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# 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

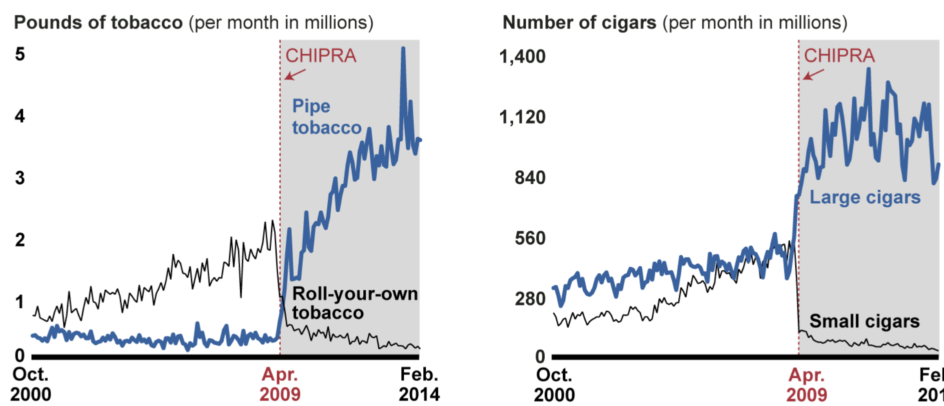
# TOBACCO TAXES

## 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.

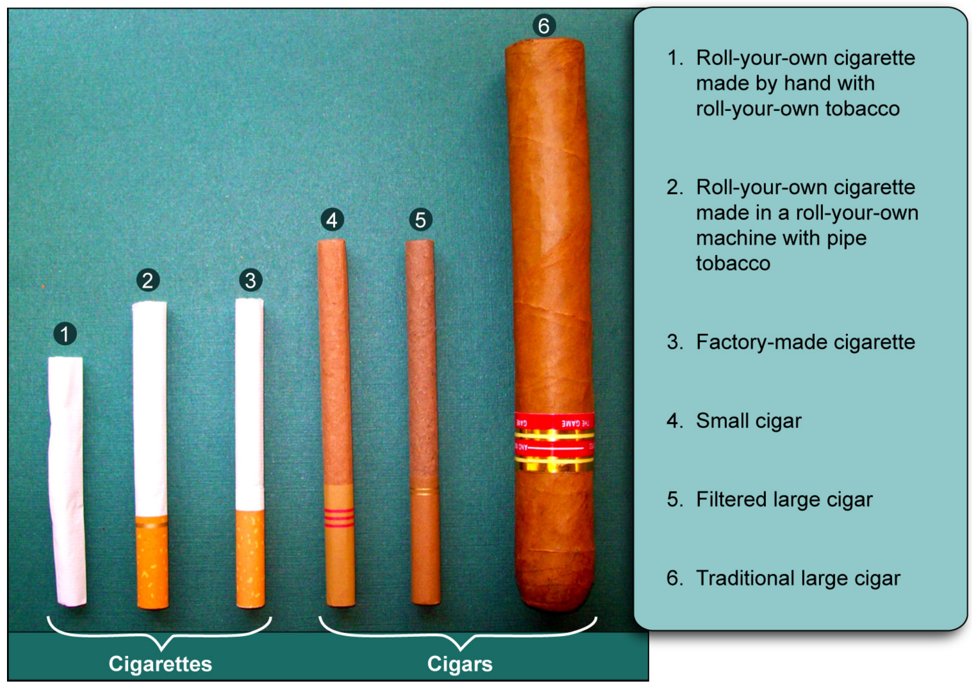
[8]*Id.*

[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.

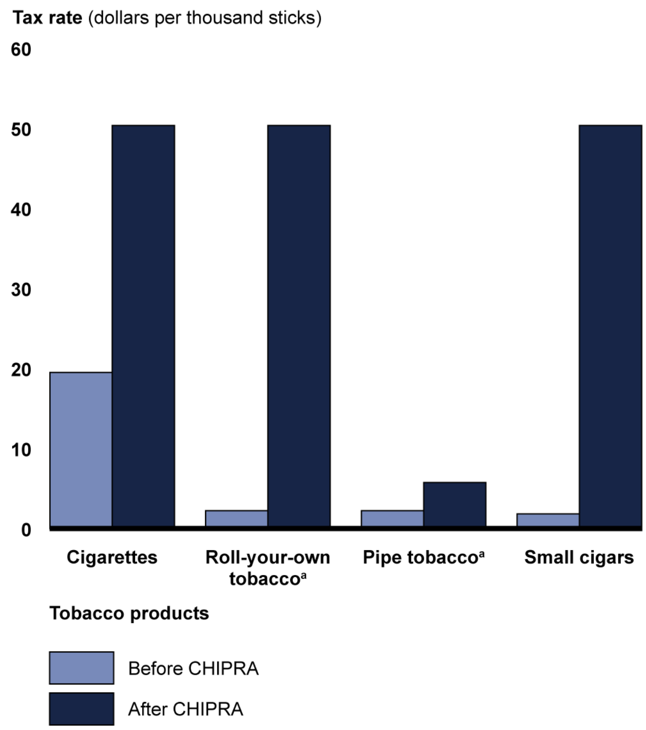
Figure 1: Examples of Cigarette and Cigar Products




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

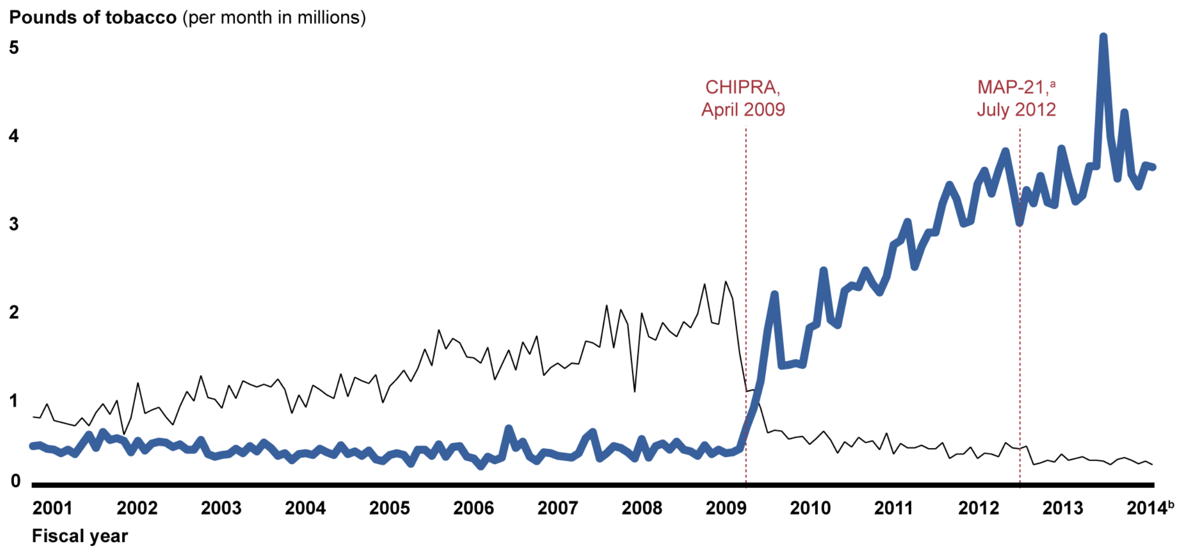
Large federal excise tax disparities among tobacco products resulting from CHIPRA created opportunities for tax avoidance and led to significant market shifts by manufacturers, importers, and price-sensitive consumers toward the lower-taxed products. Specifically, the market for roll-your-own tobacco 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

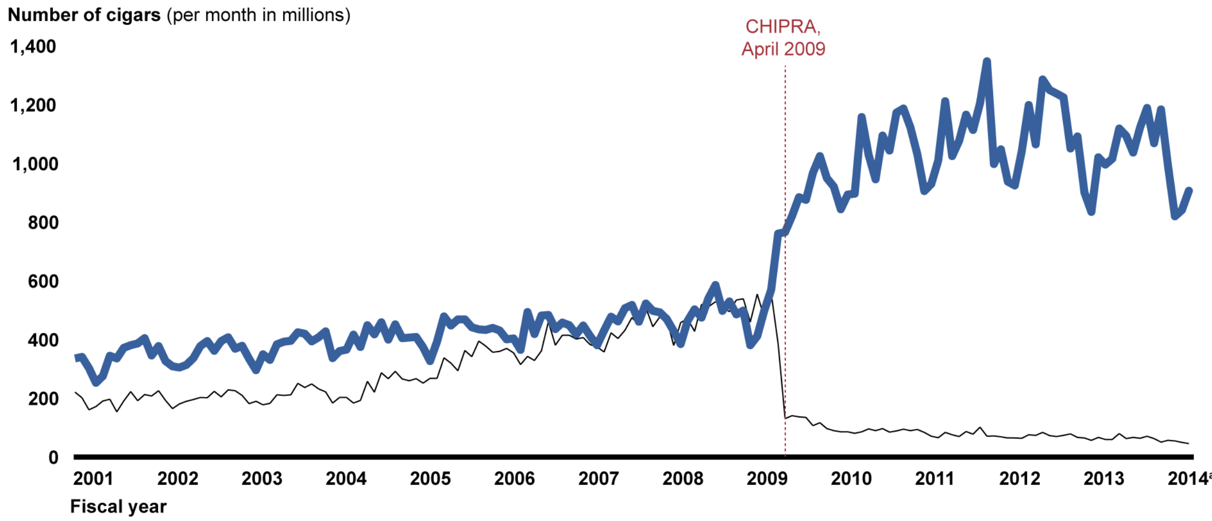
CHIPRA's 2009 changes in federal excise tax rates on tobacco products resulted in an immediate shift in the cigar market, with sales of lower-taxed large cigars rising sharply while sales of higher-taxed small cigars dropped. CHIPRA significantly changed the tax rates on cigars, resulting in a large 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 | 2014[a] |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **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

[a]Data 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]

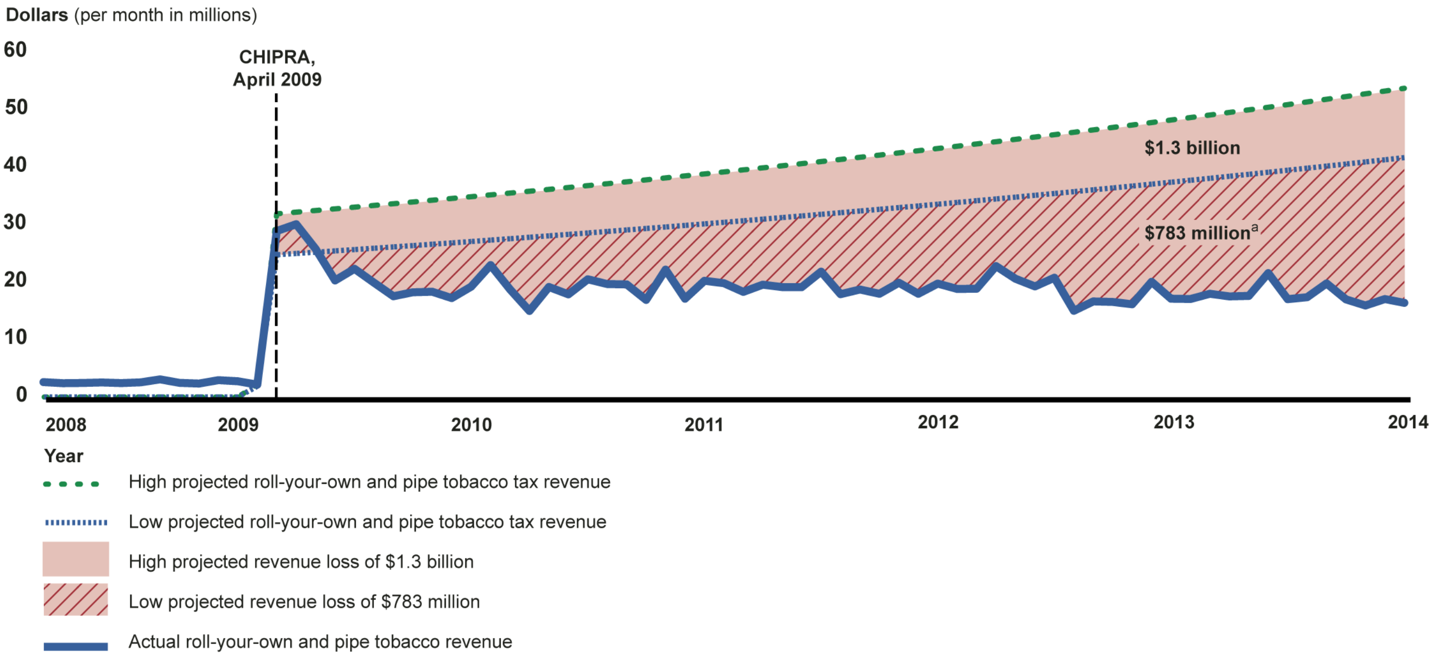
[25]In the absence of this market shift due to differential tax rates, more tax revenue would have been collected because roll-your-own tobacco and small cigars had historically much higher levels of sales than pipe tobacco and large cigars, and after CHIPRA these tobacco products also had a much higher 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)**



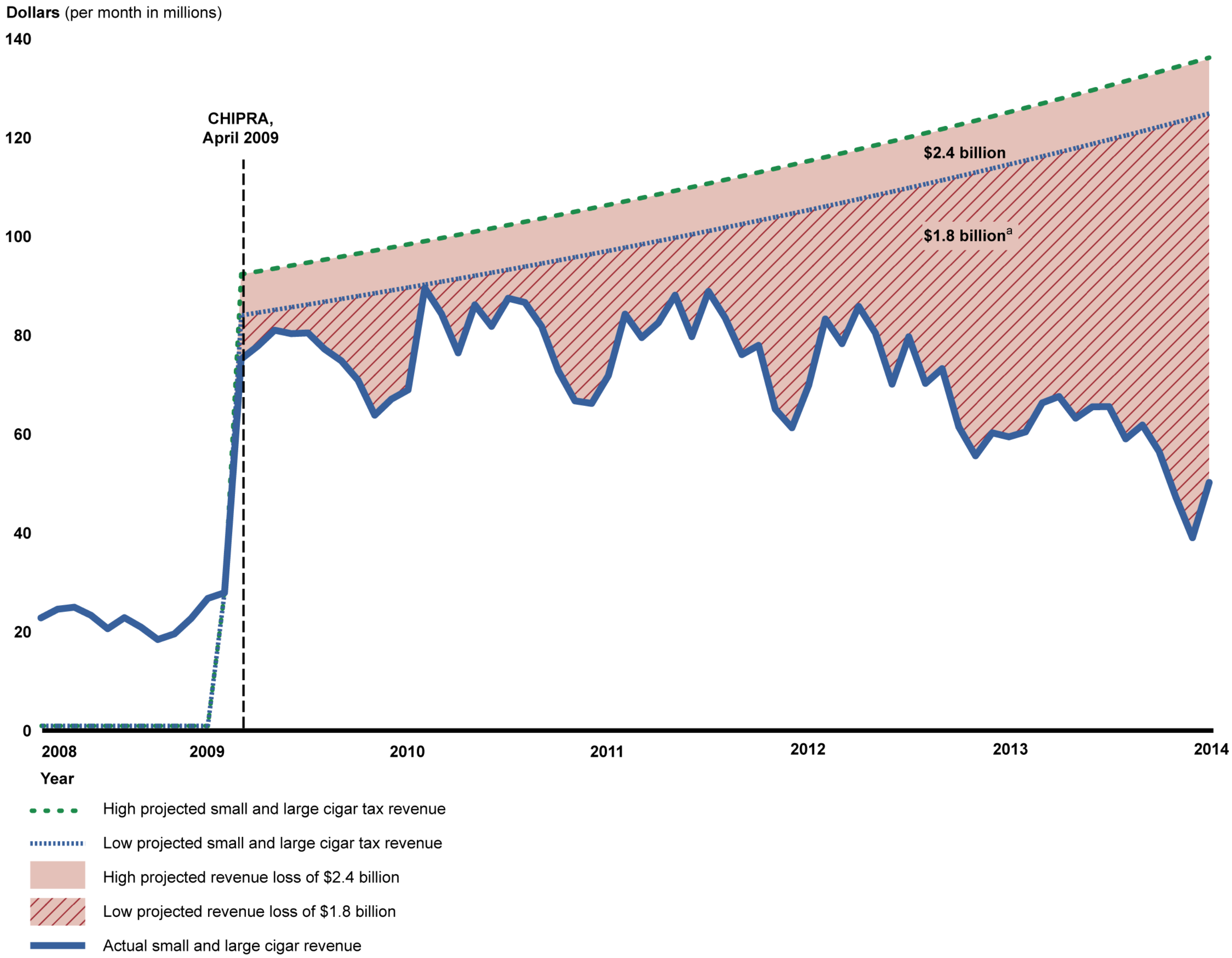

Source: GAO analysis of data from the Department of the Treasury, Customs and Border Protection, and Bureau of Labor Statistics. | GAO-14-811T

[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.

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