RYO use nationally to get state-level estimates for each month. (Equation 2)

$$\text{State estimate for lbs. of pipe tobacco sold for RYO use} = (\text{National estimate for lbs. of pipe tobacco sold for RYO use}) \times \left(\frac{\text{State cigarette sales 2008 through 2010}}{\text{National cigarette sales 2008 through 2010}}\right) \tag{2}$$

Most states levy the same excise tax rate on pipe and RYO tobacco, and base the tax on the wholesale or manufacturer's price for the product [15]. The manufacturer's price includes the federal tax, and after April 2009 the federal tax on pipe tobacco was $21.95/lb. lower than the tax on RYO tobacco [26]. Because loose tobacco sold for RYO use is less expensive at retail when it is taxed as pipe tobacco, it results in lower state excise and sales taxes being levied on the now less expensive product. Equation 3 shows the calculation for state excise tax losses used for most states. A similar calculation was used to estimate lost sales tax revenue.

Two states (ND and VT) tax RYO tobacco by the pound but tax pipe tobacco based on its price. For those states, we first calculated the amount of pipe tobacco sold for RYO use (Equation 2). We then calculated the total value of state excise tax for that amount of tobacco if it were taxed as RYO, then if it were taxed as pipe tobacco. The difference between the two totals represents the lost state excise tax revenue. Two states (AL and AZ) tax both pipe and RYO by the pound; for those states the difference in federal excise tax rates does not affect state excise tax collections, but does affect sales tax collections because sales taxes are based on price.

$$\begin{aligned}&\text{State estimate for excise tax revenue loss}\\&=\sum_{\text{April2009}}^{\text{August2011}}((\text{State estimate for lbs. of pipe}\\&\text{tobacco sold for RYO use})\\&\times(\text{Difference in federal tax rates}\\&\text{between RYO and pipe})\\&\times(\text{State excise tax rate on pipe tobacco}))\end{aligned} \tag{3}$$

Results

Joinpoint analysis identified two inflection points in the loose tobacco sales data: January 2009, when Congress passed the Federal tax increase ($p<.001$); and April 2009, when the tax changes took effect ($p<.001$) (Figure 1). The fit line on the figure shows loose tobacco production was increasing by 15% annually prior to January 2009, mainly due to increases in RYO sales. This is consistent with studies showing gradual increases in RYO use in the United States [9]. Loose tobacco production dipped after the Federal tax increase was enacted, but only until the new tax rates went into effect. Since April 2009, loose tobacco production has increased by 31% annually, twice as fast as before the tax was changed.

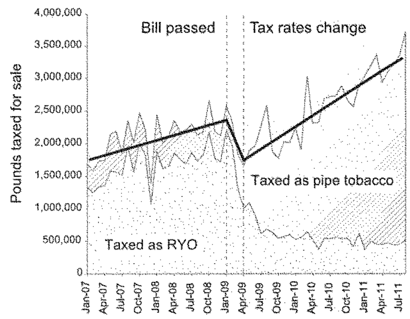
From April 2009 through August 2011, nearly 45 million pounds of pipe tobacco was sold for RYO use, lowering Federal excise tax collections by \$985 million and lowering state sales and excise tax collections by more than \$374 million (Table 2). When combined, over \$1.36 billion has been lost in total state and Federal revenue as the result of this practice.

State revenue losses range from \$63 million in Florida to \$117,000 in Vermont. Eleven states have each lost over \$10 million (CA, FL, IN, MI, MN, OH, NY, OK, TX, WA, WI), with lost revenue in those states accounting for 62 percent of all state revenue from RYO tobacco taxes lost.

Discussion

The tax discrepancy between RYO and pipe tobacco offered an opportunity for tobacco manufacturers to lower the price consumers pay for loose tobacco used for making RYO cigarettes. Our analysis indicates that this approach led to a substantial increase in the sale of loose tobacco sold for RYO purposes, and in overall loose tobacco sales.

While rates of make-your-own cigarette use in the United States were increasing slowly before the tax change [9], the dramatic shift in sales after April 2009 can be partially explained by manufacturers labeling loose tobacco as pipe tobacco, allowing retailers to



Data source: Alcohol and Tobacco Tax and Trade Bureau

Figure 1. Roll-your-own (RYO) and pipe tobacco sales in the United States, January 2007–August 2011. This stacked area graph shows the total amount of loose tobacco (RYO and pipe tobacco) sales in the United States. The joinpoint fit line shows loose tobacco production was increasing by 15% annually prior to January 2009, mainly due to increases in RYO sales. Loose tobacco production dipped after the Federal tax increase was enacted, but only until the new tax rates went into effect in April 2009. Since April 2009, loose tobacco production has increased by 31% annually, twice as fast as before the tax was changed.
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offer these products to RYO consumers at a lower price [12]. One factor that may have contributed to the sudden increase in RYO sales was the emergence of automated cigarette-rolling machines in retail stores.

Federal government and state government agencies have taken actions to attempt to curtail these tax revenue losses. For example, TTB, in its authority as the agency responsible for collecting Federal excise taxes, issued a ruling in September 2010 that found that retailers offering cigarette rolling machines are manufacturers of tobacco products, and are thus required to pay the Federal tax on all cigarettes that are produced [17]. Retailers sued TTB and a preliminary injunction was issued by the United States District Court for the Northern District of Ohio on December 14, 2010, preventing TTB from enforcing its ruling while the case remains pending [27]. As of March 2012 this court case was still pending. At the state level, New Hampshire's State Supreme Court ruled that by offering cigarette rolling machines, retailers would be classified as cigarette manufacturers and as a result would be subject to the Master Settlement Agreement, and be required to submit payments to the state for each cigarette that is produced [28]. Additionally, in March 2011, Arkansas enacted a law to prohibit licensed tobacco retailers from possessing or otherwise utilizing a cigarette rolling machine [29]. Also, the Wisconsin Department of Revenue issued a notice in September 2011 that ruled that retailers that offer cigarette rolling machines are classified as manufactures, and considers the final product to be a manufactured cigarette subject to cigarette excise taxes [30].

Selling pipe tobacco for RYO use avoids other laws and regulations as well. For example, the Prevent All Cigarette Trafficking (PACT) Act of 2009 prohibits the U.S. Postal Service from shipping cigarettes, RYO, and smokeless tobacco, but does not prohibit shipping pipe tobacco [31]. This allows internet sites to continue to sell and ship pipe tobacco marketed for RYO use.

Table 2. $374 million in state revenue losses from RYO sold as pipe tobacco, April 2009–August 2011.

State	Revenue lost	State	Revenue lost
Florida	$63,090,040	Mississippi	$3,621,319
Texas	$31,230,931	Nevada	$3,593,092
California	$27,729,785	Connecticut	$3,155,720
New York	$16,949,733	Maryland	$2,948,031
Wisconsin	$16,648,628	Pennsylvania	$2,774,241
Oklahoma	$16,051,628	South Carolina	$2,738,305
Washington	$13,239,829	Rhode Island	$2,659,804
Minnesota	$13,049,342	Idaho	$2,453,330
Michigan	$12,718,593	Hawaii	$2,418,164
Ohio	$10,417,761	Utah	$2,029,489
Indiana	$10,083,434	Nebraska	$1,777,368
Arkansas	$9,679,677	West Virginia	$1,681,977
Illinois	$9,372,385	Montana	$1,524,148
Louisiana	$8,662,924	Alaska	$1,495,507
North Carolina	$7,737,982	Kansas	$1,353,789
Kentucky	$7,621,484	New Mexico	$1,267,201
Oregon	$7,505,630	Maine	$1,160,792
New Jersey	$6,937,258	Delaware	$1,005,273
Colorado	$6,044,448	South Dakota	$990,878
Iowa	$6,016,351	Alabama	$874,862
Massachusetts	$5,834,113	Wyoming	$632,761
Virginia	$5,430,809	Arizona	$627,551
Missouri	$5,257,990	North Dakota	$457,065
Georgia	$5,132,795	District of Columbia	$222,772
New Hampshire	$4,429,013	Vermont	$116,874
Tennessee	$3,954,684		

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Further, the PACT Act requires sellers to report on quantities of cigarettes, RYO, and smokeless tobacco shipped to each state and tax administrators use this information to ensure all state taxes have been paid. There is no such reporting requirement on sales of pipe tobacco.

Additionally, the Family Smoking Prevention and Tobacco Control Act (Tobacco Control Act) prohibits candy-flavored cigarettes and RYO, but does not prohibit flavorings in pipe tobacco [32]. Brands of pipe tobacco sold for RYO use come in blackberry, black cherry, and vanilla flavors [22]. The Tobacco Control Act also prohibits the use of the descriptors "light," "mild," or "low," or similar descriptors in tobacco product labeling or advertising [32]. However, some pipe tobacco brands sold for RYO use still carry these descriptors [33].

This study has at least five limitations. First, we assumed that all pipe tobacco sales that exceeded the April 2009 baseline represented sales of pipe tobacco marketed for RYO use. This appears to be a reasonable assumption, given trends in pipe tobacco sales prior to the April 2009 tax increase. Second, for this study, the proportion of national cigarette sales that occur in each state is used as a proxy for the proportion of RYO tobacco sales in each state, causing actual RYO and pipe tobacco sales to vary from the estimates presented. This calculation also does not take into account different excise tax rates on non-cigarette tobacco products, which could further explain state-to-state variation in RYO tobacco use. Third, estimates do not factor in distributor or retailer markups. State excise and sales taxes are levied on products after these markups. Fourth, revenue lost estimates do not account for background trends in pipe tobacco sales prior to April 2009, although pipe tobacco sales were relatively flat during this period [23]. Finally, this study did not attempt to quantify changes in the number of taxed packs of cigarettes sold due to smokers switching from manufactured cigarettes to make-your-own cigarettes. Overall, these limitations mean our revenue loss estimates are likely conservative.

Conclusion

Increasing excise taxes is one of the most effective evidence-based strategies for reducing tobacco use [1–4]. However, tax structures that provide tobacco users with an opportunity to switch to other low-cost tobacco products not only result in lower Federal and state revenue from these products, but also blunt the public health impact that excise tax increases would otherwise have on preventing youth initiation, reducing cigarette consumption and prompting quit attempts. In this instance, RYO and traditional cigarette smokers who may otherwise quit can instead maintain their addiction with lower priced products.

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Author Contributions

Conceived and designed the experiments: DSM MAT. Performed the experiments: DSM. Analyzed the data: DSM. Wrote the paper: DSM MAT.

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Brief report

Continued implications of taxing roll-your-own tobacco as pipe tobacco in the USA

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ABSTRACT

Background In 2009, a US$21.95 per pound disparity was created in the Federal excise tax between roll-your-own cigarette tobacco (RYO) and pipe tobacco in the USA. After this disparity was created, pipe tobacco sales increased and RYO sales declined as some manufacturers repackaged roll-your-own tobacco as pipe tobacco and retailers began to offer cigarette rolling machines for consumers to use. A Federal law was passed in 2012 limiting the availability of these machines, however, it was unclear what impact this law had on the sales of roll-your-own tobacco labelled as pipe tobacco.

Methods The quantity of RYO sold as pipe tobacco each month was estimated using objective data on Federal excise taxes.

Results From April 2009 through June 2013, 107 million pounds of RYO were sold as pipe tobacco, reducing Federal excise tax collections by US$2.36 billion. The amount of RYO taxed as pipe tobacco climbed steadily and then levelled off following the July 2012 Federal law.

Conclusions The Federal law did not correct the market shift that occurred in pipe and RYO sales beginning in 2009. Even without access to commercial rolling machines, smokers are continuing to take advantage of the tax disparity. Without a solution, states will continue to lose revenue, and smokers who would otherwise quit will continue to have a low-cost alternative product available for purchase. Potential solutions include: (1) US Treasury Department distinguishing between RYO and pipe tobacco based on physical characteristics and (2) changing the Federal excise tax so that RYO and pipe tobacco are taxed at the same rate.

INTRODUCTION

Increasing the price of tobacco products is among the most effective methods to reduce tobacco use, prompt cessation and prevent youth initiation.[1 2] Increasing taxes is the most direct way for governments to increase cigarette prices.[2] Federal taxes on all tobacco products increased in the USA on 1 April 2009, but not by the same amount.[3] A US $21.95 per pound tax disparity was created between roll-your-own cigarette tobacco (RYO) and pipe tobacco, when previously the taxes on these products had been the same.[4] After the tax change, pipe tobacco sales increased and RYO sales declined in a manner that was described by the US Government Accountability Office as a 'significant market shift to avoid higher taxes'.[4] A previous analysis found that from April 2009 through August 2011, smokers avoided paying over $1 billion in state and Federal tobacco taxes by making cigarettes with RYO labelled as pipe tobacco.[5]

According to Federal law, RYO is defined as 'any tobacco which, because of its appearance, type, packaging, or labelling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes or cigars, or for use as wrappers thereof.'[6 7] Even though pipe tobacco and RYO have different physical characteristics (ie, pipe tobacco is coarser and moister than RYO), in practice, the products are taxed and regulated according to how manufacturers label them. After the Federal tobacco tax changed in 2009, manufacturers repackaged RYO as pipe tobacco,[8 9] causing the market shift in sales to occur. Some manufacturers have acknowledged that they knew the tobacco would be used for making cigarettes, even though it was labelled as pipe tobacco.[4]

According to findings from the International Tobacco Control (ITC) Four Country Survey, RYO cigarettes users are more likely to be male, younger, have a lower income, and typically cite cost as a reason for use.[10 11]

While rolling cigarettes by hand is time-consuming, cigarette rolling machines can stuff loose tobacco into preformed cigarette tubes more quickly. Hand-cranked and motorised rolling machines are available for home use. Additionally, larger self-service, commercial rolling machines exist that can produce 200 cigarettes in 8 min.[4 12] Retailers across the country began offering these RYO machines, allowing customers to make cigarettes that were less expensive than factory-made cigarettes, or cigarettes made with tobacco labelled as RYO.[4 13–16] This resulted in RYO cigarettes made with pipe tobacco being sold for one-third the price of commercial cigarettes.[4] The introduction of these commercial rolling machines coincided with the tax disparity,[4] offering smokers who may have otherwise quit an opportunity to switch to a less expensive alternative product.[5]

To stop the loss of tobacco tax revenues, the US Department of Treasury issued a notice in 2010 deeming stores with RYO machines as cigarette manufacturers.[12] Retailers sued and won an injunction preventing enforcement.[17] However, before the case was resolved, a provision which settled the issue was included in the Federal law which reauthorised highway programmes through 2014 (Highway Bill).[18] The provision required retailers who maintain commercial cigarette-making machines to register as cigarette manufacturers as of July 2012.[18] The Highway Bill is otherwise unrelated to tobacco prevention, but was used by lawmakers as a legislative vehicle to enact this provision. Due to increased fees and regulations, this law was expected to eliminate RYO machines in retail stores.[19] This study was conducted to assess

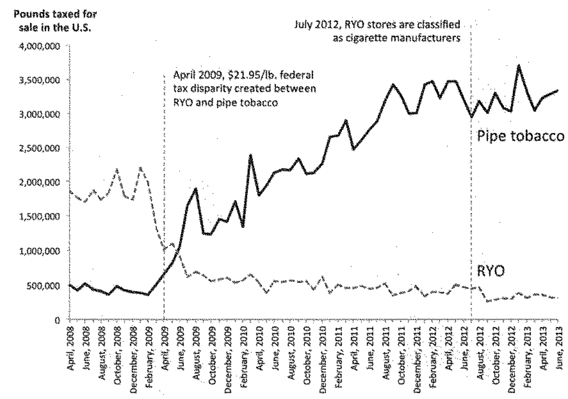

Figure 1 Market shift in sales of roll-your-own (RYO) and pipe tobacco sales in the USA, April 2008–June 2013.

whether the law had an impact on the sale of RYO labelled as pipe tobacco.

METHODS

Data on quantities of tobacco taxed in the USA are from monthly reports published by the Department of Treasury's Alcohol and Tobacco Tax and Trade Bureau (TTB).[20] Methods from the authors' previous study were replicated to estimate the quantity of RYO sold as pipe tobacco each month.[5]

In the 12 months prior to the April 2009 tax increase, an average of 432 000 pounds of pipe tobacco were taxed per month; this number is the baseline for comparison. The monthly quantity of RYO sold as pipe tobacco is estimated as the amount of pipe tobacco taxed over the baseline. To determine the effect of the Highway Bill, trends in the months before and after July 2012 were compared.

RESULTS

From April 2009 through June 2013, 107 million pounds of RYO were sold as pipe tobacco, reducing Federal excise tax collections by $2.36 billion. The amount of RYO taxed as pipe tobacco climbed steadily from April 2009 to June 2012, then levelled off following the July 2012 enactment of the Highway Bill (figure 1).

DISCUSSION

The Federal Highway Bill did halt, at least temporarily, the steady increase in loose tobacco sales (pipe and RYO tobacco combined). However, sales of RYO labelled as pipe tobacco do not appear to be declining, so the Highway Bill was not effective at correcting the market shift that occurred in response to the tax disparity. Even without access to commercial rolling machines, smokers are continuing to take advantage of the tax disparity.

It is not clear from these data how many smokers still make cigarettes using commercial-grade machines sold in stores, or how many of these machines still exist, though the US Treasury Department has pursued legal action against some businesses that have failed to comply with the law. For example, some retailers claimed not to be subject to regulation because they self-identified as a club or non-profit, while others indicated that consumers were 'renting' use of the machine.[21] However, the US Treasury Department and some states insisted that these retailers would still be classified as manufacturers.[19 21 22] An assessment of the incidence of RYO machines still in stores would clarify this issue; and machines still operating would signal the need for enhanced enforcement.

One limitation of this study is that revenue loss estimates do not account for background trends in pipe tobacco sales prior to April 2009. However, because pipe tobacco sales were slowly declining during this period, the estimates of revenue losses are likely conservative. Another limitation is that this study did not estimate losses sustained by states. However, as established in the authors' previous paper,[5] most state taxes on pipe and RYO tobacco are ad valorem (ie, taxed as a percentage of overall product price), consequently, if a lower Federal tax results in lower product prices, that will also result in reduced state excise tax and sales tax collections.

CONCLUSION

Because the provision included in the Federal Highway Bill only addressed access to commercial rolling machines and did not address the tax disparity between pipe tobacco and RYO tobacco, consumers continue to have access to RYO tobacco labelled as pipe tobacco, a low-cost alternative product. Two approaches exist that will potentially address this issue.

The US Treasury Department could begin distinguishing RYO and pipe tobacco based on physical characteristics, rather than allowing companies to self classify if a product is pipe or roll-your-own based on the label. The absence of clear standards allows manufacturers to label RYO as pipe tobacco to avoid taxes and other regulations. Classifying products using measurable standards would give the agency responsible for collecting RYO taxes the power to determine what products are to be considered RYO. The US Treasury conducted a study of 40 products labelled as pipe tobacco and RYO before the 2009 tax change took effect, that compared physical characteristics of these products.[22] Furthermore, in 2010, Treasury proposed and accepted public comment on a regulation that would establish standards to distinguish between pipe tobacco and roll-your-own tobacco based on physical characteristics, however, this regulation has not been finalised.[23] In addition to addressing the price disparity, this approach could also address other regulatory issues, specifically the availability of flavoured tobacco. As established previously, there are pipe tobacco products that are sold for RYO purposes that are available in various flavours.[5] Even though the Food and Drug Administration (FDA) prohibits the sale of flavoured cigarettes and flavoured RYO, FDA tobacco regulations do not currently apply to pipe tobacco.[24]

Because tax parity for tobacco products eliminates opportunities for tax avoidance, a direct approach would be to tax RYO and pipe tobacco at the same rate.[4] This approach would also expand the public health benefit of the 2009 Federal tobacco tax increase, such as preventing smoking initiation and promoting cessation through increased tobacco product prices. Without a solution, the Federal government and states will continue to lose revenue, and smokers who would otherwise quit will continue to have a low-cost alternative product available for purchase.

What this paper adds?

- This study found that while a 2012 national law did halt the steady increase in pipe tobacco sales in the USA, the law did not correct the market shift that has occurred since 2009 when a price US$21.95 tax disparity was created between pipe and roll-your-own tobacco.
- This study illustrates that because the new national law only addressed availability of commercial rolling machines in retail stores—and did not address the tax disparity between pipe tobacco and roll-your-own tobacco—sales of pipe tobacco will likely continue at increased levels.
- If the tax disparity remains, the Federal government and states will continue to lose revenue, and smokers who would have otherwise quit will continue to have a low-cost alternative product available for purchase.

Correction notice This article has been corrected since it was published Online First. A repeat in the 'Correspondence to' section has been deleted.

Contributors MAT and DM designed the study. DM conducted the analysis. MAT, DM, TW reviewed and analysed the results. MAT drafted and revised the paper. DM and TW revised the paper.

Competing interests None.

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Consumption of Cigarettes and Combustible Tobacco — United States, 2000–2011

Smoking cigarettes and other combustible tobacco products causes adverse health outcomes, particularly cancer and cardiovascular and pulmonary diseases (*1*). A priority of the U.S. Department of Health and Human Services is to develop innovative, rapid-response surveillance systems for assessing changes in tobacco use and related health outcomes (*2*). The two standard approaches for measuring smoking rates and behaviors are 1) surveying a representative sample of the public and asking questions about personal smoking behaviors and 2) estimating consumption based on tobacco excise tax data (*3*). Whereas CDC regularly publishes findings on national and state-specific smoking rates from public surveys (*4*), CDC has not reported consumption estimates. The U.S. Department of Agriculture (USDA), which previously provided such estimates, stopped reporting on consumption in 2007 (*5*). To estimate consumption for the period 2000–2011, CDC examined excise tax data from the U.S. Department of Treasury's Alcohol and Tobacco Tax and Trade Bureau (TTB); consumption estimates were calculated for cigarettes, roll-your-own tobacco, pipe tobacco, and small and large cigars. From 2000 to 2011, total consumption of all combustible tobacco decreased from 450.7 billion cigarette equivalents to 326.6, a 27.5% decrease; per capita consumption of all combustible tobacco products declined from 2,148 to 1,374, a 36.0% decrease. However, while consumption of cigarettes decreased 32.8% from 2000 to 2011, consumption of loose tobacco and cigars increased 123.1% over the same period. As a result, the percentage of total combustible tobacco consumption composed of loose tobacco and cigars increased from 3.4% in 2000 to 10.4% in 2011. The data suggest that certain smokers have switched from cigarettes to other combustible tobacco products, most notably since a 2009 increase in the federal tobacco excise tax that created tax disparities between product types.

USDA's previous consumption estimates were based on 1) information from TTB, including data on products that are produced domestically or imported and taxed for legal sale in the United States; 2) tobacco industry reports; and 3) information from industry advisors. CDC developed a method to estimate consumption exclusively by using publicly available federal excise tax data available from TTB on products taxed domestically and imported into the United States (*6*). Using monthly tax data, CDC calculated the per unit (e.g., per cigarette or per cigar) consumption for each product. To enable comparisons with pipe tobacco and roll-your-own tobacco, CDC converted the tax data from pounds of tobacco to a per cigarette equivalent, based on the conversion formula contained in the Master Settlement Agreement (0.0325 oz [0.9 g] = one cigarette).* Adult per capita cigarette consumption was estimated by dividing total consumption by the number of persons aged ≥18 years in the United States each year using data from the U.S. Census Bureau. When compared with USDA's previous calculations for adult per capita cigarette consumption during 2000–2006, CDC's estimates differed each year by a median of only 0.15% and a mean of 0.76%.

From 2000 to 2011, total cigarette consumption declined from 435.6 billion to 292.8 billion, a 32.8% decrease (Table 1). Per capita cigarette consumption declined from 2,076 in 2000 to 1,232 in 2011, a 40.7% decrease. Conversely, total consumption of noncigarette combustible products increased

* Available at http://www.naag.org/backpages/naag/tobacco/msa/msa-pdf.

INSIDE

Continuing Education examination available at http://www.cdc.gov/mmwr/cme/conted_info.html#weekly.

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from 15.2 billion cigarette equivalents in 2000 to 33.8 billion in 2011, a 123.1% increase, and per capita consumption increased from 72 in 2000 to 142 in 2011, a 96.9% increase. Total consumption of all combustible tobacco decreased from 450.7 billion cigarette equivalents to 326.6, a 27.5% decrease from 2000 to 2011, and per capita consumption of all combustible tobacco products declined from 2,148 to 1,374, a 36.0% decrease.

Consumption of loose tobacco (i.e., roll-your-own cigarette tobacco and pipe tobacco) changed substantially from 2000 to 2011. Roll-your-own cigarette equivalent consumption decreased by 56.3%, whereas pipe tobacco consumption increased by 482.1% (Table 2). The largest changes occurred from 2008 to 2011, when roll-your-own consumption decreased from 10.7 billion to 2.6 billion (a 75.7% decrease), whereas pipe tobacco consumption increased from 2.6 billion to 17.5 billion (a 573.1% increase).

Substantial changes also were observed in consumption of small cigars[†] and large cigars (Figure 1). From 2000 to 2011, consumption of small cigars decreased 65.0%, whereas large cigar consumption increased 233.1% (Table 2). The largest changes occurred from 2008 to 2011, when small cigar consumption decreased from 5.9 billion to 0.8 billion (an 86.4% decrease), whereas large cigar consumption increased from 5.7 billion to 12.9 billion (a 126.3% increase).

[†] In 26 USC 5701, small cigars are defined as cigars that weigh ≥3 pounds (<1.36 kg) per 1,000 cigars, and large cigars are defined as cigars that weigh >3 pounds per 1,000.

Annual cigarette consumption declined each year during 2000–2011, including a 2.6% decrease from 2010 to 2011, but total consumption of combustible tobacco decreased only 0.8% from 2010 to 2011, in part because of the effect of continued increases in the consumption of noncigarette combustible tobacco products (Figure 2). From 2000 to 2011, the percentage of total combustible tobacco consumption composed of loose tobacco and cigars increased from 3.4% (15.2 billion cigarette equivalents out of 450.7 billion) to 10.4% (33.8 billion of 326.6 billion).

Reported by

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Editorial Note

Despite continued decreases in cigarette smoking in the United States, consumption of pipe tobacco and large cigars has increased substantially since the federal tobacco excise tax was increased in 2009, creating tax disparities that made 1) pipe tobacco less expensive than roll-your-own tobacco and manufactured cigarettes, and 2) large cigars less heavily taxed than small cigars and manufactured cigarettes (*7,8*). Because loose tobacco products are classified based on how they are labeled, the loose tobacco tax disparity of $21.95 per pound

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TABLE 1. Total consumption and adult per capita consumption* of cigarettes, all combustible tobacco,† and noncigarette combustible tobacco products§ — United States, 2000–2011

	Cigarettes				All combustible tobacco				Noncigarette combustible tobacco			
Year	Total consumption (in millions)	% change	Adult per capita consumption	% change	Total consumption (in millions)	% change	Adult per capita consumption	% change	Total consumption (in millions)	% change	Adult per capita consumption	% change
2000	435,570	—	2,076	—	450,725	—	2,148	—	15,155	—	72	—
2001	426,720	-2.0	2,010	-3.2	440,693	-2.2	2,075	-3.4	13,973	-7.8	66	-8.9
2002	415,724	-2.6	1,936	-3.7	430,763	-2.3	2,006	-3.4	15,040	7.6	70	6.4
2003	400,327	-3.7	1,844	-4.7	415,930	-3.4	1,916	-4.5	15,603	3.8	72	2.6
2004	397,655	-0.7	1,811	-1.8	414,421	-0.4	1,888	-1.5	16,766	7.5	76	6.2
2005	381,098	-4.2	1,717	-5.2	401,187	-3.2	1,807	-4.3	20,089	19.8	90	18.5
2006	380,594	-0.1	1,695	-1.3	401,241	>-0.1	1,787	-1.1	20,648	2.8	92	1.6
2007	361,590	-5.0	1,591	-6.1	384,087	-4.3	1,690	-5.4	22,497	9.0	99	7.7
2008	346,419	-4.2	1,507	-5.3	371,264	-3.3	16,15	-4.5	24,845	10.4	108	9.1
2009	317,736	-8.3	1,367	-9.3	342,124	-7.9	1,472	-8.9	24,388	-1.8	105	-2.9
2010	300,451	-5.4	1,278	-6.5	329,239	-3.8	1,400	-4.9	28,788	18.0	122	16.7
2011	292,769	-2.6	1,232	-3.6	326,577	-0.8	1,374	-1.9	33,808	17.4	142	16.2
% change, from 2000 to 2011		**-32.8**	**—**	**-40.7**	**—**	**-27.5**	**—**	**-36.0**	**—**	**123.1**	**—**	**96.9**

* Adults aged ≥18 years as reported annually by the U.S. Census Bureau.
† Includes cigarettes, small cigars and large cigars, and per-cigarette equivalents for pipe tobacco and roll-your-own tobacco based on the conversion rate in the Master Settlement Agreement: 0.0325 oz (0.9 g) of tobacco = one cigarette.
§ Includes all combustible products other than cigarettes.

TABLE 2. Total consumption of noncigarette combustible tobacco product, by product category and type — United States, 2000–2011

	Loose tobacco				Cigars			
Year	Roll-your-own* (in millions)	% change	Pipe* (in millions)	% change	Small cigars (in millions)	% change	Large cigars (in millions)	% change
2000	5,995	—	2,999	—	2,279	—	3,882	—
2001	4,714	-21.4	2,915	-2.8	2,239	-1.8	4,105	5.7
2002	5,737	21.7	2,757	-5.4	2,343	4.6	4,203	2.4
2003	6,207	8.2	2,389	-13.3	2,474	5.6	4,533	7.9
2004	6,600	6.4	2,314	-3.2	2,917	17.9	4,935	8.9
2005	8,614	30.5	2,423	4.7	3,968	36.0	5,084	3.0
2006	8,594	-0.2	2,322	-4.2	4,434	11.7	5,299	4.2
2007	9,326	8.5	2,463	6.1	5,161	16.4	5,548	4.7
2008	10,721	15.0	2,586	5.0	5,881	14.0	5,657	2.0
2009	6,006	-44.0	6,256	142.0	2,343	-60.2	9,784	73.0
2010	3,168	-47.2	12,351	97.4	983	-58.1	12,287	25.6
2011	2,622	-17.2	17,459	41.4	798	-18.8	12,929	5.2
% change, from 2000 to 2011		**-56.3**	**—**	**482.1**	**—**	**-65.0**	**—**	**233.1**

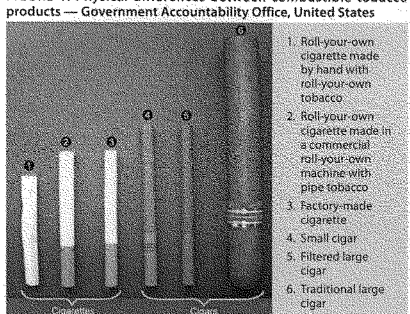
* These data are the per-cigarette equivalent based on the conversion rate in the Master Settlement Agreement: 0.0325 oz (0.9 g) of tobacco = one cigarette.

led manufacturers to relabel roll-your-own tobacco as pipe tobacco and then market this relabeled pipe tobacco for roll-your-own use (*7–9*). In addition, manufacturers were able to increase the per-unit weight of certain small cigars to take advantage of a tax benefit when classified as large cigars, which are taxed based on the product price rather than per cigar (*7*). As a result of relatively minor increases in per-unit weight, the new "large cigar" can appear almost identical to a "small cigar," which resembles a typical cigarette and can cost as little as 7 cents per cigar (Figure 1) (*7*).

This analysis shows that cigarette consumption continues to decline in the United States, a trend that has persisted since the 1960s. However, recent changes in consumption patterns, particularly increases in large cigar and pipe tobacco use, have resulted in a slowing of the decline in consumption of all combustible tobacco, and indicate that certain cigarette smokers have switched to using lower-taxed noncigarette combustible products. Moreover, a 2012 Surgeon General's report found that youths and young adults had even higher rates of cigar use and simultaneous use of multiple tobacco products (*10*).

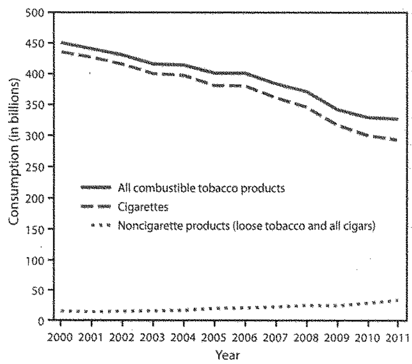
Recent analysis of excise tax data for pipe tobacco, roll-your-own cigarette tobacco, small cigars, and large cigars reveals that the tobacco industry is adapting the marketing and production of cigars and roll-your-own tobacco products to minimize federal excise tax and thus reduce these tobacco products' prices compared with cigarettes (*7–9*). Reducing the effective federal and state excise tax rates on tobacco lessens the impact of cost on reducing smoking and preventing smoking

FIGURE 1. Physical differences between combustible tobacco products — Government Accountability Office, United States



Source: Government Accountability Office. Tobacco taxes: large disparities in rates for smoking products trigger significant market shifts to avoid higher taxes. Available at http://www.gao.gov/products/gao-12-475.

FIGURE 2. Consumption of cigarettes and other combustible tobacco products — United States, 2001–2011



initiation. The Government Accountability Office (GAO) recommends modifying federal tobacco taxes to eliminate large tax differentials between roll-your-own and pipe tobacco and small and large cigars (*7*). In addition, because Food and Drug Administration (FDA) regulations currently do not apply to cigars and pipe tobacco, these products can be produced with flavoring, can be labeled with misleading descriptors such as "light" or "low tar," and can be marketed and sold with fewer restrictions than apply to cigarettes.

What is already known on this topic?

Cigarette use continues to decline in the United States, a trend that has persisted since the 1960s.

What is added by this report?

From 2000 to 2011, consumption of all combustible tobacco products decreased from 450.7 billion cigarette equivalents to 326.6 (a 27.5% decrease), and per capita consumption of all combustible tobacco products declined from 2,148 to 1,374 (a 36.0% decrease). However, whereas consumption of cigarettes decreased 32.8%, consumption of noncigarette combustible tobacco increased 123.1%. As a result, the percentage of combustible tobacco consumption composed of loose tobacco and cigars increased from 3.4% in 2000 to 10.4% in 2011.

What are the implications for public health practice?

The increase in cigar and pipe tobacco use is a public health concern because all combustible tobacco use causes cancer, heart disease, and other smoking-related diseases. A switch from cigarettes to other, lower-taxed, combustible tobacco products blunts the effect of increasing prices, one of the most effective ways to reduce smoking and prevent youth smoking initiation.

The findings in this report are subject to at least one limitation. CDC's measure for cigarette and combustible tobacco consumption only accounts for products taxed for legal sale in the United States and does not account for illicit cigarette sales, such as those smuggled into or out of the country, or for untaxed cigarettes that are produced or sold on American Indian sovereign lands. Currently, no method exists for measuring or estimating illicit or untaxed tobacco trade in the United States.

Smoke from pipes and cigars contains the same toxic chemicals as cigarette smoke (*1*). The evidence that the increase in cigar and pipe tobacco use is the result of offering cigarette smokers a low-priced alternative product is a particular public health concern, because the morbidity and mortality effects of other forms of combustible tobacco are similar to those of cigarettes. Increasing prices has been one of the most effective ways to reduce tobacco use and prevent youth smoking initiation (*10*). In addition, combustible tobacco products that are similar in design but not legally considered to be cigarettes are not subject to FDA regulations related to manufacturing, flavoring, labeling, and marketing. The availability of low-priced and less regulated alternative products appears to have led certain cigarette smokers to switch to other combustible tobacco products. This group also might include persons who otherwise might have quit smoking as a result of the 2009 federal tobacco excise tax increase and FDA cigarette regulations. Diminishing the public health impact of excise tax increases and regulation can hamper efforts to prevent youth smoking initiation, reduce consumption, and prompt quitting.

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Questions for the Record
"Tobacco: Taxes Owed, Avoided, and Evaded"
Hearing Date: July 29, 2014
Questions for Mr. Michael Tynan

Chairman Ron Wyden

1. *Mr. Tynan, e-cigarettes are not currently subject to federal tobacco taxes or regulations such as limitations on flavoring and marketing. These policies are primarily designed to discourage smoking among youth and adolescents. You stated during the hearing that left untaxed and unregulated e-cigarettes could have a long-term impact on public health. Please describe what considerations should be taken into account in deciding whether and how to tax and regulate e-cigarettes. Please also describe what is currently known about youth attraction to e-cigarettes, the dual use of e-cigarettes and combustible tobacco products, and potential impacts of taxation and regulation on youth use of these products.*

   Describe what considerations should be taken into account in deciding whether and how to tax and regulate e-cigarettes.

   Answer: Decisions on taxing e-cigarettes are complicated. For example, while cigarettes are taxed per pack, it is not clear how any taxes for e-cigarettes should be based. Should the e-cigarette device be taxed or the nicotine liquid, or both? Should price be based per product or as a percentage of the product price? These are issues that public health officials in many states are considering and for which there are no clear answers to date.

   Decisions on regulations are more straightforward, as current tobacco regulations for cigarettes could be applied to e-cigarettes, specifically restrictions on sales/age of sale, marketing (including television marketing) and flavors.

   The following excerpt is from an article was published in July 2014 by Frank Chaloupka in the journal JAMA Pediatrics (2014;168(7):601-602) and discusses how and what level to tax e-cigarettes. Please note that e-cigarettes are referred to in the article as ENDS: electronic nicotine delivery devices.

   > *"Less clear is whether ENDS should be taxed and, if they are, at what level to tax them. Extensive research shows that a significant increase in tobacco taxes that raises tobacco product prices is the single most effective policy for reducing tobacco use and shows that use among young people is particularly sensitive to price,[8] while new research shows that ENDS sales are highly responsive to changes in their prices (Jidong Huang, PhD, John A. Tauras, PhD, and F.J.C., unpublished data, December 2013). Additionally, many ENDS users report that the low cost of ENDS relative to cigarettes is a key reason for use (Maansi Bansal-Travers, PhD, Andrew Hyland, PhD, Cheryl Rivard, MPH, F.J.C., Jidong Huang, PhD, and Dianne Barker, MHS, unpublished data, January 2014). This implies that taxing ENDS at rates comparable to cigarettes would be highly effective in deterring youths' initiation of ENDS use but at the same time would discourage many current smokers from switching to ENDS. At the other extreme, failing to levy a tax on ENDS*

would keep their prices relatively low, which could lead to youths' experimentation with ENDS and subsequent progression to conventional cigarette smoking. This suggests that governments that decide to levy taxes on ENDS should at the same time adopt significant increases in their other tobacco taxes so that the prices of cigarettes and other combusted tobacco products rise relative to prices for ENDS. Such a policy would have the benefit of deterring initiation of all tobacco use, including ENDS use, among young people while increasing cessation among current tobacco users, at least in part by encouraging substitution to ENDS. To date, only Minnesota levies an excise tax on ENDS, with similar taxes under consideration in several others states (Camille K. Gourdet, JD, MA, Jamie F. Chriqui, PhD, and F.J.C., unpublished data, November 2013)."

Please also describe what is currently known about youth attraction to e-cigarettes, the dual use of e-cigarettes and combustible tobacco products, and potential impacts of taxation and regulation on youth use of these products.

Answer: Regarding the potential impact of price. Increasing the price of tobacco products is the most effective policy tool for reducing tobacco use. A 10% increase in product price will reduce consumption by 4% and will have a greater impact on youth and other price-sensitive smokers. As noted by Chaloupka above, new research shows that e-cigarettes sale are responsive to price increases, which means that a corresponding reduction in consumption would result from a meaningful tax increase on these products.

Regarding what is known, the following linked report was published by the Oregon Health Authority, Public Health Division and summarized national studies on e-cigarettes: http://public.health.oregon.gov/DiseasesConditions/CommunicableDisease/CDSummaryNewsletter/Documents/2013/ohd6227.pdf.

Generally, attraction to e-cigarettes is similar to other tobacco products; specifically the availability of flavors and novelty of the product. However, e-cigarettes are unique in that there is unregulated advertising of these products, including celebrity endorsements and TV commercials, which can occur during youth-oriented broadcasting. Television advertisements for cigarettes and little cigars have been prohibited by Congress since 1971 by 15 USC 1335. Further complicating matters is the lower perceived harm (which has been reinforced through implied claims of cessation in television ads), and a price per product that continues to decrease for these products. As mentioned during my testimony, Congress banned the sale of flavored cigarettes in 2009, however those restrictions have not been extended to e-cigarettes or other tobacco products.

Regarding dual use, available evidence indicates that a substantial portion of e-cigarette users, both adult and youth, also use cigarettes. Please see the following article produced for the World Health Organization that discusses this dual use issue in detail: http://nicotinepolicy.net/documents/position_papers/Grana_Glantz_WHO_ENDS_Report_Dec2013.pdf

2. *Mr. Tynan, during the hearing you mentioned that as a result of the CHIPRA legislation at least one company increased the weight of a product marketed before 2009 as a small cigar in order to qualify for a preferential tax rate for large cigars by adding clay found in kitty litter to the product's filter. I understand a number of other companies have also modified products or established new products with increased weight for the sole purpose of avoiding federal tobacco taxes. In fact, Mr. Manfreda's testimony states that of domestic large cigar removals after CHIPRA, over 45 percent were made by companies that had switched the majority of their production from small to large cigars. Could you please describe the various methods manufacturers have used to exploit this loophole?*

   Answer: Cigarettes and little cigars can qualify for the lower tax rate for large cigars by slightly increasing their weight and, in the case of cigarettes, adding tobacco to their wrapper paper. Also, as the Government Accountability Office found in their first report on this issue (http://www.gao.gov/assets/600/590192.pdf), tobacco manufacturers have also reformulated or re-labeled products to capitalize on disparities between tax rates on different types of tobacco products and minimize the impact taxes have on product prices. As found in the GAO Report, there are numerous examples of products that otherwise would be considered a cigarette, that are classified for tax and regulatory purposes as a cigar because of brown paper and the weight of the product.

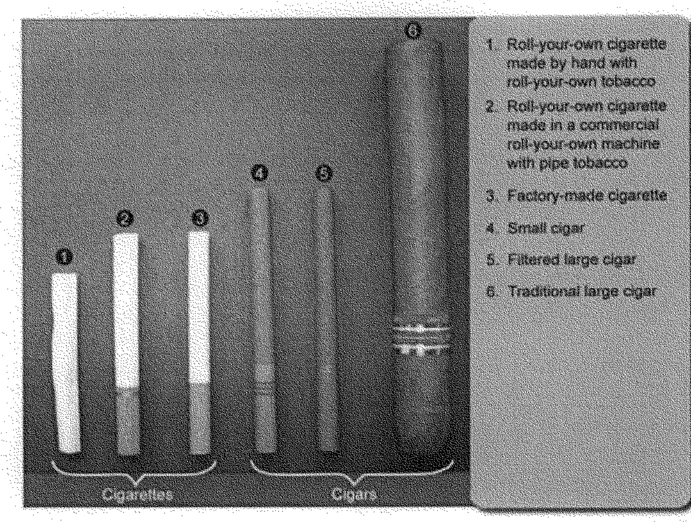
Ranking Member Orrin Hatch

1. *Mr. Tynan, you have experience in both federal and state public health offices. Generally, what types of tobacco products appeal to youth nonsmokers? Do you believe that products that are marketed as large cigars appeal to youth nonsmokers? Do you believe that products that are marketed as pipe tobacco appeal to youth nonsmokers?*

   Answer: Generally, inexpensive tobacco products or products available in flavors appeal to youth.

   One challenge is that there are tobacco products on the market, which are taxed and marketed as large cigars, which function and appeal to youth as a cigarette. As noted during my testimony, there are products on the market today that are sold in a pack of 20 (just like cigarettes), that are the same size as a cigarette, yet because they are made with brown paper instead of white paper and weigh above a certain weight threshold, they are actually classified as a large cigar for tax and regulatory purposes (see figure below from report by the Government Accountability Office, available here: http://www.gao.gov/assets/600/590192.pdf). This means that while these products may be used like a cigarette, and look like a brown cigarette, they are taxed at a lower rate (as a cigar) and can be sold in flavors that appeal to youth.

   Regarding pipe tobacco, the issue is that roll-your-own tobacco is being labeled/marketed as pipe tobacco to be sold as a much lower price and can then be rolled into a cigarette. These products are offered in flavors that appeal to youth.



Source: GAO.

2. *Mr. Tynan, to the extent there are black and gray markets for tobacco products, how does that impact available date on use of tobacco products? Given the difficulty in measuring black market activity, now reliable is available data on tobacco usage?*

Answer: The data we have on youth and adult tobacco use are from public health surveys that are either telephone surveys, household surveys or based on review of existing data for other purposes (e.g. tax receipts). Research findings from these data sources are accepted by the scientific community as a reliable source of information on tobacco use patterns and other health behaviors, and are included in scientific journals, reports, and publications. Surveys are conducted nationally and at the state level and include questions that have been cognitively tested and used consistently. It is agreed upon globally that these data are reliable and valid.

The United States Senate
COMMITTEE on FINANCE
CHAIRMAN RON WYDEN, D-OREGON
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July 29, 2014

Wyden Statement on Tobacco Tax Avoidance and Evasion

Today the Finance Committee will examine a classic case of tax evasion: How dozens of companies making tobacco products dodge taxes owed under current law by changing only a few words on packaging labels. This evasion fleeces taxpayers out of billions of dollars, and it means children and teens are more easily hooked on tobacco.

The tax evasion tale goes like this: In 2009, Congress renewed the Children's Health Insurance Program, which currently provides insurance coverage to more than eight million children each year. To pay for that coverage, Congress raised excise taxes on certain types of tobacco products, including cigarettes and loose, roll-your-own tobacco. The tax rates on tobacco for pipes and some large cigars, however, remained lower. So immediately after the law was enacted, companies pried open a big loophole. They started changing the labels on their packaging.

Products that would have been labeled "roll-your-own" tobacco one day were labeled "pipe" tobacco the next, and the tax bill on them plummeted. Companies also stuffed "small cigars" with a few extra grams of tobacco. That way, they'd be considered "large cigars" and be taxed at a lower rate.

The numbers show how big this loophole has become. Sales of pipe tobacco have skyrocketed -- more than tenfold in just five years. It seems implausible that so many more Americans would suddenly start smoking pipes.

Today, the Finance Committee will inquire as to why it's so easy to skirt the law. Clearly, there has been a lapse in good government. After five years, the Treasury Department's Alcohol and Tobacco Tax and Trade Bureau, or TTB, still has not drawn a meaningful distinction between tobacco products. Instead, they've ignored everything except for the words on the package: "roll-your-own" or "pipe."

All it takes to exploit this loophole is some ink on a label, and the committee will see it demonstrated today. No muss, no fuss, no teams of tax lawyers pouring over legal documents.

Unfortunately, the financial burden this loophole inflicts on America's taxpayers is enormous. The committee will hear today that the tobacco loophole has cost taxpayers more than $2 billion over the last five years – more than $2 billion.

Furthermore, the loophole seriously undermines the effort to discourage smoking among America's children and teens. According to the Surgeon General, evidence shows that raising the cost of cigarettes stops kids from smoking. But when tobacco is cheap because of a blatant loophole, young people will buy it.

TTB has had ample time to solve this problem, but it hasn't followed through. Today we are going to ask why. Is it a lack of resources needed to mount an adequate effort at enforcement? After all, TTB has only four criminal agents to enforce the law for the entire country. Could it be that one hand doesn't know what the other is up to? When the Food and Drug Administration was dragged into the situation, it made matters worse by actively allowing companies to continue using the loophole. The FDA even sent letters to companies giving them the "OK."

My bottom line is that this loophole hurts taxpayers and kids, and it needs to be closed. As always, we will seek to address this important issue in a bipartisan manner.

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How many companies were involved in switching between small and large cigars and what is the percent of their "market share"?

Tables A and B list the number of companies that "switched" between the manufacture or importation of small and large cigars after CHIPRA, and their share of total domestic removals or imported removals. The reported period is from April 01, 2009-March 31, 2012.

The "class" column shows the extent of the switch between small to large cigars three years before CHIPRA (April 01, 2006 - March 31, 2009) as compared to the reported period, or three years after CHIPRA. "Class" is based on the observed change in the share of large cigar removals (i.e. how much a company switched from removing small cigars to large cigars). For example, the "Very Big Switch (91% - 100%)" class includes all companies that switched from small percentages of large cigar removals (e.g. 5% large cigars/95% small cigars before CHIPRA) to very large percentages of large cigar removals in the reported period (e.g. 96% large cigars/4% small cigars after CHIPRA). Similarly, the "Big Switch (51% - 90%)" class includes all companies that switched between 51 and 90 percentage points across the two time periods (e.g. from 25% large cigar removals before CHIPRA to 76% large cigar removals or more after CHIPRA).

The tables include, for the reported period: the count of companies in each class; their overall share of removals of all large and small cigars; their share of all the large cigars removed; the total quantity of large and small cigars removed; the quantity of large cigars removed; the total reported tax liability of large and small cigars removed; and the reported tax liability of the large cigars removed.

TTB provided the information regarding manufacturers and importers separately, because it relied on different data sources for analysis. Table A on domestic cigar removals is based on excise tax returns and operating reports submitted to TTB by permitted manufacturers. Table B on imported cigar removals is based on data from the Customs and Border Protection (CBP) Automated Commercial System (ACS), submitted to CBP by permitted importers. Note that numbers in the tables may not add up due to rounding error.

Table A: Domestic Removals, Large Cigars and Small Cigars; April 01, 2009 to March 31, 2012

Class	Companies	Share of Domestic Cigar Removals	Share of Domestic Large Cigar Removals	Domestic Cigar Removals (Sticks)	Domestic Large Cigar Removals (Sticks)	Domestic Cigar Reported Tax Liability	Domestic Large Cigar Reported Tax Liability
Very Big Switch (91% - 100%)	10	34.57%	37.58%	10,991M	10,920M	$130M	$127M
Big Switch (51% - 90%)	5	8.39%	7.80%	2,667M	2,266M	$47M	$27M
Moderate Switch (11%-50%)	2	27.51%	24.23%	8,744M	7,040M	$737M	$651M
Small Switch (1%-10%)	4	1.03%	0.06%	329M	17M	$16M	$254K
No Switch (0%)	58	24.35%	25.82%	7,740M	7,502M	$1,076M	$1,064M
No Activity Before April 01, 2009	54	4.15%	4.54%	1,321M	1,320M	$17M	$17M
Total	133	100.00%	100.00%	31,792M	29,065M	$2,023M	$1,886M

Table B: Imported Removals, Large Cigars and Small Cigars; April 01, 2009 to March 31, 2012

Class	Companies	Share of Imported Cigar Removals	Share of Imported Large Cigar Removals	Imported Cigar Removals (Sticks)	Imported Large Cigar Removals (Sticks)	Imported Cigar Reported Tax Liability	Imported Large Cigar Reported Tax Liability
Very Big Switch (91 - 100%) and Big Switch (51% - 90%)[1]	11	18.64%	19.09%	1,424M	1,418M	$29M	$29M
Moderate Switch (11%-50%)	35	11.62%	10.15%	888M	754M	$98M	$91M
Small Switch (1%-10%)	29	1.15%	1.08%	88M	80M	$23M	$22M
No Switch (0%)	155	23.94%	23.91%	1,829M	1,775M	$351M	$347M
No Activity Before April 01, 2009	558	44.65%	45.77%	3,412M	3,399M	$242M	$241M
Total	788	100.00%	100.00%	7,641M	7,426M	$743M	$730M

[1] Classes merged due to the presence of "return information" that is prohibited from public disclosure pursuant to 26 USC 6103.

How many companies were involved in switching between roll your own tobacco and pipe tobacco, and what is the percent of their "market share"?

Tables C and D list the number of companies that "switched" between the manufacture or importation of roll your own tobacco (RYO) and pipe tobacco, and their share of domestic removals or imported removals. The reported period is from April 01, 2009-March 31, 2012.

The "class" column shows the extent of the switch between RYO to pipe tobacco three years before CHIPRA (April 01, 2006 - March 31, 2009) as compared to the reported period, or three years after CHIPRA. "Class" is based on the observed change in the share of large cigar removals (or imports), (i.e. how much a company switched from removing or importing RYO to pipe tobacco). For example, the "Very Big Switch (91% - 100%)" class includes all companies that switched from small percentages of pipe removals (e.g. 5% pipe/95% RYO before CHIPRA) to very large percentages of pipe removals in the reported period (e.g. 96% pipe/4% RYO after CHIPRA). Similarly, the "Big Switch (51% - 90%)" class includes all companies that switched between 51 and 90 percentage points across the two time periods (e.g. from 25% pipe removals before CHIPRA to 76% pipe removals or more after CHIPRA).

The tables include, for the reported period: the count of companies in each class; their overall share of removals of RYO and pipe tobacco; their share of pipe tobacco removed; the total quantity of RYO and pipe tobacco removed; the quantity of pipe tobacco removed; the total reported tax liability of RYO and pipe tobacco removed; and the reported tax liability of pipe tobacco. Note for purposes of determining the impact of the classes' relative share of removals for pipe tobacco and RYO tobacco, we combined these two types of tobacco products in several columns in the chart below, with a separate breakout for pipe tobacco as indicated.

TTB provided the information regarding manufacturers and importers separately, because it relied on different data sources for analysis. Table C on domestic removals is based on excise tax returns and operating reports submitted to TTB by permitted manufacturers. Table D on imported removals is based on data from the Customs and Border Protection (CBP) Automated Commercial System (ACS), submitted to CBP by permitted importers. Note that numbers in the tables may not add up due to rounding error.

Table C: Domestic Removals, Pipe Tobacco and Roll Your Own Tobacco; April 01, 2009 to March 31, 2012

Class	Companies	Share of Domestic Pipe and RYO Removals	Share of Domestic Pipe Removals	Domestic Pipe and RYO Removals (Pounds)	Domestic Pipe Removals (Pounds)	Domestic Pipe and RYO Reported Tax Liability	Domestic Pipe Reported Tax Liability
Very Big Switch (91% - 100%)	18	38.64%	47.07%	37M	36M	$120M	$103M
Big Switch (51% - 90%)	5	25.43%	20.40%	24M	16M	$257M	$44M
Moderate Switch (11%-50%)	2	5.91%	4.32%	6M	3M	$67M	$9M
Small Switch (1%-10%)	2	0.07%	0.00%	66K	3K	$2M	$6K
No Switch (0%)	21	12.68%	8.85%	12M	7M	$151M	$19M
No Activity Before April 01, 2009	40	17.28%	19.36%	16M	15M	$84M	$44M
Total	88	100.00%	100.00%	95M	77M	$681M	$221M

Table D: Imported Removals, Pipe Tobacco and Roll Your Own Tobacco; April 01, 2009 to March 31, 2012

Class	Companies	Share of Imported Pipe and RYO Removals	Share of Imported Pipe Removals	Imported Pipe and RYO Removals (Pounds)	Imported Pipe Removals (Pounds)	Imported Pipe and RYO Reported Tax Liability	Imported Pipe Reported Tax Liability
Very Big Switch (91% - 100%) and Big Switch (51% - 90%)[2]	6	0.60%	0.65%	49K	49K	$131K	$131K
Moderate Switch (11%-50%)	6	15.35%	16.07%	1M	1M	$5M	$3M
Small Switch (1%-10%)	2	8.22%	5.61%	665K	415K	$7M	$1M
No Switch (0%)	35	62.59%	63.80%	5M	5M	$22M	$13M
No Activity Before April 01, 2009	80	13.25%	13.87%	1M	1M	$4M	$3M
Total	129	100.00%	100.00%	8M	7M	$38M	$21M

[2] Classes merged due to the presence of "return information" that is prohibited from public disclosure pursuant to 26 USC 6103.

Communications

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To: US Senate Committee on Finance

Through: Senate Finance Committee Staff

From: Jim Tozzi

Date: July 8, 2014

Subject: Comments to the Hearing Record on Tobacco: Taxes Owed, Avoided, and Evaded

The Finance Committee has performed a tremendously important public service by casting the Senate's spotlight on tobacco tax evasion, a type of crime that is at the nexus of transnational efforts to undermine our country's fiscal and physical security.

The revenues stolen by tobacco tax evaders from the federal government and from state and municipal governments are only part of the criminal equation. Many of the tobacco tax evaders are working on behalf of Foreign Terrorist Organizations[1] (FTOs) and Transnational Criminal Organizations[2] TCOs. These criminal groups are not only stealing much-needed government revenues, they are also using those stolen resources to finance an array of crimes against Americans including drug smuggling, human trafficking and terrorism.

Attached to this memo is a paper that the Center for Regulatory Effectiveness (CRE) prepared on the issue, *Counterfeit Products, Genuine Harm: How Intellectual Property Theft Fuels Organized Crime*. The CRE paper, prepared last year in partial response to the President's Executive Order 13581 – Blocking Property of Transnational Criminal Organizations, provides an in-depth discussion of tobacco trafficking by terrorists and other criminals.

I am bringing the *Counterfeit Products, Genuine Harm* paper to your attention because it further highlights a crucial issue that was discussed in the Finance Committee Staff memo of July 24th, the need for additional federal resources to be devoted to combatting tobacco tax evasion. Our paper states (p. 31) that "Counterfeit and other contraband tobacco needs to be subjected to increased law enforcement attention at all levels of government."

The Staff memorandum also highlighted the need for the government to devote increased resources to enforcement work by explaining that "TTB currently has four criminal agents to enforce taxation on all regulated products – alcohol, tobacco, and firearms. TTB states that while its enforcement success rate remains high, caseloads exceed the Bureau's current capacity."

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[1] See, http://www.state.gov/j/ct/rls/other/des/123085.htm.

[2] See, http://www.treasury.gov/resource-center/sanctions/programs/pages/tco.aspx

We are currently preparing a follow-up paper discussing how to use the budget process to prioritize federal counter-trafficking law enforcement work. I expect to bring our new report to the Committee this fall. The budget paper will reflect my experience with the federal budget process gained during my service to five Administrations, including serving as Deputy Administrator of the Office of Management and Budget (OMB), http://thecre.com/ombpapers/OMB_Officials.htm.

The forthcoming CRE paper will also reflect the extensive experience and knowledge base we have gained by spending years working in opposition to tobacco trafficking. I call your attention to one of our ongoing activities, operating the Counterfeit Cigarettes: An Enforcement Forum website http://www.thecre.com/cc/. The Enforcement Forum is an Interactive Public Docket[3] which allows everyone concerned about contraband tobacco to exchange information to support law enforcement. An example of how our IPD is used to assist tax revenue authorities may be found here, http://www.thecre.com/cc/?p=1341.

I look forward to working with the Committee to enhance enforcement of tobacco tax laws.

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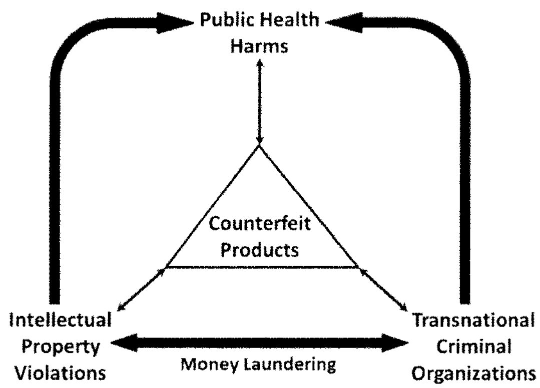
[3] http://en.wikipedia.org/wiki/Interactive_Public_Docket.

COUNTERFEIT PRODUCTS, GENUINE HARM:

HOW INTELLECTUAL PROPERTY THEFT FUELS ORGANIZED CRIME WHILE UNDERMINING AMERICAN COMMUNITIES



January 2013

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COUNTERFEIT PRODUCTS, GENUINE HARM:
HOW INTELLECTUAL PROPERTY THEFT FUELS ORGANIZED CRIME WHILE UNDERMINING AMERICAN COMMUNITIES

Executive Summary

On July 24, 2011, President Obama signed Executive Order 13581 blocking the control of property by transnational crime organizations. The Order was part of the National Security Council's Strategy to Combat Transnational Organized Crime.[1] In the Order, the President made a formal determination

> *that significant transnational criminal organizations constitute an unusual and extraordinary threat to the national security, foreign policy, and economy of the United States, and hereby declare a national emergency to deal with that threat.*

Most of the organizations named in the Executive Order as examples of transnational crime organizations, and many similar criminal organizations, profit from trafficking in counterfeit items ranging from industrial parts to consumer products.

Trafficking in counterfeit products harms the public both directly, through the sale of dangerous parts and products, and indirectly by providing financing support to violent organizations and by undermining legitimate economic activity. Moreover, the social harms from the trafficking in counterfeit, pirated and otherwise contraband (untaxed) consumer goods falls disproportionately on predominately African American communities which are targeted by the traffickers as venues for their crimes.

Effectively countering the counterfeiters will require, as described in the President's Strategy, building "international consensus, multilateral cooperation, and public-private partnerships to defeat transnational organized crime."[2]

In terms of specific policies and actions, effectively countering the counterfeiters will require:

1. Consumer refusal to buy counterfeit/contraband/pirated products;

2. Enhanced law enforcement actions by all levels of government against counterfeiters; and

3. Federal regulatory policies that limit the opportunities for counterfeiting.

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[1] See, National Security Council, "Strategy to Combat Transnational Organized Crime," *available at* http://www.whitehouse.gov/administration/eop/nsc/transnational-crime.

[2] See, National Security Council, "Executive Summary – Strategy to Combat Transnational Organized Crime," available at http://www.whitehouse.gov/administration/eop/nsc/transnational-crime/summary.

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COUNTERFEIT PRODUCTS, GENUINE HARM: HOW INTELLECTUAL PROPERTY THEFT FUELS ORGANIZED CRIME WHILE UNDERMINING AMERICAN COMMUNITIES

In the City of Los Angeles, investigations by law enforcement have substantiated the report that individuals involved in counterfeiting activities and the illegal sale of cigarettes are significant fund-raisers for known terrorist groups such as Hezbollah and Hamas.

– William F. Bratton, Chief of Police, Los Angeles, CA, May 2007.

Terrorists and insurgents increasingly will turn to crime to generate funding and will acquire logistical support from criminals, in part because of successes by U.S. agencies and partner nations in attacking other sources of their funding.

– James R. Clapper, Director of National Intelligence, January 31, 2012.

Fake cigarettes made from human excrement, asbestos, mould and dead flies are being smoked regularly in Britain, undercover detectives have found.

– The Daily Mail, 9 September 2012.

Counterfeiting – A Multidimensional Crime

Counterfeiting is a multi-dimensional crime. The production and sale of counterfeit goods triggers a series of legal violations with each criminal resonance contributing one or more social harms to the overall toll from the original crime. For example, a counterfeit product:

1. Is an intellectual property violation which causes revenue loss from the lawful property owner;

2. Is not made to a genuine product's quality standards, thus posing threats to public health and safety;

3. Is often sold without all legally required taxes resulting in reduced government revenues leading to reduced services and/or higher taxes on law abiding citizens;

4. Produces profits from the illegal sales which are "laundered," a process that the Treasury Department's Financial Crimes Enforcement Network (FinCEN) explains "has devastating social consequences;"[3] and

5. The laundered profits frequently fuel transnational organized crime.[4]

With respect to the economic harm from counterfeit/pirated[5] products, the US government estimates that "[c]ounterfeiting and piracy cost the U.S. economy between $200 billion and $250 billion per year, are responsible for the loss of 750,000 American jobs, and pose a threat to health and safety."[6] By 2015, the global trade in counterfeit and pirated products is grow to $1.5 trillion.[7]

As illustrated in Figure 1 on the next page, counterfeit products harm public health both directly and through the activities of the organized crime groups which traffic in counterfeit products, often as part of a larger financing strategy which is underpinned by money laundering.

Counterfeit products endanger public health when they are placed into service in a safety-related capacity, such a aircraft fasteners or electronics parts in an emergency communications system, or when they are consumed as in the case of counterfeit medicines and certain other consumer products such as alcohol[8] and tobacco.[9]

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[3] Treasury Department/FinCEN, http://www.fincen.gov/about_fincen/wwd/faqs.html#money.

[4] National Security Council, "Strategy to Combat Transnational Organized Crime: Definition," http://www.whitehouse.gov/administration/eop/nsc/transnational-crime/definition.

[5] Pirated goods refers to products in electronic format (software, movies, music, etc.) which are illegally copied.

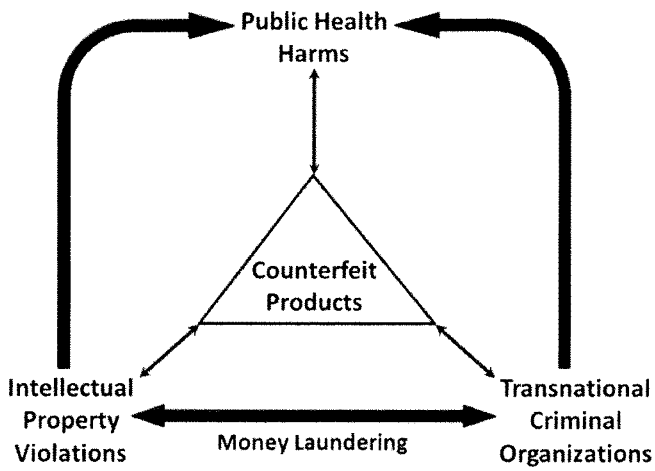
[6] Department of Commerce/International Trade Administration, "Top 10 Ways to Protect Yourself From Counterfeiting and Piracy," http://www.stopfakes.gov/sites/default/files/Consumer_Tips.pdf.

[7] Frontier Economics, Ltd., "Estimating the global economic and social impacts of counterfeiting and piracy," February 2011, p. 5, available at http://thecre.com/pdf/Global%20Impacts%20-%20Final.pdf.

[8] A. Young, The Drinks Business, "Counterfeit alcohol costs UK £1.2bn a year," http://www.thedrinksbusiness.com/2012/11/counterfeit-alcohol-costs-uk-1-2bn-a-year/.

[9] J. R. Blackwell, Richmond-Times Dispatch, Chinese delegation here to discuss counterfeit cigarette problem," http://www.timesdispatch.com/business/chinese-delegation-here-to-discuss-counterfeit-cigarette-problem/article_c299c97b-422a-5164-8305-acb751f94be7.html.

Figure 1



Rather than focusing on the economic harms from counterfeiting, which have been extensively studied,[10] this paper will focus on the less studied issue of how counterfeit products directly and indirectly threaten public health and safety. Moreover, although this paper will discuss various types of counterfeit products, it will focus the greatest attention on counterfeit products which receive the least attention but play an important role in financing international criminal organizations.

Counterfeit Products Trafficked by Organized Crime

Counterfeit Parts

A 2012 report by the Senate Armed Services Committee discussed the "flood" of counterfeit electronic parts (electronic parts being only one type of parts/supplies which are counterfeited) and determined that the problem is of substantial magnitude.

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[10] See, for example, the GAO report "Observations on Efforts to Quantify the Economic Effects of Counterfeit and Pirated Goods" available at http://www.gao.gov/assets/310/303057.pdf and the OECD study, "The Economic Impact of Counterfeiting and Piracy" available at http://www.oepm.es/cs/OEPMSite/contenidos/ponen/InformeOCDE26feb09/2009_03_03_OECD_Study_on_Counterfeiting_and_Piracy.pdf.

> *The Committee's investigation found the problem of counterfeit parts to be widespread in the defense supply chain. Looking at just part of the supply chain over a two year period from 2009 to 2010, the investigation uncovered approximately 1 ,800 cases of suspect counterfeit electronic parts. The total number of individual suspect parts involved in those cases exceeded one million.*
>
> *As to the source of those parts, the Committee tracked well over 100 of the approximately 1,800 cases of suspect counterfeit parts back through the supply chain. The vast majority of those trails led to China, with more than 70 percent of the suspect parts being traced to that country. U.S. government reports consistently point to China as the epicenter of the global trade in counterfeits. The Committee's findings provide overwhelming and undeniable evidence in support of that assessment.*[11]

In addition to discussing some of the economic consequences of counterfeits, the report also discussed some of the direct dangers to US citizens from counterfeit parts in the military supply chain.

> *The President of the Semiconductor Industry Association likened using counterfeit parts to "playing Russian roulette," explaining, "[w]ith luck, the chip will not function at all and will be discovered in testing. But in some cases the chip may work for a while, but because of the environmental abuse it could fail at a critical time when the product containing the chip is stressed - as in combat."*[12]

A Task Force on Counterfeit Parts established by the American Bar Association's Section of Public Contract Law recently noted that "No type of company or organization has been untouched by counterfeit electronic parts. Even the most reliable of parts sources have discovered counterfeit parts within their inventories."[13]

Although the ABA report's focus was on use of counterfeit parts in national defense applications, the paper reveals how very many industries are affected by counterfeit parts. The public dangers posed by

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[11] "Inquiry into Counterfeit Electronic Parts in the Defense Supply Chain," A Report of the Committee on Armed Services, United States Senate, May 21, 2012, ("Senate Report") pp. i-ii, *available at* http://www.levin.senate.gov/newsroom/press/release/senate-armed-services-committee-releases-report_on-counterfeit-electronic-parts/

[12] Senate Report, p. 8.

[13] Task Force on Counterfeit Parts of the Committee on Acquisition Reform and Emerging Issues of the American Bar Association Section of Public Contract Law, "A White Paper Regarding Department of Defense Implementation of Section 818 of the National Defense Authorization Act for Fiscal Year 2012" October 5, 2012, ("ABA Task Force") p. 1, *available at* http://www.americanbar.org/content/dam/aba/administrative/public_contract_law/aba_pcl_taskforce_on_counterfeit_part_white_paper.authcheckdam.pdf

counterfeit parts in the energy industry, described below by the ABA, is disturbing but not surprising and is notable for helping illustrate the extraordinarily wide-ranging scope of parts which may be counterfeit.

> *DOE first formally addressed "suspect/counterfeit items" in July 1988, after receiving a U.S. Nuclear Regulatory Commission Notice regarding discoveries of suspect electrical equipment at commercial nuclear facilities. DOE has reported discovering counterfeits of the following items at DOE or National Nuclear Safety Administration ("NNSA") sites: threaded fasteners, including assemblies containing fasteners such as ratchet tie down straps; various electrical components (semiconductors, circuit breakers, current and potential transformers, fuses, resistors, switchgear, overload and protective relays, motor control centers, heaters, motor generator sets, DC power supplies, AC inverters, transmitters, ground fault circuit interrupters ("GFCIs")); piping components (fittings, flanges, valves and valve replacement products, couplings, plugs, spacers, nozzles, pipe supports); preformed metal structures; elastomers (O-rings, seals); spare or replacement kits from other than the OEMs, weld filler material; and diesel generator speed governors and pumps.*[14]

As the ABA Task Force pointed out, even the construction industry needs to be concerned with counterfeit parts and equipment.

> *Although it is difficult to imagine a "counterfeit" building, the construction industry is just as prone to counterfeit parts – particularly with regard to construction materials and electronic building systems – as any other industry.*[15]

It is important to note that virtually everyone is at risk from counterfeit parts as illustrated by the following statement from the United States Attorney's Office – Eastern District of Michigan.

> *Two Metro Detroit residents face criminal charges following their arrests Monday during an enforcement action targeting an alleged counterfeit air bag trafficking scheme, announced United States Attorney Barbara L. McQuade and Special Agent in Charge Brian Moskowitz, U.S. Immigration and Customs Enforcement's (ICE) Homeland Security Investigations (HSI)*
>
> ***
>
> *The arrests come after a joint announcement Oct. 10 by ICE and the National Highway Transportation Safety Administration (NHTSA) warning consumers of the grave dangers associated with the use of counterfeit air bags.*

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[14] ABA Task Force, p. 40.

[15] Ibid.

> *"Counterfeit auto parts like air bags not only violate intellectual property laws, they also create a serious safety risk to consumers", McQuade said.*[16]

Counterfeit military parts, counterfeit construction supplies and and counterfeit air bags are linked by a common thread – they are all smuggled and sold by organized crime groups. As the Director of U.S. Immigration and Customs Enforcement (ICE) explained with regard to the automotive equipment,

> *"Organized criminals are selling dangerous counterfeit and substandard airbags to consumers and suppliers with little to no regard to hazardous health and safety consequences."*[17]

Similarly, a 2012 University of Florida research article on how "[c]ounterfeit construction materials are flooding the U.S. market," noted that

> *New York City officials report that organized crime rings now consider counterfeiting to be a more attractive line of business than prostitution or drugs.*[18]

These organized crime rings are a serious threat to US and international security. It is in response to the national security threats posed by organized crime that President Obama established a White House strategy to combat transnational criminal organizations.[19]

Counterfeit Pharmaceuticals

As is the case with parts, pharmaceutical products are also extensively counterfeited. The problem of counterfeit pharmaceuticals can be summarized by three statements. Counterfeit medicines are:

1. Very big business. According to the Department of Justice, "fake drugs raked in an estimated $75 billion last year."[20]

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[16] United States Attorney's Office – Eastern District of Michigan, Press Release, October 15, 2012, http://www.justice.gov/usao/mie/news/2012/2012_10_15_sayoub_hjomaa.html

[17] NHTSA, "Safety Advisory: NHTSA Alerting Consumers to Dangers of Counterfeit Air Bags," October 10, 2012, http://www.nhtsa.gov/About+NHTSA/Press+Releases/2012/Safety+Advisory:+NHTSA+Alerting+Consumers+to+Dangers+of+Counterfeit+Air+Bags

[18] G. L. Lawrimore, University of Florida, Office of Research, Explore Magazine, "Buyer Beware," http://www.research.ufl.edu/publications/explore/current/story_4/.

[19] White House, "FACT SHEET: Strategy to Combat Transnational Organized Crime," http://www.whitehouse.gov/the-press-office/2011/07/25/fact-sheet-strategy-combat-transnational-organized-crime

[20] Stuart F. Delery, Acting Assistant Attorney General, Civil Division, Department of Justice, blog post "The Real Cost of Cheap Online Meds," April 26, 2012, http://blogs.justice.gov/main/archives/2161.

2. Deadly. For example, the US Food and Drug Administration (FDA) has sent out warnings about fake chemotherapy drugs.[21] Sen. Grassley, in a statement discussing a bipartisan bill to increase penalties for trafficking in counterfeit drugs, stated that "Counterfeit drugs reportedly result in 100,000 deaths globally each year...."[22]

3. Part of the global trade in counterfeit products which fund terrorist organizations and other transnational crime groups. A 2011 report by the Stimson Center on Counterfeit Drugs and National Security stated that

   > *not only have groups such as the Russian mafia, Colombian drug cartels, Chinese triads, and Mexican drug gangs all become heavily involved in producing and trafficking counterfeit drugs over the past decade, but mounting evidence also points to the direct involvement of Hezbollah and al Qaeda.*[23]

   The report concluded that "counterfeit pharmaceuticals pose a direct threat to national and international security."

The global nature of the trade in counterfeit medicines was made clear in an August 2012 news release from ICE noted that a "man faces up to 10 years in prison after being found guilty by a jury this week on federal charges stemming from his role as a key operative for a drug ring that distributed large quantities of Chinese-made counterfeit pharmaceuticals throughout the United States and worldwide."[24]

The Center for Regulatory Effectiveness (CRE)[25] has long been active in the fight against counterfeit drugs. For example, in 2003, CRE released its white paper, "Dirty Deals: The Drug Diversion Trade – How It Victimizes the Vulnerable and How to Stop It" which highlighted that "Drug diversion, and the intertwined crimes of adulteration and counterfeiting, is a widely recognized threat to public health."[26]

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[21] FDA, "Another counterfeit cancer medicine found in U.S. - Illegal practice puts patients at risk," http://www.fda.gov/Drugs/DrugSafety/DrugIntegrityandSupplyChainSecurity/ucm298047.htm

[22] Sen. Grassley, "Leahy-Grassley Bill To Increase Penalties For Counterfeit Drugs Adopted In FDA Bill," http://www.grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=40786

[23] Brian D. Finlay, The Stimson Center, "Counterfeit Drugs and National Security," February 2011, http://www.stimson.org/images/uploads/research-pdfs/Full_-_Counterfeit_Drugs_and_National_Security.pdf

[24] U.S. Immigration and Customs Enforcement, News Release, August 9, 2012, http://www.ice.gov/news/releases/1208/120809losangeles.htm

[25] *See*, http://www.thecre.com/oira/?page_id=8.

[26] CRE, "Dirty Deals: The Drug Diversion Trade – How It Victimizes the Vulnerable and How to Stop It," Working Draft, July 2003, http://thecre.com/forums/attachment.php?attachmentid=22&d=1058453962

CRE also served as an information source for the book, "Dangerous Doses: How Counterfeiters Are Contaminating America's Drug Supply."[27]

Counterfeit Cigarettes and Counterfeit Tax Stamps

A counterfeit product that has received relatively little attention is cigarettes, perhaps because even the authentic products are so highly hazardous. Counterfeit cigarettes are, however, orders of magnitude more dangerous than legal products. Moreover, counterfeit cigarettes along with other forms of contraband (untaxed) tobacco, is the leading edge of a crime wave that is helping fuel organized crime around the globe.

The sale of counterfeit cigarettes is often abetted by the production and use of counterfeit tax stamps. An example of the extent to which tax stamps are counterfeited is illustrated by the experience of New York State:

> *The New York State Department of Taxation and Finance announced the arrest of two Brooklyn men for possession of over 100,000 counterfeit tax stamps with an estimated black market value of over half a million dollars. The seizure also included over 2,000 cartons of untaxed cigarettes.*[28]

It's estimated that 40% of the cigarettes sold in New York City have counterfeit tax stamps[29] which may be affixed to either counterfeit or illegally transported cigarettes.

As was noted earlier, counterfeiting is particularly serious crime because it triggers a series of other crimes. For example, the production and sale of counterfeit cigarettes creates demand for counterfeit tax stamps which, in turn, results in at least four types of harm:

- Abetting the illegal sale of hazardous products;
- The loss of state and local tax revenue;
- Providing counterfeiters with highly profitable experience in forging government documents which can than be applied to forging other government documents, such as drivers licenses; and
- Counterfeit drivers licenses, as *The Washington Post* reported, are used to commit an array of crimes ranging from underage drinking to credit card fraud.[30]

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[27] Katherine Eban, "Dangerous Doses: How Counterfeiters Are Contaminating America's Drug Supply." http://www.amazon.com/Dangerous-Doses-Counterfeiters-Contaminating-Americas/dp/0151010501

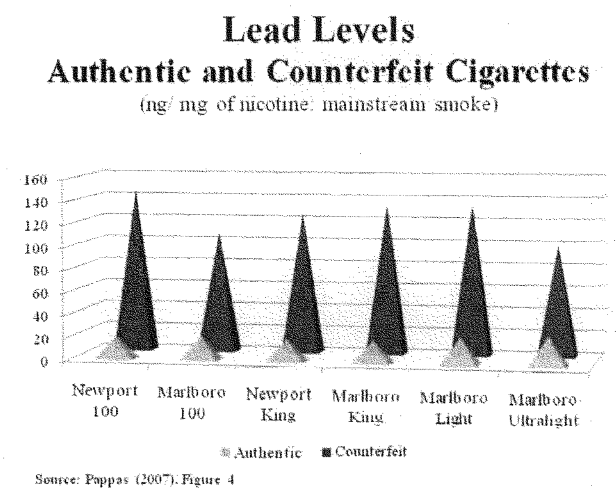
[28] http://www.thecre.com/cc/?p=880

[29] http://www.thecre.com/cc/?p=1119

[30] See, http://www.thecre.com/cc/?p=366

Health Hazards of Counterfeit Cigarettes

The particular health hazards associated with counterfeit cigarettes, as described in the peer reviewed literature, have been discussed in detail in CRE's Monograph, *An Inquiry into the Nature, Causes and Impacts of Contraband Cigarettes*.[31] Although the Monograph should be consulted for in-depth analysis of counterfeit cigarette-specific health hazards, the Figure 2 below (Monograph, p. 7) derived from data in a peer reviewed study by US Centers for Disease Control and Prevention (CDC) researchers provides an indication of the hazards by comparing the lead levels of lead in counterfeit and authentic cigarettes. The Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) has reported that, in addition to having higher levels of lead, cadmium and other toxic metals, counterfeit cigarettes are higher in nicotine than legal products[32] which would make them more addictive, a particular concern since counterfeit cigarettes are often purchased by underage buyers since criminals don't check their customers' age.



[31] *See*, http://www.fda.gov/downloads/AdvisoryCommittees/CommitteesMeetingMaterials/TobaccoProductsScientificAdvisoryCommittee/UCM243625.pdf.

[32] *See*, http://www.atf.gov/publications/factsheets/factsheet-tobacco-diversion.html

Despite the work by researchers at CDC and other government and university laboratories discussed in the Monograph, there is much that is not known about the health effects of counterfeit cigarettes. For this reason, CRE has called for additional federal research on the health hazards of counterfeit cigarettes.[33]

Recent media reports on the contaminants found in counterfeit cigarettes have further highlighted the need for additional research on counterfeit cigarettes. The following are a half-dozen examples from a half-dozen countries of reports on the contaminants and particular hazards from counterfeit cigarettes.

From: The Australian (Australia)

> *As well as millions of dollars lost in Government revenue, the health risks are considerable because counterfeit cigarettes contain "dangerous contaminates and much higher levels of carcinogens than legitimate cigarettes". Most are imported from China and Indonesia.*[34]

From: BuaNews (South Africa)

> *This equates to more than 15 million cigarettes being sold illegally every day, or more than 6 billion per year. This defrauds the fiscus of more than R2.6 billion in unpaid excise duties.*
>
> *Furthermore, illegal cigarettes pose an even greater threat to people's health, as these products do not comply with the strict government regulations to which legal manufacturers and traders adhere.*[35]

From: Curaçao Chronicle (Curaçao)

> *WILLEMSTAD – During an inspection in a mini market, customs recently discovered and seized 15,000 fake cigarettes. These fake cigarettes were open and exposed in a large box which rats and other vermin could walk across it. "It is a serious situation which is very harmful to health", Varressa Elisabeth, the interim director for customs, stated yesterday during a press conference.*[36]

From: Shandong Provincial Tobacco Monopoly Bureau (China)

> *Many counterfeit cigarettes manufacturers use mostly tobacco waste, poor, substandard tobacco even moldy leaf tobacco. Counterfeit cigarettes in the filter*

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[33] http://www.ojp.usdoj.gov/docs/sabappendixmsabcomments062012.pdf

[34] See, http://www.thecre.com/cc/?p=1704

[35] See, http://allafrica.com/stories/201102041010.html

[36] See, http://www.thecre.com/cc/?p=1886

paper use inferior quality products even waste or contaminated waste products. Studies show that a counterfeit cigarette combustion will produce a large quantity of 3.4-benzopyrene and other carcinogenic substances. The tar content significantly exceeds the national standard. Counterfeit cigarettes contain "bemisia tabaci" eggs that, once inhaled, will be like "pork tapeworm" as chronic parasitic in humans, the large population of which will cause very great harm to the nervous system and, in severe cases, can lead to necrosis of the brain. Second, industrial dyes and industrial flavors used counterfeit cigarettes, and their combustion products, will produce severe damage to the reproductive system and visual system, resulting in "my eyesight is getting worse and even blindness" and other symptoms of toxic amblyopia and including sexual dysfunction. More seriously, is that residual sulfur ingredients used in curing smoked harm the respiratory system and even pose a direct threat to life.[37]

From: The Daily Mail (United Kingdom)

Fake cigarettes made from human excrement, asbestos, mould and dead flies are being smoked regularly in Britain, undercover detectives have found.[38]

From: Virginia State Crime Commission (United States)

• *"Most counterfeit cigarettes...tend to differ in every respect from their legal counterparts, including tobacco, paper, filter tips, and packaging "(Shen et al., 2010).*

• *This does more than result in a cigarette that is less pleasant in taste; serious health risks are implicated by counterfeit cigarettes.*
• *Contaminants and excessive levels of cadmium, thallium and lead have been found in counterfeit cigarettes.*[39]

Counterfeit and Contraband Cigarettes – Differences and Similarities

Counterfeit cigarettes are a subset of the larger issue of contraband tobacco. Contraband tobacco refers to tobacco (primarily cigarettes and loose tobacco for roll-your-own cigarettes) on which all required taxes have not been paid. Thus, contraband tobacco includes all counterfeit cigarettes as well as unbranded and

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[37] See, http://www.thecre.com/cc/?p=69

[38] See, http://www.thecre.com/cc/?p=1622

[39] See p. 52, http://www.thecre.com/cc/wp-content/uploads/2012/09/frmvscc.pdf

off-brand cigarettes sold through illicit means,[40] and major label cigarettes which have been illegally transported across state or national borders.[41]

Although not all contraband cigarettes share the extreme health hazards of counterfeit cigarettes, they do share some health-related commonalities. For example, a study in the journal Nicotine & Tobacco Research found that Australian smokers of the unbranded contraband cigarettes known locally as "chop-chop" had significantly worse health than other smokers. Specifically, the study found that

> *relative to smokers of licit tobacco, current users of illicit tobacco had significantly greater odds of beginning smoking at younger than legal age, 60% greater odds of reporting below-average social functioning on the SF-8 [a standardized health survey], and nearly twice the odds of reporting a measurable disability.*[42]

The study explained that is chop-chop is "sourced from unlicensed domestic growers or suburban homegrown production." Moreover, the study's authors point out that chop-chop "is similar to contraband tobacco in Canada sourced from domestic production by illegal manufacturers."[43] Thus, the elevated health hazards from unbranded contraband cigarettes above and beyond the health hazards of legal cigarettes is not limited to Australia.

An additional substantial health hazard from contraband cigarettes irrespective of their country of origin is from their being sold to underage smokers. As was noted, illegal sellers of cigarettes, don't adhere to age restrictions.

> *A Research Letter in the Canadian Medical Association Journal (CMAJ) estimated that "[c]ontraband cigarettes accounted for about 17.5% of all cigarettes smoked by adolescent daily smokers in Canada overall, and for more than 25% in the provinces of Ontario and Quebec." In a more recent study in Tobacco Control, Callaghan (2010) increased the estimate of the share of the youth market accounted for by contraband cigarettes to 43%.*[44]

An additional hazard to underage smokers from illicitly sold cigarettes reported in the English newspaper the Spalding Guardian is that "[t]eenagers face an added risk of being asked for sexual favours if they smoke toxic fake cigarettes...."[45]

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[40] http://www.thecre.com/cc/?p=142

[41] http://www.thecre.com/cc/?p=295

[42] See CRE Monograph p. 59 or http://www.ncbi.nlm.nih.gov/pubmed/19541950

[43] See, CRE Monograph p. 17.

[44] CRE Monograph, p. 19. [Notes omitted]

[45] See, http://www.thecre.com/cc/?p=1760

From a law enforcement perspective, the most significant commonality between counterfeit and other contraband cigarettes is that, irrespective of whether the illicit transport and sales are domestic or international, both types of cigarettes are trafficked by transnational criminal organizations.

It is because counterfeit and other contraband cigarettes are at the nexus of so many different crimes and threats to national security, from terrorism to drug trafficking, that contraband tobacco requires particular attention from:

1. Federal, state and law enforcement;
2. Government policy officials; and
3. The public who purchases illicit tobacco, often without realizing the chain of crimes involved and the consequences.

There are three key issues with respect to the criminal organizations trafficking in cigarettes:

1. The traffickers include groups designated by the US State Department as Foreign Terrorist Organizations (FTOs);[46]
2. There is a convergence between FTOs and traditional organized crime groups with cigarette trafficking being common to crime organizations irrespective of any ideological motivations; and
3. Tobacco smuggling is closely intertwined with and funds drug smuggling, arms trafficking and human trafficking.

Each of these three issues will be discussed below.

[46] http://www.state.gov/j/ct/rls/other/des/123085.htm

The Terror– Tobacco Trafficking Connection

On July 24, 2011, President Obama signed Executive Order 13581 – Blocking Property of Transnational Criminal Organizations.[47] In the Order, the President stated

> *I therefore determine that significant transnational criminal organizations constitute an unusual and extraordinary threat to the national security, foreign policy, and economy of the United States, and hereby declare a national emergency to deal with that threat.*

The Order included an Annex which listed examples of significant transnational criminal organizations including Los Zetas, the violent, Mexican-based criminal syndicate which is heavily involved in the narcotics trafficking, Camorra, and Yakuza. These three groups were also named in federal report, along with Chinese Triads, La Cosa Nostra, and the Russian Mafia as being involved in cigarette counterfeiting.[48]

Although the President's Order is relatively recent, it was based on extensive federal information gathering and experience with the criminal organizations. The role of counterfeit and other contraband cigarettes in financing terrorists and other dangerous criminals has been long established. In a 2004 article published in The Police Chief, a publication of the International Association of Chiefs of Police (IACP), an ATF senior intelligence analyst explained that

> *The trafficking of cigarettes by terrorists and their sympathizers has been going on worldwide since the mid-1990s, and the last four years have seen a sudden increase in trafficking. The trafficking schemes provide the terrorist groups with millions of dollars annually, which fund the purchasing of firearms and explosives to use against the United States, its allies, and other targets.*[49]

The ATF federal official also explained that

> *Known and suspected Hezbollah and Hamas members have established front companies and legitimate businesses in the cigarette trade in Central and South America. Indications from law enforcement sources are that these companies*

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[47] http://www.whitehouse.gov/the-press-office/2011/07/25/executive-order-blocking-property-transnational-criminal-organizations

[48] National Intellectual Property Rights Coordination Center "Intellectual Property Rights Violations: A Report on Threats to United States Interests at Home and Abroad nation Center,," November 2011, Figure 10, p. 36.

[49] William Billingslea, "Illicit Cigarette Trafficking and the Funding of Terrorism," The Police Chief, February 2004.

> *traffic in contraband and counterfeit cigarettes and tax stamps for profit and then use the proceeds to purchase arms and ammunition.*[50]

The trafficking in counterfeit cigarettes and tax stamps is not unique to any type of FTO or geographic region. For example the intelligence official points out that the "The IRA was one of the first groups to begin using cigarettes to fund their activities." Similarly,

> *The Kurdish Workers Party (PKK) is involved in the trafficking of contraband cigarettes and tax stamps. In one particular instance in 2000, the Turkish military and Turkish federal police conducted a raid at a PKK safe house, which was suspected of actually being one of the PKK headquarters for eastern Turkey. Initially, the Turkish authorities were expecting to find caches of arms, ammunition, and explosives. But the authorities actually found a gravure printing press for producing counterfeit tax stamps and other forged documentation.*[51]

More recently, an article published by Scientific American, quoting a retired FBI agent the role of counterfeit cigarette trafficking in financially supporting terrorism, stated

> *"Obviously there is a concern of what is coming into the United States and how it's being examined," said Bob Hamer, a retired FBI agent. Hamer's last assignment was Operation Smoking Dragon, lasting from 2002 to 2005. Through sales of counterfeit Marlboro cigarettes and tax stamps, the FBI learned about many of the funding sources helping to finance terrorism through the transport of items via Southern California ports. "A lot of the profits from these counterfeit cigarettes were, particularly, going to support Hezbollah and Hamas," said Hamer. "The whole thing began with counterfeit cigarettes. It eventually evolved into something much greater than that."*[52]

Similarly, a Congressional Research Service report noted that,

> *Cigarette smuggling schemes as a means for financing terrorists have been discovered in a range of countries and regions, including the United States, Europe, Turkey, the Middle East and North Africa, and Iraq.*[53]

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[50] Ibid.

[51] Ibid.

[52] Reut Rory Cohen, "Security and Commerce: Finding a Balance in a Post-9/11 World with Risk-Analysis Science," Scientific American Blogs, May 3, 2012.

[53] John Rollins and Liana Sun Wyler, "Terrorism and Transnational Crime: Foreign Policy Issues for Congress," Congressional Research Service, October 19, 2012 available at http://www.thecre.com/cc/wp-content/uploads/2012/11/R41004.pdf.

It is important to recognize that cigarette trafficking means more than just a flow of funds to violent organizations, it is about murder. In 2009, a Florida newspaper detailed the how the trafficking of cigarettes through Florida was used to finance the murder of two British soldiers.

> *The bullets rang out thousands of miles away, but investigators now believe the assault had its origin in an anonymous cargo ship docked at a bustling South Florida port.*
>
> *A gray-haired 57-year-old Cutler Bay man with no criminal history named Roman Vidal sold millions of cigarettes that had been smuggled to Dublin criminals who funded the terrorist group that killed Quinsey and Azimkar, investigators say. The charges are just the latest link between black-market U.S. smokes and violent terrorist groups around the world.*[54]

The Terror– Tobacco Smuggling – Organized Crime Connection

The peer reviewed paper "Methods and Motives: Exploring Links between Transnational Organized Crime & International Terrorism," researched and written by academicians utilizing a National Institute of Justice grant, "identifies and analyzes the points of convergence between organized criminals and terrorists to draw useful conclusions for investigators."[55]

The researchers from American University and other institutions explain that,

> *The interaction between terrorism and organized crime is growing deeper and more complex all the time. First, transnational criminal groups are expanding, both through the addition of new groups and the growth of existing ones. Such growth led to more connections between these groups as well as with other shadowy actors like insurgents, arms proliferators and indeed terror cells. For example, as gangs have evolved into the newest transnational crime groups in North America, stories have recently surfaced that an Al Qaeda operative made contact with members of one gang, Mara Salvatrucha or MS-13, in Honduras in 2004. Terrorists in European prisons recruit criminals to their cause, allowing incarcerated individuals move between their identities as terrorists and criminals.*

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[54] Tim Elfrink, "South Florida Cigarette Smuggling Funds Terrorism," Broward Palm Beach New Times, July 2009, available at http://www.browardpalmbeach.com/2009-07-02/news/south-florida-cigarette-smuggling-funds-terrorism/

[55] Dr. Louise I. Shelley, John T. Picarelli, et al, "Methods and Motives: Exploring Links between Transnational Organized Crime & International Terrorism," September 2005, p. 5, *available at* http://www.thecre.com/ccsf/wp-content/uploads/2011/06/Methods-and-Motives.pdf

Second, the dealings between terrorist and organized crime groups have long since ceased to be a matter of business alone; the two phenomena now intersect on many different levels. Many international terrorists sustain themselves only with the support of organized crime. That dependency, combined with the fact that terrorists commit a range of relatively minor crimes too, can be important keys to detecting and apprehending them.

With so many individuals active in both terrorism and organized crime, there now exists a merging and blurring of functions.[56]

Cigarette smuggling is part of organized crime and terrorist financial dealings. For example, the authors note that "[c]igarette and alcohol smuggling has fueled the Kurdish-Turkish conflict as well as the terrorist violence in both the Abkhaz and Ossetian conflicts."[57]

Los Angeles Police Chief William F. Bratton discussed the convergence of organized crime and terrorist groups in an article in The Police Chief in which he wrote,

The connection between organized crime and the illicit trade market has undergone a mutation of sorts, to the extent that organized-crime entities have morphed from the traditional fixed hierarchies with controlling leaders or families to more decentralized, loosely linked, multiple networks that come together and cooperate only on an opportunistic basis and then separate. In his book Illicit: How Smugglers, Traffickers, and Copycats Are Hijacking the Global Economy, Moisés Naim takes the view that this mutation is similar to that of international terrorist organizations such as al Qaeda and Islamic Jihad. As Naim puts it, the world's first unmistakable glimpse of this transformation came on September 11, 2001. Although many—politicians included—took the position that the "world changed," it may be more accurate to say that something about the world was revealed to us.[58]

Chief Bratton also emphasized that cigarette trafficking plays a significant part of the organized crime-terrorist convergence:

In the City of Los Angeles, investigations by law enforcement have substantiated the report that individuals involved in counterfeiting activities and the illegal sale

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[56] Ibid., p.11. [Notes omitted].

[57] Ibid., p. 66.

[58] William F. Bratton, Chief of Police, Los Angeles, California, "The Mutation of the Illicit Trade Market," The Police Chief, May 2007 available at http://www.policechiefmagazine.org/magazine/index.cfm?fuseaction=display_arch&article_id=1177&issue_id=52007.

> *of cigarettes are significant fund-raisers for known terrorist groups such as Hezbollah and Hamas.*[59]

More recently, the links between organized crime, terrorist organizations and the trafficking in cigarettes and other counterfeit consumer products has been widely noted around the world by reporters, commentators and government officials. Examples include:

From: Malaya Business Insight:

> *Cigarette smuggling has now become a major security concern for many countries because terrorist networks such as Al Qaeda are turning to this illicit trade to finance their criminal activities, according to a study done by a global non-profit tax research foundation. ... The ITIC study disclosed that terrorist organizations and other organized crime groups are exploiting the illicit trade in tobacco products because the highly lucrative activity is relatively low-risk compared to other heavily penalized crimes like drug trafficking and human smuggling.*[60]

From DOJ/ATF:

> *The Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) Atlanta Field Division, together with officials from the Georgia Attorney General's Office, Georgia Department of Revenue, the Gwinnett County District Attorney's Office, the Lawrenceville Police Department, and the Gwinnett County Sheriff's Department, announced today a large-scale enforcement operation involving the execution of multiple arrest, search, and seizure warrants in connection with the illegal trafficking of cigarettes in Georgia.*
>
> ***
>
> *Organized criminal groups, including those with ties to terrorist organizations, have increasingly engaged in the illegal trafficking of tobacco products, particularly counterfeit and lawfully manufactured cigarettes. Prior to 2003, ATF averaged about 40 new diversion investigations annually. Since 2003, ATF has initiated more than 1,050 tobacco diversion investigations, with an average of 131 investigations per year.*[61]

From: The Peterborough Telegraph (UK):

> *The Tax and Investment Centre report said: "Counterfeits of UK brands originate mostly from the Far East.*

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[59] Ibid.

[60] http://www.thecre.com/cc/?p=907.

[61] http://www.thecre.com/cc/?p=555

"The counterfeiters show ever-increasing sophistication in the face of international enforcement efforts.

"Cigarette smuggling is a highly profitable option for organised crime gangs and terrorist networks.

"People involved in the illicit trade of tobacco products are also involved in other forms of illicit trade, such as drugs, human trafficking and guns."[62]

From Business World Online (Philippines):

With the proposed sharp rise in tax rates on, and hence the price of, cigarettes, the Philippine government might have to deal with the return of cigarette smuggling into the country. ... The return of smuggling could provide new life to criminal syndicates and enemies of the State. Experiences in other countries show that smuggling provides financial muscle to organized crime and terrorist activities. Is the Philippine military establishment ready for this?[63]

From News Letter (UK):

Former Assets Recovery Agency chief Mr McQuillan said the seizure of cigarettes in Dublin would cause "serious damage" to dissidents.

"It seems quite clear that dissident republicans are inextricably linked to organised crime and they are probably using this money to fund paramilitary operations," he said.

"But really what you have here is organised crime gangs. It has to be priority for the community to get behind the police in order to stop these economic and terrorist crimes.

"I am delighted to see this seizure in Dublin but what we really need is for people to stop buying illegal cigarettes.

"They need to know that their money is going to kill their neighbours through dissident republican terrorism."[64]

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62 http://www.thecre.com/cc/?p=1677

63 http://www.thecre.com/cc/?p=1667

64 http://www.thecre.com/cc/?p=479

From The Philippine Star:

> *The World Economic Forum noted in 2011 that illicit trade is a major source of revenue for terrorist groups and transnational criminal networks. According to Framework Convention Alliance (2008), recent studies estimate that over 600 billion cigarettes a year is illicit resulting in annual government revenue losses of over $40 billion.*[65]

From Rep. Peter King:

> *Yet every day, the failure to strongly combat the growing crime of contraband cigarette smuggling deprives governments of billions of dollars in tax revenues — siphoned off by terrorist and criminal organizations. ...*
>
> *Disturbingly, the financial loss and budget effect are only part of the problem. Often the state's loss is terrorist organizations' gain. In 2008, under my leadership, a House Homeland Security Committee investigation found a terrifying nexus between cigarette smuggling and terrorism.*
>
> *We uncovered far too many examples. Consider, counterfeit cigarette tax stamps were found in an apartment used by members of the Egyptian Islamic Jihad cell that carried out the 1993 bombing of the World Trade Center. The notorious "Lackawanna Six" Islamic-terrorist cell received $14,000 from a former gas station operator, who was subsequently convicted for cigarette trafficking and money laundering.*[66]

From WJLA ABC-7:

> *ATF agent Ashan Benedict has handled several major cigarette smuggling cases in our region.*
>
> *"Cigarette smuggling is as lucrative or more lucrative than smuggling drugs or smuggling guns," Benedict says.*
>
> *The Department of Justice puts the scope of the problem into the billions of dollars, with big organized crime, and even groups with links to terrorists cashing in.*

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[65] http://www.thecre.com/cc/?p=1259

[66] http://www.thecre.com/cc/?p=645

"You are looking at millions of dollars and the more organized they get we are seeing links to human smuggling, links to narcotics, weapons and violence," Benedict says.[67]

The Narcotics – Gun Running – Human Trafficking – Tobacco Smuggling - Crime Connection

As reported above by a Washington, DC television station, cigarette smuggling is linked to a host of other crimes. The Voice of America has also reported on the close links between cigarette trafficking, counterfeiting and other crimes:

Fake designer brand purses, clothing and even prescription medications are made and sold around the world. Investigators say it is bigger business than the illegal drug trade. And police say that when consumers buy counterfeit items, they could be contributing to the funding other crimes. ... At the Port of Los Angeles, police seize counterfeit purses, clothing, prescription medications, appliances and cigarettes.[68]

It's important to recognize that tobacco smuggling is more than simply one element in a portfolio of illegal activities by crime organizations, tobacco smuggling is the fuel for an array of crimes. As the the Former Assistant Chief Constable, Head of Organised Crime in Northern Ireland made clear, trafficking in contraband cigarettes should be understood as a gateway crime that in turn funds other crimes:

I have dedicated 30 years of my life to policing crime on the streets of Northern Ireland, where organised crime gangs and terrorist groups turned smuggling tobacco into a multi-million pound black market business, funding prostitution and drug trafficking.[69]

Similarly, the Royal Canadian Mounted Police (RCMP) has reported that,

"The illicit tobacco trade is a global phenomenon that contributes to the growth of transnational organized crime and undermines public health objectives."[70]

A senior Google official, during a discussion of the role of illicit networks in supporting crime, explained that seemingly different crimes in different places are closely connected and need to be understood and countered in a unified manner:

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[67] http://www.thecre.com/cc/?p=1897

[68] http://www.thecre.com/cc/?p=1204.

[69] http://www.thecre.com/cc/?p=2009

[70] http://www.thecre.com/cc/?p=1641.

> *Some illicit networks, such as Hezbollah, are involved in activities as diverse as cigarette smuggling in the United States, money laundering in West Africa, drug smuggling in Europe, and illicit arms sales all over the world. To combat such illicit activities, the first step is to view them holistically rather than through traditional silos, and the second step is to identify critical nodes, such as financial intermediaries, that could play a disruptive role if armed with the appropriate information and tools.*[71]

The Myth that Counterfeiting and Piracy are Victimless Crimes

The question arises as to why, given the close links between tobacco smuggling and violent organizations does cigarette trafficking receive relatively little attention? Part of the answer, as previously noted, is that cigarettes are an inherently hazardous product. Another part of the answer, however, is found in the myth that the sale of counterfeit and other contraband cigarettes is a victimless crime.

A consultant the IHS Jane's Information Group and writer for several trade publications explained the victimless crime myth by stating:

> *The contraband of tobacco products internationally has attracted little interest on a media level, although it constitutes an important and increasing form of revenue for a variety of illicit actors, be they organized crime figures, terrorists or extremist sects. In contrast to narcotics trade or human trafficking, tobacco smuggling constitutes no obvious social threat; nevertheless, these activities are conducted by the same people who run the bulk of other dangerous illicit trades, while fueling governmental corruption in developing nations.*[72]

The Department of Justice is long on record making the same point,

> *"Tobacco diversion is not a victimless crime," said ATF Special Agent in Charge Rich Marianos. "Depriving the government of tax revenue impacts the funding of necessary services for our citizens. Many times these investigations also lead to the funding of violent criminal organizations."*[73]

A municipal official in England similarly explained,

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[71] Neal Ungerleider, "How Google Fights Terrorists And Human Traffickers," Fast Company, July 17, 2012.

[72] Ioannis Michaletos, International Tobacco Contraband, May 11, 2012 *available at* http://www.worldpress.org/Europe/3911.cfm.

[73] http://www.thecre.com/cc/?p=1787.

"There is a commonly held view that dealing in imported cigarettes is a victimless crime which doesn't do any harm.

"The perception of a 'Robin Hood' type figure, not paying tax to the government so they can sell them cheaply to the poor is totally false as it affects the livelihood of other local shops who sell cigarettes."[74]

The mistaken view that the purchase of contraband tobacco is a victimless crime is a subset of the larger problem which is that a significant share of the public views the purchase of counterfeit/pirated products as victimless crimes,

Bob Barchiesi has a saying: "If you can make it, they can fake it."

That was apparent yesterday as more than 400 people from 50 countries gathered for an international intellectual property crime conference in Halifax.

On display were everything from fake handbags to fake circuit breakers – and many of them were indistinguishable from the real thing.

"If you knew where your money was going, you'd probably think twice about (buying counterfeit goods)," said Barchiesi, president of the International Anti-Counterfeiting Coalition.

"The people that are engaged in the sale of counterfeit goods are often engaged in other nefarious criminal conduct. It's been linked to organized crime, it's been linked to funding terrorist organizations. It's not victimless."[75]

As CNBC reported,

Counterfeit goods may have a reputation for poor design, unsafe parts and toxic elements, but consumers don't seem to mind.

No country has been associated with dangerous knockoffs more often than China. According to US Customs & Border Protection data, more than 75 percent of counterfeit goods seized between 2004 and 2009 were manufactured there. Apparently, people love a bargain, and they don't mind taking a risk to get one. Despite the risks, it's easy to see why counterfeit goods are appealing. The customer gets what looks like a Louis Vuitton handbag for $50 instead of $2500, and if anything shady happened on its way from the factory to the hawker's table,

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[74] http://www.thecre.com/ccnf/?p=66.

[75] Paul McLeod, "Counterfeiting not a victimless crime, expert says," Metro News, June 26, 2008 available at http://metronews.ca/news/halifax/75395/counterfeiting-not-a-victimless-crime-expert-says/.

the buyer usually doesn't know about it. This allows most people to assume that counterfeiting is a victimless crime. The truth, however, is a different story.

Illegal Products and Illegal Labor

A counterfeit product is often created in a sweatshop, in violation of child labor laws, anti-sweatshop laws and basic human rights. Dana Thomas, described the conditions she witnessed in sweatshops in her 2007 book Deluxe: How Luxury Lost Its Luster.

"I remember walking into an assembly plant in Thailand a couple of years ago and seeing six or seven little children, all under 10 years old, sitting on the floor assembling counterfeit leather handbags. The owners had broken the children's legs and tied the lower leg to the thigh so the bones wouldn't mend. [They] did it because the children said they wanted to go outside and play."[76]

The Victims of Contraband Cigarettes: Disproportionally Young and African American

The victims of contraband cigarettes are numerous and diverse. Everyone who smokes extraordinarily toxic counterfeit cigarettes is a victim as is every underage person who illegally purchases cigarettes from a contraband vendor. Cities and states are victims of the massive lost tax revenues. Mark Quinsey and Patrick Azimkar of British 38th Regiment Royal Engineers whose murders were funded by cigarette trafficking are also victims of the trade.

While the victims of trafficking in counterfeit and other contraband cigarettes are numerous, taken as a whole, they have clear demographic characteristics. As the previously discussed article in the Canadian Medical Association Journal explained, citing an article in Tobacco Control, the young are particularly victimized by the availability of contraband cigarettes stating that a new study "increased the estimate of the share the share of the youth market accounted for by contraband cigarettes to 43%."

The contraband cigarette also disproportionately impacts lower income and non-white citizens. An article published in the American Journal of Public Health analyzing the contraband cigarette trade in New York City summarized its results by stating:

A large tax increase led to what focus group participants described as a pervasive illegal cigarette market in a low-income minority community.[77]

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[76] Daniel Bukszpan, "Counterfeiting: Many Risks and Many Victims," CNBC, 13 Jul 2010 available at http://www.cnbc.com/id/38229835/Counterfeiting_Many_Risks_and_Many_Victims

[77] Donna Shelley, MD, MPH, M. Jennifer Cantrell, MPA, et al., (2007) "The $5 Man: The Underground Economic Response to a Large Cigarette Tax Increase in New York City," American Journal of Public

> *Furthermore, the researchers found that African Americans noted that Blacks compared with all other ethnic groups and were clustered in low-income neighborhoods (NYC Department of Health and Mental Hygiene, unpublished data, 2003).*[78]

While smokers that were included in the study's focus groups cited the lower price of illicit cigarettes as an attraction, they also highlighted the fact their economic status was the reason the contraband dealers were in their neighborhood. As one woman explained,

> *"We're thankful for the $5 man. Everyone is happy that the fare is gonna go back down. We're happy that we found the man on 125th Street that says Newport $5. We don't care that the cops are standing right there and he's doin' something illegal. It's not very important down on 86th Street, Central Park West. That's because they got a lot of money." (Female smoker, 18–24 years)*[79]

The study's subjects were also keenly aware of the racial aspects of the illegal sale of cigarettes and the role that race, economic status and discrimination play in causing African Americans to smoke and in the availability of contraband tobacco:

> *"I sometimes wonder if someone is pushing cigarettes in Harlem because you can go outside of Harlem and you don't see, you don't hear. But in these streets of Harlem, someone is walking around saying, 'cigarettes $5.'" (Female smoker, 50 years)*[80]
>
> *"I need this to calm down and that plays a big role in the life of a Black man of course, there's a lot of things that's put to us that stresses us out and we run to these packs." (Male smoker, 25–49 years)*
>
> *"It's stressful living in Harlem especially with the economy now. You can find a pack of cigarettes before you can find a job." (Female smoker, 18–24 years)*
>
> *"Ya know, we're poor and this [smoking] is the way we get over a lot of things." (Female smoker, 18–24 years)*[81]

Health, Vol 97, No. 8, pp. 1483-1488.

[78] Ibid., p. 1483 [note omitted].

[79] Ibid., p. 1485.

[80] Ibid, p. 1486.

[81] Ibid.

The study also provides a street level view of the same point that the an ATF official made, that cigarette "smuggling is as lucrative or more lucrative than smuggling drugs...."

> *"The profit is unbearable. You know, I watch guys today in Harlem. Bought cars [with the money they made] selling cigarettes. Buy vans and jeeps [with the money they made] selling cigarettes." (Male smoker, 25–49 years)*[82]

One of the ways in which street level contraband dealers increase the availability of cigarettes is by breaking up packs of smuggled cigarettes and selling them individually. The term for such cigarettes is "loosies" for loose cigarettes. The availability of illegal loose cigarettes allows people to buy one or two cigarettes at a time rather than spending the much larger sum that would be needed to buy an entire pack.

> *"It's been about 4 months since I stopped buying packs. I buy loose cigarettes." (Female nonsmoker, 25–49 years)*[83]

The New York Times ran a profile on an African American contraband cigarette vendor, Lonnie Warner. In 2011. Mr. Warner, who is better known as "Lonnie Loosie" because he specializes in the sale of loose cigarettes, buys smuggled menthol cigarettes for a little over $50/carton and "then resells them for 75 cents each, two for $1 or $8 for a pack ($7 for friends)."[84]

According to Mr. Warner, "he and each of his two partners took home $120 to $150 a day, profit made from selling about 2,000 cigarettes, mostly two at a time. Each transaction is a misdemeanor offense." Thus, the illicit cigarette vendors discussed in the story are engaging in nearly 1,000 illegal cigarette transactions a day.

With crime comes punishment. Mr. Warner is frequently arrested. He "recalls being arrested 15 times, generally on the charge of selling untaxed tobacco." Punishment "usually means a few days in jail on Rikers Island, or a week of community service, some of it spent sweeping cigarette butts."

There are three key lessons to be learned from the story of Lonnie Loosie:

1. ***Availability of Loose Cigarettes Undermines Smoking Cessation Efforts***. The article quotes Mr. Warner explaining how people who have the stated intention of quitting smoking have their intent undermined by the availability of single cigarettes.

   > *In his time, Mr. Warner has learned a lot about smokers' habits. He sometimes hears from customers who explain to him they are quitting as they buy two final loosies.*

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[82] Ibid.

[83] Ibid., p. 1485.

[84] Joseph Goldstein, "A Cigarette for 75 Cents, 2 for $1: The Brisk, Shady Sale of 'Loosies'," New York Times, April 4, 2011.

"A lot of them believe they are quitting," he said, "but they come back every day."[85]

2. ***Cigarette Restrictions Increase the Black Market.*** Tax policies which effectively restrict lawful cigarette purchases to relatively upper income smokers have spurred the growth in the contraband cigarette market. As Mr. Warner explains,

   > *"The tax went up, and we started selling 10 times as much," Mr. Warner said. "Bloomberg thinks he's stopping people from smoking. He's just turning them onto loosies."*[86]

   Thus, efforts to weaponize poverty, *i.e.*, policies that use a low income population segment's economic status as the fulcrum in an attempt to alter behavior, can and do backfire.

3. ***Limited Economic Opportunities for Disadvantaged Citizens Also Spur the Black Market.*** As Mr. Williams explains, one of the reasons why he sells contraband cigarettes, despite his frequent arrests, is that he has few other opportunities.

   > *After his release from a 13-year sentence in 2006, Mr. Warner tried to find steady work in New York, but was invariably rebuffed — because of his felony status, he suspects. When he considers his options for making a living, he sees few besides selling loosies.*
   >
   > *"I'm sorry that it's come to this, but this is what it's come to," he said.*

The specific issue of limited economic opportunities for disadvantaged citizens and the larger issues of racism and the daily burdens associated with in living in a disadvantaged community are crucial to understanding both the contraband cigarette market and the prevalence of smoking among African Americans. Moreover, any fair assessment of the victims of the illegal trafficking in any contraband item, whether cigarettes or narcotics, needs to recognize the fact that it is disproportionately African Americans who go to prison. As one the participants in the Shelley (2007) study explained,

> *"It creates more of a way for the lot of us in jail too because for them raising the price and forcing us now to go across state line. They know what's going on and they'll catch you knowing we have a big demand for this, and they lock you up or they catch guys on the street and they grab them and put them in jail, and the most people they're grabbing and putting in jail are people of color."*
> *(Male smoker, 25–49 years)*[87]

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[85] Ibid.

[86] Ibid.

[87] Shelley (2007), p. 1486.

The statement by the study participant that "the most people they're grabbing and putting in jail are people of color" is based on fact. The Fair Sentencing Act was passed by Congress and signed into law in 2010 because of the extreme racial disparities in punishment for African Americans who sold cocaine in the form most common in lower income communities compared with the punishment for whites holding the same quantity of the drug in the form most common in upper income environments.

> *While a person found with five grams of crack cocaine faced a five-year mandatory minimum prison sentence, a person holding powder cocaine could receive the same sentence only if he or she held five hundred grams. Similarly, those carrying ten grams of crack cocaine faced a ten-year mandatory sentence, while possession of one thousand grams of powder cocaine was required for the same sentence to be imposed.*[88]

The racial disparity in sentencing occurred even though a 1997 study "examined the addictive nature of both crack and powder cocaine and concluded that one was no more addictive than the other."[89]

Moreover, the racial disparity in sentencing for the sale of contraband items is not unique to cocaine. As National Public Radio noted in a discussion of the Fair Sentencing Act,

> *In New York and California, state data analyses suggest blacks are much more likely to be arrested for marijuana violations than whites, and census data show a stark reality: African-Americans make up about 12 percent of the U.S. population - and about 44 percent of America's prison inmates.*[90]

An article in Time Magazine, discussing a study published in the Archives in General Psychiatry based on the federal 2005 to 2008 National Survey on Drug Use and Health datasets, explained that

> *Black youth are arrested for drug crimes at a rate ten times higher than that of whites. But new research shows that young African Americans are actually less likely to use drugs and less likely to develop substance use disorders, compared to whites, Native Americans, Hispanics and people of mixed race.*[91]

The racial imbalance in persons serving time for substance offenses is also illustrated by the most recent statistics from the Department of Justice's Bureau of Justice Statistics regarding "sentenced prisoners under state jurisdiction...." Among prisoners sentenced for "drugs" a category that includes "trafficking,

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[88] http://en.wikipedia.org/wiki/Fair_Sentencing_Act.

[89] Ibid.

[90] National Public Radio, "Black Men's Jail Time Hits Entire Communities," August 23, 2010, available at http://www.npr.org/templates/story/story.php?storyId=129379700.

[91] Maia Szalavitz, "Study: Whites More Likely to Abuse Drugs Than Blacks," November 7, 2011.

possession, and other drug offenses" 46% where Black and only 28% were White.[92] Thus, there is a sharp racial divergence between the people who commit substance-related crimes and those who go to prison for the offenses – a fact which needs to inform federal development of substance-related legal policies.

Will Menthol Smokers be the New Contraband Victims?

The US Food and Drug Administration (FDA) is considering banning menthol-flavor cigarettes. The FDA was directed to undertake the review of menthol cigarettes by the Family Smoking Prevention and Tobacco Control Act. The Act, however, also required the Secretary of the Department of Health and Human Services to

consider all other information submitted in connection with a proposed standard, including information concerning the countervailing effects of the tobacco product standard on the health of adolescent tobacco users, adult tobacco users, or nontobacco users, such as the creation of a significant demand for contraband or other tobacco products that do not meet the requirements of this chapter and the significance of such demand. (Public Law 111-31, §907(b)(2))

Advising the FDA on the menthol issue was a Tobacco Products Scientific Advisory Committee (TPSAC) authorized by the Tobacco Control Act. After reviewing evidence presented to the committee at a series of public meeting, the TPSAC said in their final report that,

> *TPSAC acknowledges that the potential for contraband menthol cigarettes exists, should FDA choose to implement a ban or take some other policy action that restricts availability of menthol cigarettes.*[93]

The TPSAC did not, however, reach any conclusions regarding the size and scope of a contraband market for menthol cigarettes. Instead, the committee stated that they were "not constituted to carry out analyses of the potential for and impact of a black market for menthol cigarettes" and "concluded that FDA would need to assess the potential for contraband menthol cigarettes as required by the Act."[94]

CRE's Monograph developed an estimate of the increase in the contraband market resulting from a ban on menthol cigarettes based on federal and state government data and the peer reviewed literature. Because menthol cigarettes are often preferred by African Americans and younger smokers – the same communities already disproportionately targeted by contraband tobacco sales organizations, CRE

[92] E. Ann Carson, Ph.D., and William J. Sabol, Ph.D., U.S. Department of Justice, Office of Justice Programs Bureau of Justice Statistics, "Prisoners in 2011," December 2012, NCJ 239808, Table 9.

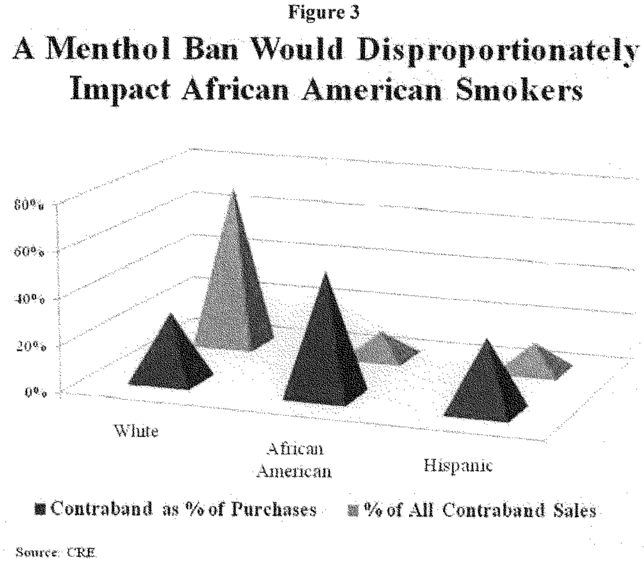
[93] TPSAC, "Menthol Cigarettes and Public Health: Review of the Scientific Evidence and Recommendations," p. 227.

[94] Ibid., p. 225.

estimated that African American neighborhoods would be the focal point of contraband sales organizations in event of a menthol ban.

CRE found that, even though whites, Asians, Hispanics and African Americans currently purchase contraband tobacco at about the same rate, it is African Americans who are most likely to purchase contraband menthol cigarettes as illustrated in Figure 3 (appearing as Figure 13 in the Monograph).

Figure 3

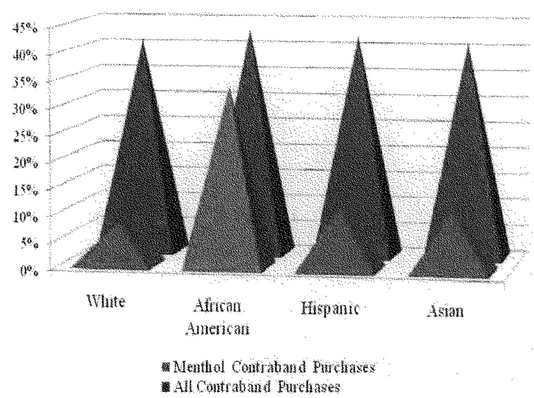


CRE projected that, if there were a menthol ban, it would be African Americans who would disproportionately purchase contraband tobacco even though whites would be, by far, the primary purchaser of illicit cigarettes as illustrated in Figure 4 (appearing as Figure 17 in the Monograph).

Figure 4

Share of Adult Male Smokers Who Have Purchased Contraband Cigarettes

Comparison of all Contraband Purchases to Menthol Contraband Purchases



Source: CRE based on Taylor (2005), NSDUH, Census Bureau Current Population Survey

Counterfeit and other contraband tobacco needs to be subjected to increased law enforcement attention at all levels of government. As President Obama stated in the Executive Order about transnational criminal organizations that traffic in illegal cigarettes, drugs, weapons and humans, they "constitute an unusual and extraordinary threat to the national security, foreign policy, and economy of the United States..." An increase in the contraband cigarette trade resulting from a menthol cigarette ban, however, would mean that the social burden of those enhanced law enforcement efforts would be experienced predominantly in lower income, largely minority communities.

According to data from HHS/CDC presented to the TPSAC, adult white menthol smokers outnumber adult African American menthol smokers by 1.8:1. Among underage menthol smokers, whites outnumber African Americans by 4.7:1.[95] Experience with illegal substances strongly suggests, however, that those

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[95] http://www.fda.gov/downloads/AdvisoryCommittees/CommitteesMeetingMaterials/TobaccoProductsScientificAdvisoryCommittee/UCM207153.pdf

who are subjected to law enforcement actions for contraband tobacco in event of a menthol ban would not be predominately white. This is particularly true given the relative lack of access in disadvantaged communities to tobacco cessation programs and other social support services.

The concerns regarding the impact of a potential menthol ban go far beyond law enforcement issues. As was explained above, in event of a ban on legal menthol cigarettes, contraband tobacco dealers will be even more prevalent in African American communities and will enjoy even larger financial rewards.

The likely impacts of a menthol ban would include:

- More criminals selling cigarettes to children – contraband dealers don't adhere to age restrictions.
- More cigarettes with extreme levels of lead, cadmium and other toxics as well as potentially higher levels of nicotine.
- More street level hawking aka advertising, of cigarettes. As a participant in the Shelley (2007) study explained,

  > *"How could we all forget the biggest advertisement going now when you pass the corner on the street (mimics people selling cigarettes). That's the new advertisement, the people who sell them. (Female nonsmoker, >50 years)*[96]

- More cigarettes sold as singles, aka loosies, increasing their affordability.
- More money going to organized criminal groups to finance other criminal activities.
- More money laundering activities.

In short, the bad guys ranging from Los Zetas to Hezbollah would be the beneficiaries of a ban on menthol cigarettes. Everyone else would lose.

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[96] Shelley (2007), p. 1486.

Conclusions

1. Transnational crime organizations are a threat to national security, as determined by President Obama in Executive Order 13581.

2. The illegal transport and sale of counterfeit and other contraband products is a major revenue source for terrorist and related crime organizations.

3. Counterfeit products pose severe health threats to consumer health and safety.

4. Counterfeiting/piracy of consumer goods is NOT a victimless crime.

5. The trafficking in counterfeit and other contraband cigarettes has a disproportionately harmful impact on African American communities.

6. Any successful strategy to reduce smoking in African American communities will need to focus on making positive improvements in peoples lives rather than on punitive actions.

Recommendations

1. Consumers refuse to buy or use counterfeit/contraband/pirated products.

2. Law enforcement agencies at all levels of government assign a higher priority to fighting counterfeiters.

3. Federal regulators not expand the opportunities for transnational crime organizations by banning menthol cigarettes.

NACS®

Statement of the

National Association of Convenience Stores (NACS)

"Tobacco: Taxes Owed, Avoided and Evaded"

United States Senate Committee on Finance

July 29, 2014

This statement is submitted on behalf of the National Association of Convenience Stores ("NACS").

NACS is an international trade association composed of more than 2,200 retail member companies and more than 1,600 supplier companies doing business in nearly 50 countries. The convenience and petroleum retailing industry has become a fixture in American society and a critical component of the nation's economy. In 2013, the convenience store industry generated almost $700 billion in total sales, representing approximately 2.5% of United States GDP. Tobacco products accounted for approximately 37% of convenience stores' in-store sales in 2013.

NACS's underlying policy objective is to enable its members to sell legal products responsibly and be able to do so on a level playing field. Today's hearing on tobacco taxation evasion and avoidance is an opportunity for the Committee to realize and appreciate the exceedingly *unlevel* playing field on which convenience stores in the United States sell tobacco products. Specifically, there exist in the United States today a number of channels through which illicit sales of tobacco products occur:

- Many Native American tribes and tribal retailers are abusing their sovereignty to evade state taxes on sales of tobacco. Such tribes and retailers abuse their ability to sell tax-free to their own members and expand those sales to non-members even though the Supreme Court has

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said states can tax tribal sales to non-members. Given the large tax component of the price of cigarettes, avoiding taxation can drive many consumers to tribal businesses, resulting in losses for off-reservation businesses and for the states that rely on that revenue.

- Non-face-to-face (*e.g.*, Internet) tobacco sales are far less likely to abide by pertinent tax provisions than sales in brick-and-mortar establishments. Congress took important steps to address this problem when it passed the Prevent All Cigarette Trafficking ("PACT") Act, but continued vigilance by enforcement authorities is needed to build on the progress made to date.

- Certain tobacco manufacturers are evading a recent tax increase applicable to cigarettes, "roll your own" tobacco, and little cigars, by mislabeling their "roll-your-own" tobacco as "pipe tobacco." The United States Congress has already taken steps to address this problem, but it remains pervasive.

- Due to the large disparities in tobacco product taxation in various states, some individuals purchase cigarettes in "low tax" states and transport them to "high tax states" to tell them on the black market. Such sales are at a substantial discount compared to the retail price in the "high tax" states that incorporates state tobacco taxes. Increased federal enforcement efforts are necessary to curtail this practice.

Background

Under the current system of taxation, cigarettes cannot leave the manufacturer unless the federal excise tax is collected. As a result, there is very little federal tax evasion. State excise taxes, however, are collected by private actors in the product's distribution chain. These tax collection points can be evaded in some circumstances and those avenues of tax evasion can be quite lucrative for those willing to try it.

Congress's most recent forays into tobacco tax evasion policy are the Prevent All Cigarette Trafficking ("PACT") Act[1] and the MAP-21 highway reauthorization bill passed in 2012. The PACT Act provided the Department of Justice and states with the enforcement tools they needed to stop the rampant tax evasion by Internet

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[1] Pub. L. no. 111-154.

sellers of tobacco. MAP-21 addressed the proliferation of roll-your-own tobacco machines which were popping up in retail settings, along with roll-your-own tobacco that was falsely labeled as "pipe" tobacco. Both of these laws made important progress to deal with these problems but the work in these areas is not finished.

Illicit Sales by Native American Tribes and Tribal Retailers

Native American tribes are exempt under federal law from charging state excise taxes on sales of tobacco to members of their own tribes. Unfortunately, many tribes and tribal retailers are abusing this special tax exemption by expanding it to sales of tobacco to non-Native Americans. These tribal retail enterprises have refused to collect lawful state excise and sales taxes when they sell these products to non-Native Americans even though they are required to do so.

Native American tribes have immunity from lawsuits in U.S. courts. This immunity is greater than the immunity granted to the United States or foreign governments – all of which can be sued when they act in a commercial rather than a governmental capacity. Tribes have used this unprecedented immunity as a tool to block state efforts to enforce their tax laws. While the federal government can enforce its laws against tribes, states simply cannot. This is a problem that must be dealt with if we are to avoid continued erosion of state tax collections. Tribes should not have greater immunity than foreign governments and should not be able to use the cover of their sovereignty to evade state tax laws and sell tobacco and other products to state residents without collecting and remitting all taxes.

The results of these abuses are widespread. They can include injury to local businesses (that have trouble competing with the large price advantages unfairly bestowed when taxes are not collected) and substantial losses of state and local tax revenues. In fact, in some states, retailers in close proximity to recognized tribes have experienced a more than 80 percent decrease in cigarette sales, as non-Native American customers have migrated to tax-free purchases on Native American land. These retailers are not only losing out on tobacco sales, but also the ancillary sales that tobacco purchasers would otherwise make. Customers who purchase cigarettes frequently purchase other items in a store when they visit to buy cigarettes. Losing the foot traffic that cigarette sales generate results in losses for a retailer well beyond the sale of just a pack of cigarettes.

The volume of tax evasion happening through reservation sales appears to be increasing. One study found that the volume increased by almost 50% between

2008 and 2011.[2] In New York State alone, NACS estimates that tribal tax evasion has generated annual losses of almost $600 million in economic activity (totaling billions of dollars in lost revenue for the State) and more than 6,500 jobs. Some convenience stores have been put out of business because of these tax abuses. And, there are some major convenience store businesses that will not open a new store in areas near reservations because of the threat of lost sales to tribal businesses that evade taxes. These lost investments can stunt economic growth.

This problem has become so significant that new tribes should not be recognized without protections in place that prevent tobacco tax evasion and ensure strong enforcement (overcoming tribal sovereignty) if evasion does occur.[3]

When NACS members are forced to compete against tribal competitors who can evade tax law to gain a competitive advantage, the harm is borne not only by the store owners, but also by the taxpayers. America's convenience store owners are an essential part of our economy, and it is not only critical but economically fair to ensure that these small businesses are able to compete on a level playing field.

Non-Face-to-Face Sales

Congress made real progress on the tax problems with Internet and mail order sales of tobacco products with the PACT Act. Individuals and businesses that sell tobacco products via the Internet or mail order frequently do not pay applicable tobacco taxes and do not have sufficient safeguards to prevent sales to minors. Additionally, Internet sellers are typically located in distant states, on tribal lands, or even overseas, making state or local law enforcement more complicated and expensive.

This has serious policy implications. State cigarette taxes have been on the rise for ten years, doubling between 2002 and 2007 alone. With the 2009 reauthorization of the State Children's Health Insurance Program,[4] the tax portion of a pack of cigarettes in some areas can be more than half of the overall prices of the product. As cigarette prices increased at retail stores, more consumers began to buy

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[2] Gyindon, G.E., Driezen, P., Chaloupka, F.J., and Fong, G.T., "Cigarette Tax Avoidance and Evasion: Findings from the International Tobacco Control Policy Evaluation Project." Nov. 13, 2013, *available at* http://tobaccocontrol.bmj.com/content/early/2013/11/13/tobaccocontrol-2013-051074/T1.expansion.html.
[3] *See* Department of Interior Proposed Rule, "Federal Acknowledgment of American Indian Tribes," 79 Fed. Reg. 30766 (May 29, 2014).
[4] Pub. L. no. 111-3.

cigarettes online.[5] This has led to huge losses of government revenues and undercuts state tobacco policy.[6] The State of New York loses at least $1.7 billion a year in tax revenue and 6,700 jobs on account of cigarette tax evasion.[7] Washington State estimates that it loses $336 million per year in unpaid cigarette taxes.[8]

Although a substantial majority of recognized tribes in the United States do not sell tobacco online, those that do often engage in the same tax evasion schemes as tribal brick-and-mortar retailers by selling tax-free products to non-Native Americans. In addition, the Internet makes it easy to sell cigarettes from low tax states into high tax states without collecting the taxes required in the purchaser's state (see below). Internet sellers have exploited this fact to evade taxes.

The advent of the Internet, and particularly by the lure of websites touting "tax-free" cigarette sales in the face of increasing excise taxes, has generated a significant increase in mail order cigarette sales.[9] Often times, these are black market cigarettes that are not regulated in any way. Indeed, the Internet has been a tremendous tool for purveyors of black market cigarettes; absent additional legal obstacles, this trend will continue.

Although there is minimal research quantifying the extent of damage this does to state coffers, a 2001 study by Forrester Research, Inc.[10] projected that because of tax-evading Internet cigarette sales, states lost $200 million in revenues in 2001. Of course, the exponential expansion of the Internet leads one to deduce that this number is dramatically higher today. Indeed, according to one of the most recent formal surveys, there were more than 700 Internet websites selling cigarettes to U.S. consumers in 2006, up from only a handful in the late 1990s.[11]

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[5] Ribisl, K.M., Kim, A.E., and Williams, R.S.; "Internet Cigarette Sales Knowledge Asset," Web Site created by the Robert Wood Johnson Foundation's Substance Abuse Policy Research Program; October 2007. *Available at* http://saprp.org/knowledgeassets/knowledge_detail.cfm?KAID=3.

[6] *Id.*

[7] "Cigarette-Tax Evasion Costs New York, Illinois Millions," CSP News, December 13, 2012. *Available at* http://www.cspnet.com/category-news/tobacco/articles/cigarette-tax-evasion-costs-new-york-illinois-millions.

[8] Washington State Department of Revenue, "Cigarette Tax Evasion Estimate – FY 2013." March 12, 2014. *Available at* http://dor.wa.gov/Docs/Reports/Cig_Tax_Evasion_FY13.pdf.

[9] Jamie F. Chriqui, Kurt M. Ribisl, Raedell M. Wallace, Rebecca S. Williams, Jean C. O'Connor, and Regina el Arculli, "A comprehensive review of state laws governing Internet and other delivery sales of cigarettes in the United States." Nicotine & Tobacco Research, Vol. 10, No. 2 (Feb. 2008) 253-265, at 253.

[10] Rubin, R. et al., Online Tobacco Sales Grow, States Lose, Forrester Research, Inc., April 27, 2001, available at: http://www.forrester.com/er/research/brief/excerpt/0,1317,12253,00.html.

[11] Campaign for Tobacco Free Kids, "Internet Sales of Tobacco Products – Reaching Kids & Evading Taxes," April 28, 2008, available at http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/internet.

Enforcement is needed to deal with this problem. Congress did its part on the tax front in the PACT Act, and the Family Smoking Prevention and Tobacco Control Act provided the FDA's Center for Tobacco Products with the power to enforce other laws (such as prohibitions against underage sales) against Internet sellers. These laws need to be enforced in order to stem the tide of tax evasion and illicit sales.

Phony Pipe Tobacco

In 2009, Congress raised tobacco taxes to help fund the State Children's Health Insurance Program ("S-CHIP"). As part of this effort, Congress created a wide disparity between the taxes imposed on "roll your own" ("RYO") cigarette tobacco ($24.78/lbs) and the taxes imposed on pipe tobacco ($2.83/lbs).

Once these tax increases took effect, certain tobacco manufacturers began evading the tax increase on cigarette and RYO by relabeling their RYO tobacco as "pipe tobacco." The newly labeled "pipe tobacco" is in fact RYO tobacco; the only difference between the two products is the label. In fact, at NACS's annual trade show, a manufacturer freely admitted to NACS staff that this was common industry practice. Consumers are well aware that so-called "phony pipe" tobacco is in fact suitable (indeed, designed for) for cigarettes – and it is offered and advertised to be used for that purpose.

In the MAP-21 highway reauthorization legislation enacted in 2012,[12] Congress recognized this growing problem. MAP-21 included a provision stipulating that retailers who provide in-store access to a cigarette-rolling machine that produces cigarettes out of "phony pipe" tobacco are "tobacco manufacturers." This status imposed a variety of regulatory obligations on retailers, and achieved its intended effect of dramatically reducing the number of retailers that would allow their customers to produce cigarettes in the store using "pipe" tobacco. NACS supported that provision, and thanks the Committee for its role in helping pass that legislation.

Nonetheless, more than two years later, the problem still exists. Rather than customers using a retailer's machine to "roll their own" tobacco, they have begun purchasing the phony pipe tobacco and simply rolling their own cigarettes off-site. NACS would welcome the opportunity to work with the Committee to identify further measures that can be taken to end this practice once and for all.

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[12] Pub. L. no. 112-14.1

Black Market Sales Arising from State Tax Disparities

There is a wide disparity in the amount that different states tax tobacco products. New York, for example, has a $4.35 tax on each package of cigarettes, while Georgia has a $0.37 tax on each package. This has led to a black market for cigarettes whereby individuals purchase cigarettes in "low tax states" and sell them to smokers in "high tax states," causing the latter to lose out on significant amounts of revenue. Indeed, smuggled cigarettes make up substantial portions of cigarette consumption in many states, and greater than 25 percent of consumption in 12 states.[13] Enforcement efforts to prevent this type of tax evasion would benefit from more federal efforts. States are at a disadvantage trying to fight these sales on their own due to the fact that many activities furthering the schemes take place in other states. The inherently interstate nature of these crimes puts federal enforcement front and center in the fight against tax evasion.

Conclusion

NACS welcomes the attention that the Committee is bringing to this issue. Please feel free to contact me directly if I can be of any further assistance.

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[13] Henchman, Joseph, Drenkard, Scott. "Cigarette Taxes and Cigarette Smuggling by State." March 19, 2014. *Available at* http://taxfoundation.org/article/cigarette-taxes-and-cigarette-smuggling-state.

SMALL BUSINESS CIGAR COALITION
Written Statement for the Record
for
"Tobacco: Taxes Owed, Avoided, and Evaded"
Before the Senate Committee on Finance
July 29, 2014

The Small Business Cigar Coalition (SBCC) appreciates the opportunity to submit these written comments for the record relating to the above-titled hearing on tobacco tax issues. Our comments focus on issues related to the taxation of cigars.

SBCC is a trade coalition that represents 15 small cigar product manufacturers, marketers and component suppliers defined in §900(16) of the Food Drug and Cosmetic Act (FDCA) as domestic tobacco manufacturers and importers that employ fewer than 350 people. They maintain business operations that are geographically located primarily in: NC, LA, FL, KY, TN, CA, PA, MD, NY and NJ. The focus of this organization is exclusively cigars and cigar-related products (although some SBCC members offer the full spectrum of tobacco products, including cigarettes, smokeless (snus, snuff and chewing tobacco), RYO tobacco, cigars, pipe tobacco, cigar wrappers, and e-cigarettes). Members of SBCC offer a wide variety of cigar products to adults only including: premium hand-made cigars, large cigars, cigarillos and filtered cigars, which come in thousands of shapes, sizes, blends, packaging styles and flavors. None of these member companies market to underage smokers. They voluntarily include prominent safety warnings, age-verification software on Internet sites, selective advertising, retailer-screening and other precautions to prevent underage use.

Member companies commonly operate in economically depressed rural areas, some reestablishing closed manufacturing facilities, and providing competitive full-time salaries, health benefits, contributory 401(k)s and related retirement benefits. Together, these small manufacturers are responsible for creating and maintaining thousands of jobs in their companies, communities, ancillary component suppliers and wholesale/retail distribution networks, most of which are also small businesses. They pay significant amounts of income, sales, excise taxes as well as "buy out" payments to the U.S. Department of Agriculture (USDA), Master Settlement Agreement (MSA) payments (on cigarettes and RYO cigarette tobacco) and FDA user fees into localities, states and Federal coffers that constitute the majority of the sale price of each tobacco product sold.

Additionally, U.S. companies that produce cigars overseas create thousands of jobs in Caribbean/Latin American countries that are economically disadvantaged and dependent on U.S. aid. They also create U.S. jobs with their import agents, shipping companies, trucking company partners, sales force and administrative staffs, purchase from U.S. suppliers, and operate wholesale/retail distribution networks in the U.S.

The hearing focused on a very small subset of the overall tobacco market. Filtered cigars comprise approximately 2 percent of annual U.S. tobacco product sales.[1] Most of these products are made by small manufacturers many of which use reconditioned manufacturing equipment and reopened facilities in economically depressed rural areas.

The hearing left out cigarettes – which remain the dominant portion of the market comprising nearly 92% of all tobacco products sold based on TTB excise tax payment statistics. Health policy advocates all agree that cigarettes pose the greatest health risks.[2] Changes to cigar taxes such as those discussed in the hearing would: not increase enforcement, and not address core health concerns – i.e., the pervasive availability of cigarettes. Such changes would, however, adversely impact small business and their adult consumers, benefit higher income individuals compared to the average American (depending on the specifics of the proposal), and potentially eliminate adult consumer choice driving some smokers to cigarettes if other choices are not available.
Our comments consist of the following simple points in support of the above conclusions:

1. Cigars are <u>not</u> substitutes for cigarettes when the two choices are available. Consumers do <u>not</u> confuse the two products. Thus, the historical and separate tax regime for cigars and cigarettes remains appropriate.

2. Additional tax increases focused on one type of cigar will disproportionately impact small businesses whose customers and products were subjected to a record 2,653% tax increase in a single year in 2009. Further, a flat minimum tax on cigars would favor higher income individuals by disproportionately affecting lower-priced products.

3. Manufacturers of cigars are properly applying clear definitions of "large" and "small" cigars that have been included in the law for decades.

4. Illegal behavior undermines the tax system, presents health risks, and should be targeted by enforcement authorities. This behavior becomes more prevalent with higher excise taxes.

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[1] Three-hundred forty five billion cigarettes are sold annually compared to 1 billion small cigars and 8 billion large cigars. *See* http://www.ttb.gov/statistics/13tobstats.shtml.

[2] *See* National Cancer Institute, Monograph 9: Cigars: Health Effects and Trends, http://cancercontrol.cancer.gov/BRP/tcrb/monographs/9/index.html.

DETAILED COMMENTS

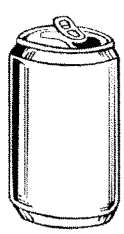
A. Cigars are not substitutes for cigarettes and consumers do not confuse the two products.

Some of the witnesses at the hearing argued that products that are like cigarettes should be taxed as cigarettes on the theory that consumers will readily substitute one such product for the other if they are taxed differently. However, detailed analysis indicates the opposite is true -- cigars are not substitutes for cigarettes -- and, thus, the separate tax regime for cigars and cigarettes remains appropriate.

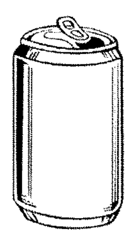
1. Products that look similar are not necessarily similar.

To substantiate the point that cigars are not substitutes for cigarettes, we first borrow an approach used in the hearing and refer to a basic visual aid. Consider the following two product containers. This type of container is almost ubiquitous in America, and is encountered by consumers on a daily basis, often multiple times a day:

Product 1:



Product 2:



Some of the testimony would appear to indicate that, because the containers for a product are identical in size and shape, the products they contain must be similar. However, nothing could be further from the truth. Containers such as these may hold a very broad range of products, including juices of different types, carbonated beverages of varying flavors and calorie content, and alcoholic beverages like beer or flavored malt liquors. It is possible that some of these different products are close substitutes, but also obvious that some are not – such as soda and alcoholic beverages.

How then does one determine whether two products that come in similar packages are substitutes? More detailed analysis is required, including an examination of the product content, how consumers use the product, and market data.

2. Market data demonstrates that consumers do not view cigars as comparable to cigarettes. Rather, cigarettes dominated the market when they were taxed at higher rates compared to cigars and they continue to dominate the market.

The fact that cigars are not substitutes for cigarettes is clear from market data, including that presented at the hearing. First, the most obvious, cigars existed long before cigarettes, yet cigarettes have dwarfed the size of the cigar market for over 100-years. Second, before the record-setting tax increases imposed on tobacco products in 2009 to fund the Children's Health Insurance Program Reauthorization Act (CHIPRA), cigars were all taxed at rates significantly lower than cigarettes. Yet, the lowest price filtered cigar market remained at approximately 2% of total tobacco product sales (removals), while cigarettes were over 92% of the market.[3] Heavier filtered cigars continue to have significantly lower prices than cigarettes. If the products were such good substitutes, the market would have reacted to the price differences and presence of flavors. Sales of filtered cigars should have been much greater and should have increased in the aggregate in comparison to cigarettes. Yet, they remain flat still at approximately 2 percent of total tobacco sales. Today, the GAO reports, cigarettes "continue to dominate the market" in the updated report released during the hearing. The fact is cigarettes will continue to dominate the total tobacco market for the foreseeable future.

3. Cigars differ from cigarettes in appearance and content.

Cigars generally use harsher low-sugar air-cured burley tobacco blends v. sweeter high-sugar flue-cured oriental tobacco blends, as regulated, tested and certified by the Tax and Trade Bureau (TTB) of the Department of the Treasury. Their wrappers by law must contain 2/3 leaf tobacco and consequently are brown in color, rough and fragile in texture, unlike a cigarette paper which is white in color and smooth in texture. They burn differently, are made differently (more expensively), and differ in appearance. The brands must by law be labeled prominently as "Cigars." Little cigars have been made since the turn of the century, and filtered cigars have been made since the early 1970s, both long before the drafting or enactment of CHIPRA.

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[3] Based on 2013 sales data, nearly 300 times more cigarettes were sold than small cigars (all types) (345 billion cigarettes compared to 1 billion small cigars and 8 billion large cigars). *See* http://www.ttb.gov/statistics/13tobstats.shtml. If a little cigar was "likely to be offered to, or purchased by, consumers as a cigarette" because of its appearance, packaging and labeling, it is curious that 300 times more cigarettes than cigars were sold in the United States. This is especially perplexing because heavier cigars are taxed less and are, therefore, cheaper per pack. The answer is obvious to smokers and industry experts. Cigars are not substitutable and they have different consumer demographics, such that they are not mistaken by consumers for cigarettes. Finally, FDA is permitted to regulate cigars as cigarettes if consumer confusion exists.

Cigars come in thousands of shapes, sizes and tobacco blends including machine-made tipped and untipped, or filtered and unfiltered cigarillos, to large Churchill and Monte Cristo type hand-rolled varieties. Cigars are commonly smoked in much fewer numbers and generally, like the pipe smokers tobacco, are not inhaled. Cigarette smokers and cigar smokers are not interchangeable. They represent very different demographics with the average smoker of filtered cigars being older and less affluent.[4]

4. Cigarettes remain the largest tobacco health issue. The burden of death and disease from tobacco use in the United States is overwhelmingly caused by cigarettes.[5]

5. Some cigars are similar in size to cigarettes based on equipment availability, legal requirements and economic factors that enable small businesses to compete.

We end this section of the discussion where we started – the size of the product. Some tipped or filtered cigars are the same size as cigarettes. They are made utilizing lower-priced adapted cigarette manufacturing equipment. Small businesses are not able to compete head-to-head with major cigarette brands produced by large tobacco companies that dominate the market. The ability to make a niche product, using old repurposed cigarette machinery, creates these opportunities for small businesses. The use of the machines is also consistent with the decades-old definitions of cigars in the Internal Revenue Code and ensures proper classification of products for tax purposes.[6]

B. Additional tax increases focused on certain cigar products will disproportionately impact small businesses whose customers and products were subjected to a record 2,653% tax increase in a single year in 2009. Further, a flat, minimum tax on cigars would favor higher income individuals by disproportionately affecting lower-priced products.

[4] The most recent findings from SAMHSA in its 2012 National Survey on Drug Use and Health contradict CDC data that suggests youth usage of cigars is on the rise. In fact, cigar smoking among all populations age 12 or older declined slightly from 5.4% in 2002 to 5.2% in 2012 after peaking at 5.7% in 2004. When these figures are limited to underage smokers only (ages 12-17), the numbers reflect a steady decrease in cigar smoking, from 4.5% in 2002 to 2.6% in 2012 after peaking at 4.8% in 2004. These findings also demonstrate that underage smokers most commonly smoke cigarettes and not cigars. (In 2012, 6.6% took a puff of a cigarette at least once in the 30-days prior to the interview v. 2.6% trying a cigar).

[5] *See* 2014 Surgeon General's Report. http://www.surgeongeneral.gov/library/reports/50-years-of-progress.

[6] 26 U.S.C. §5702(b)(2) states that cigarette means- (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco; (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)[which refers to any roll of tobacco wrapped in paper or in any substance not containing tobacco].

Most tipped or filtered cigars and unfiltered cigarillos are made by American manufacturing companies with fewer than 350 employees. These companies are generally located in economically depressed rural areas where they reopened closed factories; offer full-time employment and health and retirement benefits. Over 200 US tobacco manufacturers are small businesses (down from over 350 before the excise tax increases in CHIPRA). About half of them make cigars. Cigar manufacturers, wholesalers, importers and retailers employ approximately 4,300 people full-time, while suppliers to industry create an additional 48,660 jobs. Over 1.5 billion in wages and almost $9 billion in economic activity are generated by this market segment.[7]

Imposition of additional taxes would result in further economic loss in already depressed areas, particularly given the large federal excise tax increases so recently in 2009. For the first time, CHIPRA taxed small cigars at the same rate as cigarettes, raising the tax rate on small cigars from $1.83 per thousand sticks to $50.33 per thousand sticks, an extraordinary 2,653% tax increase in a single year.[8] Many States followed suit by raising their own State excise taxes to match the Federal tax resulting in an average sales price of $5 per pack of 20 v. the prior $1 per pack of 20. CHIPRA also significantly increased the excise tax on large cigars -- the rate (which is imposed on price) was increased by 155%, and the maximum tax per stick was increased by 726%.

As noted by TTB in its testimony, overseas production of cigars increased dramatically following imposition of higher Federal and state excise taxes following enactment of CHIPRA in 2009. A major factor favoring overseas production is lower production costs resulting in a lower sales price for excise tax purposes. Experienced economists estimated that fully implementing a new tax increase on small cigars would result in a loss of over 16,000 jobs, including wrapper manufacturers, tobacco farms and retail display companies.[9]

The tobacco industry is diverse. Different companies make different types of products. Because of this diversity, some companies may not object (and may even support) certain tax changes because their own products and market share will not be adversely affected. Small businesses cannot compete head-to-head with large manufacturers of well-known brand name cigarettes. The ability to use a repurposed cigarette machine, to make certain cigar products enables small manufacturers to survive in a niche market.

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[7] Report by John Dunham and Associates.

[8] The Senate considered a transition rule that would have phased in the increase over a period from 3 to 5 years. Unfortunately, because of the dynamics of final consideration of CHIPRA, the Senate sponsor's proposal could not be considered because it would change the House bill and require a conference.

[9] *Supra* note 7.

Some have also suggested that "premium" cigars be specially recognized in the law as a distinct tobacco product. American budgets and tastes come in all shapes and sizes. Just as not everyone can afford a million dollar home, or to shop in the most expensive stores, not all budgets readily support the expense of higher-priced cigars. In short, "Joe the Plumber" should not be subject to higher tax simply because he (or his budget) chooses a lower priced product.

Should the Congress consider changing tobacco taxes, or once again increasing such taxes, care should be taken to ensure that any such changes do not discriminate within the industry or among adult consumers; especially those least able to afford increased excise taxes.

C. Manufacturers of cigars are properly applying clear definitions of "large" and "small" cigars that have been in the law for decades.

Excise tax compliance involves the application of a specified rate of tax to a specified product. In applying tobacco excise taxes, manufacturers are applying long-established statutory definitions, and are being regularly audited by the TTB to ensure proper amounts of Federal excise taxes are being collected against such products. The distinction between large and small cigars based on weight has been in the law at least as far back as the 1950's. The current definitions of cigarettes and cigars have been in the law since 1965. These definitions were retained in the FDA Tobacco Control Act. Both TTB and the GAO confirmed in their testimony that manufacturers are complying with the law in the classification of cigar products based on weight, and on physical attributes required to distinguish them from cigarettes. Their statements confirm that the change in tax is due to a change in market shifts, i.e., consumer demand, not lack of legal compliance.

Lighter weight large cigars were marketed before the enactment of CHIPRA, and the use of filters in cigars is also not new. To suggest that manufacturers should remove filters from cigars because such products may look like cigarettes is inappropriate since cigar smokers would lose potential filtration benefits that may come from using a filtered product. Thus, while there has been a shift in consumer demand and the market following CHIPRA, there were preexisting products in this category and the legal definitions governing taxable products are decades old.

Despite these facts, there was considerable rhetoric in the testimony attempting to paint cigar manufacturers in a negative light. Characterizing those who are compliant with the law as tax "evaders" (i.e., illegally escaping tax liability) is not only inaccurate, it is bad tax policy. It paints with a single brush those who comply with the law and those who do not.

Judge Learned Hand aptly described the role of the citizen in tax matters: "Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury."[10] Some witness's view, if applied across the tax laws, would require all Americans to structure their businesses and lives to generate the maximum tax possible. Ironically, there would be less "tax avoidance" or "tax evasion" under this view, if individuals smoked more cigarettes. As Senator Hatch noted in his opening remarks, "It seems that there is some truth to the quip attributed to former House Majority Leader Thomas Foley, that 'If you don't drink, smoke, or drive a car, you're a tax evader.'"

The focus on cigar-makers in this context is inappropriate. We note that, just as it contains a definition of large and small cigar, the Code contains a definition of large and small cigarette.

Code section 5701 provides that "there shall be imposed the following taxes:

> **(1) Small cigarettes.**
> On cigarettes, weighing not more than 3 pounds per thousand, $50.33 per thousand.
> **(2) Large cigarettes.**
> On cigarettes, weighing more than 3 pounds per thousand, $105.69 per thousand; except that, if more than 6 1/2 inches in length, they shall be taxable at the rate prescribed for cigarettes weighing not more than 3 pounds per thousand, counting each 2 3/4 inches, or fraction thereof, of the length of each as one cigarette."

TTB data confirms that there are no sales (removals) of large cigarettes. This is no doubt, at least in part, due to the higher tax rate. Yet, there has been no suggestion that cigarette manufacturers are evading or avoiding the law because they are not manufacturing large cigarettes.

In summary, cigar manufacturers, by applying existing tax rates to clearly defined products as specified in the law, are complying with their tax responsibilities. What the GAO describes as "revenue losses" are really "tax increases" that would result if Congress were to change the law. This situation is very different from the corporate tax inversion issue the Committee recently examined – in this case, small cigar manufacturers are working hard to keep jobs here in the U.S. -- in spite of the over 2,600% tax increase from CHIPRA. Further tax increases will only make that more difficult.

D. <u>Illegal behavior undermines the tax system, presents health risks, and should be targeted by enforcement authorities</u>.

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[10] *Gregory v. Helvering* 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935).

A number of witnesses, including TTB and the Tax Foundation, as well as Senator Warner in his comments, noted that there is clear evidence of illegal activity with respect to tobacco taxes, particularly cigarette taxes. This black-market activity increases as the economic benefit increases from evading (i.e., illegally escaping) higher excise taxes. It includes such things as failing to obtain proper permits, smuggling, and counterfeiting. For example, the Tax Foundation noted that counterfeit cigarettes often come from overseas and do not adhere to the standards applicable in the US. Inappropriately high taxes that have the goal of banning products may have just the opposite impact – encouraging additional illegal behavior. Not only does this undermine tax collection, but it presents increased health risks.

The SBCC agrees that these types of behaviors are of a concern and that enforcement activities should focus on these illegal activities.

We note that the possible cigar tax changes mentioned by some of the witnesses would not address this type of behavior but, rather, would merely increase taxes on compliant manufacturers.

Conclusion

Any consideration of tobacco tax changes should examine a full-range of issues, including the potential for significant adverse unintended consequences. The hearing focused on a small subset of the overall tobacco market (approximately 2 percent). This segment, as relates to cigars, is comprised mainly of small businesses, many of which are already operating in thin margins in economically depressed rural areas. The hearing left out cigarettes – which remain the dominant portion of the market (approximately 92 percent) and which researchers all agree pose the greatest health risks. Changes to cigar taxes such as those discussed in the hearing would not increase enforcement, would adversely impact small business and their consumers, could (depending on the proposal) benefit higher income individuals compared to the average American, and would not address core health concerns – i.e., cigarettes.

INCREASED CIGAR TAX PROPOSALS UNFAIRLY TARGET SMALL BUSINESS

Producers of cigars are small businesses that create American jobs, most of them in economically depressed rural areas.

- Producers and distributors of cigar products include many American companies with less than 350 employees. Small cigar manufacturing businesses, wholesalers, importers and retailers together employ approximately 4,300 workers. Industry suppliers create an additional 48,660 U.S. jobs. Over $1.5 billion in wages and almost $9 billion of economic activity are created by this market segment.

By producing cigarillos, small businesses are able to operate in a niche market that accounts for less than 5% of the total US tobacco market, which is dominated by large cigarette companies.

- Cigars are very different products than cigarettes. Cigars generally use harsher low-sugar air-cured burley tobaccos v. sweeter high-sugar flu-cured oriental tobacco blends used to make cigarettes. Cigar wrappers are commonly brown, not white, and contain required amounts of tobacco leaf that are made differently, burn differently and differ in appearance. These products must be labeled prominently as "Cigars."
- Cigars are commonly smoked in much fewer numbers and are not inhaled.
- Some cigarillos are tipped or filtered and similar in size to cigarettes, utilizing lower-priced, often refurbished cigarette machines. It is the ability to use such machinery that creates opportunities for small businesses.
- Cigar and cigarette smokers have different demographics (i.e., machine-made cigar smokers are commonly older, less affluent).

Small businesses faced tax increases on their products of between 155%- 2,600% in a single year in 2009, but were only able to survive due to market changes.

- For the first time, CHIPRA taxed filtered cigars at the same rate as cigarettes, raising their tax rate from $1.83 per 1,000 sticks to $50.33 per 1,000 sticks, a 2,653% tax increase. CHIPRA also significantly increased the excise tax on large cigars -- the rate (which is imposed on price) was increased by 155%, and the maximum tax per stick was increased by 726%. Many States similarly raised taxes, resulting in an average sales price on filtered cigars of $5 per pack of 20 v. the prior $1 per pack of 20.
- Cigar consumers reacted by choosing heavier filtered cigars, which are considered large for tax purposes. A number of manufacturers made such products before CHIPRA, others followed customer demand and introduced new cigar products, maintaining the less than 2% market share of overall tobacco products.

Cigar manufacturers are paying excise taxes in accordance with well-established law, vigorously enforced by U.S. Treasury's Tax and Trade Bureau (TTB).

- Since Federal tobacco taxes began in the early 1900's, cigars have been taxed at lower rates than cigarettes, due in part to smaller manufacturers, lower margins, fewer sales, lower use and different patterns of use.
- The law defines "small cigars" as weighing 3 pounds or less per 1,000 sticks. "Large cigars" are defined as weighing more than 3 pounds per 1,000 sticks. These definitions have existed in the law since at least the 1950's.

A few current cigar tax proposals would again impose significant tax increases on cigar products, adversely affecting small businesses, without corresponding health benefits.

- Some proposals redefine a small cigar by weight or whether it is filtered. Other proposals would impose a minimum tax of 5 cents per stick ($1 per pack of 20) or not more than 100.06 cents per cigar. Because the current tax is based on price, this would be an additional 100% tax increase.
- Statistics compiled by the SAMHSA indicate there have been significant declines in cigar usage, including filtered cigars, among all persons aged 12 and older since use peaked in 2004.
- Information gathered by Dr. Joel Nitzkin, Chair, Tobacco Control Task Force, American Association of Public Health Physicians, indicates that the health issue is cigarettes not alternative tobacco products, which includes cigars. Limiting consumer choice of possibly less addictive and harmful alternatives is a questionable policy vis-à-vis the greater public good.

In order to protect American small businesses and their employees, further increases in the tax on cigar products should be opposed.

Small Business Cigar Coalition

INCREASED CIGAR TAX PROPOSALS TARGET SMALL BUSINESS

Summary of Issue

American manufacturing companies represented by the Small Business Cigar Coalition (SBCC) produce and sell all types of cigar products and their components. They make important contributions to the domestic economy. Most of these companies employ less than 350 workers, with an average of between 100-150 employees, located in economically depressed rural areas in the United States. Small cigar manufacturers, wholesalers, importers and retailers together employ approximately 4,300 workers, while industry suppliers create an additional 48,660 U.S. jobs. Over $1.5 billion in wages and almost $9 billion of economic activity are generated by this market segment.

Cigar products experienced extraordinary tax increases that ranged from 155% on large cigars to over 2,600% on small cigars in a single year due to legislation adopted in 2009. Despite this recent tax increase, there are a handful of proposals that seek again to increase taxes on these products significantly. Such proposals would have a disproportionate impact on small businesses, and the jobs created by these businesses, without a related positive impact on health. **In order to protect American small businesses and their employees, these proposals should not be adopted.**

Background

Cigars are not Substitutable for Cigarettes. One of the rationales advanced for proposals targeting cigar products is that they may be used as substitutes for cigarettes. In actuality, cigars are very different products. Cigars generally use harsher low-sugar air-cured burley tobaccos v. sweeter high-sugar flu-cured oriental tobacco blends, as regulated by the Tax and Trade Bureau (TTB) of the Department of the Treasury. Their wrappers commonly contain leaf tobacco and are brown, not white. They burn differently, are made differently (more expensively), and differ in appearance. The brands must be labeled prominently as "Cigars."

Cigars come in many sizes including machine-made tipped or filtered cigarillos to large Churchill and Monte Cristo type hand-rolled varieties. Some tipped or filtered cigars are the same size as cigarettes, utilizing lower-priced cigarette manufacturing equipment. Indeed, it is the ability to use such machinery, which is often refurbished, that creates the opportunities for small businesses. Cigars are commonly smoked in much fewer numbers and not inhaled. Cigarette smokers and cigar smokers are not interchangeable. They represent very different demographics. The fact that they are not substitutes is also clearly supported by market data. Before the 2009 tax increase, cigars were taxed at rates significantly lower than cigarettes yet, the lowest price filtered cigar market remained at approximately 2% of total tobacco product sales (removals), while cigarettes were over 90% of the market. Today, their market share has not changed significantly and te total cigar market approximates 8-9% of tobacco sales.

Cigars Historically Taxed Significantly Less Than Cigarettes. Since Federal tobacco excise taxes were initiated in the early 1900's, cigars have been taxed at lower rates than cigarettes. This is due in part to smaller manufacturers, lower margins, fewer sales, lower use and different patterns of use.

CHIPRA Dramatically Increased Cigar Excise Taxes. Historically, separate tobacco tax rates have been imposed on cigarettes, small cigars, and large cigars as enforced by the TTB. The most recent overall changes to tobacco excise taxes were adopted in 2009, by the Children's Health Insurance Program Reauthorization Act (CHIPRA). For the first time, CHIPRA taxed small cigars at the same rate as cigarettes, raising the tax rate on small cigars from \$1.83 per thousand sticks to \$50.33 per thousand sticks, an extraordinary 2,653% tax increase in a single year.[1] Many States followed suit by raising their own State excise taxes to match the Federal tax resulting in an average sales price of \$5 per pack of 20 v. the prior \$1 per pack of 20. CHIPRA also significantly increased the excise tax on large cigars -- the rate (which is imposed on price) was increased by 155%, and the maximum tax per stick was increased by 726%

Small and Large Cigars Are Defined by Weight. Under long-standing definitions in the Internal Revenue Code (§5702), "small cigars" are defined as weighing 3 pounds or less per 1,000 sticks. "Large cigars" are defined as weighing more than 3 pounds per 1,000 sticks. This distinction has been in the Code for decades.

Consumers Reacted to Tax Increase by Choosing Heavier Cigars. Cigar consumers refused to pay the 2,653% tax increase on small cigars choosing to purchase heavier large cigars. A number of manufacturers already made heavier cigar products well before the proposed CHIPRA increases. Other companies followed customer demand and introduced heavier cigar products.

Current Proposals Disproportionately Impact Small Businesses without Significant Health Benefits. Certain proposals target cigars for additional increases in Federal excise taxes. For example, under some proposals, a filtered cigar would be defined by weight (less than 4 lbs. per 1,000) and by whether the product contains an acetate filter, similar to the filter on cigarettes. Other proposals, such as the Tobacco Tax Parity Act, would impose a minimum tax of 5 cents per stick (\$1 per pack of 20) or a maximum of 100.06 cents per cigar. Because the current tax is based on price (52.75% of price), for filtered cigars, which are lower in price, this represents another large tax increase; this time an additional 100%.

Discussion

Cigar Manufacturers Add Jobs to the U.S. Economy. Most tipped or filtered cigarillos are made by American manufacturing companies with fewer than 350 employees. These companies are generally located in economically depressed rural areas where they reopened closed factories; offer full-time employment and health and retirement benefits. Over 300 US tobacco manufacturers are small businesses. About half of them make cigars. Cigar manufacturers, wholesalers, importers and retailers employ approximately 4,300 people full-time, while suppliers to industry create an additional 48,660 jobs. Over 1.5 billion in wages and

[1] The Senate considered a transition rule that would have phased in the increase over a period from 3 to 5 years. Unfortunately, because of the dynamics of final consideration of CHIPRA, the Senate sponsor's proposal could not be considered because it would change the House bill and require a conference.

almost $9 billion in economic activity are generated by this market segment. Imposition of additional taxes would result in further economic loss in already depressed areas. It would be unfair given the large federal excise tax increases so recently in 2009. Experienced economists estimated that fully implementing a new tax increase on tipped or filtered cigarillos would result in a loss of over 16,000 jobs, including wrapper manufacturers, tobacco farms and retail display companies. These jobs would be lost if market demand shifts to large cigars produced offshore.

Cigars Are Not Substitutes for Cigarettes. The product design of cigars differs from cigarettes. Filters are used on cigars to keep leaf tobacco out of the smoker's mouth and to reduce harmful smoke constituents. The smoke is not intended to be inhaled. Undisputed market data bears out these differences. If cigars and cigarettes were interchangeable, the lower-priced filtered cigar market share, for example, would exceed the relatively flat 2% of total tobacco sales.

Definitions Long Established by IRC. Manufacturers are applying long-established statutory definitions when applying tobacco excise taxes. Current cigar and cigarette definitions have existed unchanged dating at least as far back as the 1950's. They were retained in the FDA Tobacco Control Act and have been validated by Treasury TTB and GAO.

Excise Taxes Overseen by TTB. TTB continues to regulate and audit features distinguishing products successfully to enforce existing excise tax structures. Companies comply with existing rules by submitting to audit, voluntary testing and certification.

New Tax Increases Do Not Have Corresponding Health Benefits. Statistics compiled by the Substance Abuse and Mental Health Services Administration (SAMSHA) indicate that there have been significant declines in cigar usage since use peaked in 2004, including use of smaller cigars, among all persons aged 12 and older (see http://www.samhsa.gov/data/NSDUH/2012SummNatFindDetTables/NationalFindings/NSDUHresults2012.htm). According to information gathered by Dr. Joel Nitzkin, Chair, Tobacco Control Task Force, American Association of Public Health Physicians, the health issue is cigarettes not alternative tobacco products, which include cigars. Limiting consumer choice of possibly less addictive and harmful alternatives is a questionable policy vis-à-vis the greater public good. The cigar tax increases do not address health concerns with cigarettes.

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