

80th Annual FTA Tobacco Tax Conference 2006

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CIGARETTES vs. LITTLE CIGARS

I. Historical Perspective

A. Differences in Definitions

B. Differences in Sales

C. Differences in Marketing and Advertising

II. Telling the Difference

A. Tobacco Characteristics

B. Smoking Characteristics

C. Current tests to distinguish

III. Current Issues

DEFINITIONAL DIFFERENCES

- Federal Cigarette Labeling and Advertising Act (“FCLAA”)
- State Definitions
- Master Settlement Agreement (“MSA”) and Related State Statutes
- Federal Trade Commission Consent Decree

FCLAA (1965)

- “The term ‘cigarette’ means
(1) any roll of tobacco wrapped in paper or in any substance not containing tobacco; or (2) tobacco, in any form, that is functional in the product, 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; or (3) 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”

15 USCS § 1332 (2004)

FCLAA AMENDED (1973)

- “The term ‘little cigar’ means any roll of tobacco wrapped in leaf tobacco or any substance containing tobacco (other than any roll of tobacco which is a cigarette within the meaning of subsection (1)) and as to which 1000 units weigh not more than three pounds.”

15 USCS § 1332 (2004)

STATE DEFINITIONS

- Montana Code:

“Cigarette’ means (i) any roll of tobacco wrapped in paper or in any substance not containing tobacco; (ii) tobacco, in any form, that is functional in the product and that, 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; or (iii) any roll of tobacco wrapped in any substance containing tobacco that, because of its appearance or the type of tobacco used in the filler and regardless of its packaging and labeling, is likely to be offered to or purchased by consumers as a cigarette....”(Mont. Code Ann. §16-11-102 (2005))

1998 MSA

- MSA resolved AG actions against *cigarette* manufacturers
- Adopted FCLAA definition of cigarette
- **MSA does not apply to little cigars**

MSA STATE QUALIFYING STATUTES

- MSA effectively required each settling state to enact an identical “qualifying statute”
- Qualifying statutes adopt FCLAA definition of cigarette
- All states have done so (See, for example, Mont. Code Ann. §16-11-402 (2005))

2000 FTC CONSENT DECREE

- Signed by Federal Trade Commission and seven largest cigar manufacturers
- Adopted definition of little cigar created by FCLAA

SALES DIFFERENCES

- Unit volume
- Dollar amount
- Excise tax payments

NATIONAL SALES

- 2005 Unit Sales:

- Cigarettes 381,000,000,000

- Little Cigars 3,800,000,000

More cigarettes are sold in 4 days than little cigars are sold in an entire year

NATIONAL SALES

- 2005 Retail Sales:
 - Cigarettes \$ 82,000,000,000
 - Little Cigars \$ 312,000,000

Cigarette sales generate more revenue in 2 days than little cigar sales do in an entire year

NATIONAL SALES

- 2005 Federal Excise Tax Payments:

- Cigarettes \$ 7,430,000,000

- Little Cigars \$ 7,200,000

MONTANA SALES

- 2005 Unit Sales:
 - Cigarettes 1,176,000,000
 - Little Cigars 7,128,000

More cigarettes are sold in 3 days than little cigars are sold in an entire year

MONTANA SALES

- 2005 Retail Sales:

- Cigarettes \$ 283,100,000

- Little Cigars \$ 800,000

Cigarette sales generate more revenue in 2 days than little cigar sales do in an entire year

MONTANA SALES

- 2005 State Excise Tax Payments:

- Cigarettes \$ 59,500,000

- Little Cigars \$ 197,000

ARKANSAS SALES

- 2005 Unit Sales:
 - Cigarettes 4,516,000,000
 - Little Cigars 75,850,000

More cigarettes are sold in 7 days than little cigars are sold in an entire year

ARKANSAS SALES

- 2005 Retail Sales:

- Cigarettes \$ 797,000,000

- Little Cigars \$ 5,800,000

Cigarette sales generate more revenue in 3 days than little cigar sales do in an entire year

ARKANSAS SALES

- 2005 State Excise Tax Payments:

- Cigarettes \$ 127,000,000

- Little Cigars \$ 475,000

MARKETING AND ADVERTISING DIFFERENCES

- No little cigars are line extensions of cigarettes
- Many are line extensions of regular size cigars
- Planograms for little cigars have products merchandised separately from cigarettes
- Little cigars always treated as sub-category of cigars

TELLING THE DIFFERENCE

- Tobacco Characteristics
- Smoking Characteristics
- Current Tests to Distinguish

- Tobacco Characteristics:

- Type of Filler Tobacco Used

- Cigarettes use flue cured tobaccos (more acidic)
 - Cigars use air cured (more alkaline)

- Wrapper

- Cigarettes use paper
 - Little cigars use tobacco

- Smoking Characteristics:

- Cigarette smoke is usually inhaled; cigar smoke is not
- Cigarettes will continue burning even if not “puffed”; most cigars will not
- Significant differences in taste, flavor, aroma and draw

- Smoking Characteristics:

- “Most cigarette smokers smoke every day. In contrast, as many as three-quarters of cigar smokers smoke only occasionally, and some may only smoke a few cigars per year.”

National Institutes of Health, Smoking and Tobacco Control
Monograph 9 – Cigars (1998) at p. iii

- CURRENT TESTS TO DISTINGUISH:
 - 1973 ATF Ruling 73-22
 - Chemical composition test

- 1973 ATF Ruling 73-22
 - Offers guidance on differences between cigarettes and cigars
- Type of tobacco used in filler
 - “The inclusion of flue-cured or aromatic (oriental) tobaccos – which traditionally have been the primary constituents of cigarette filler – can contribute significantly to making a product cigarette – like.... Conversely, if a product is made predominantly of cigar-type tobaccos with distinctive cigar taste and aroma . . . it would probably be classified as a cigar.”

- Likely to be offered to, or purchased by, consumers as a cigarette
 - “Two other factors which are relevant under the Code in determining the tax category of a product are whether the product is likely to be offered to, or purchased by, consumers as a cigarette. It is, therefore, important that the package for a product to be offered as a cigar conspicuously declare it to be a cigar and that all marketing materials and advertising clearly present the product to the consumer as a cigar and not as a cigarette. There must be no representations or implications on the package or in other merchandising or advertising materials, which tend to negate the tax declaration that the product is a cigar. If the package for a cigar product is comparable to the traditional 20-cigarette soft (cup) pack or the similar hard pack, the declaration ‘cigars,’ ‘small cigars,’ ‘little cigars’ must appear in direct conjunction with, parallel to, and in substantially the same conspicuousness of type and background as the brand name each time the brand name appears.”

- Chemical Composition:
 - TTB National Laboratory promulgated current procedures for testing tobacco filler
 - TTB compares carbohydrate levels of products
 - Cigars are mostly air-cured tobacco; process results in a carbohydrate content of generally 3% or less
 - Cigarettes are mostly flue-cured tobacco; process results in a carbohydrate content as high as 23%
- TTB concluded “differentiation of the tobacco products should be possible by a comparison of the carbohydrate profiles of each.”

Zook CM, Patel PM, LaCourse WR. Characterization of tobacco products by high-performance anion exchange chromatography-pulsed amperometric detection. *J Agric Food Chem*, **44**, 1773-9.

CIGARETTES vs. LITTLE CIGARS

- Both cigarettes and little cigars are recognized by Congress and federal agencies as separate and distinct categories of tobacco products
- Cigarettes and little cigars each have distinct tobacco and smoke characteristics
- Both cigarettes and little cigars should continue to be defined at the Federal level to avoid inconsistent definitions being developed and applied by individual states

CURRENT ISSUES

- State Efforts to Change Definitions
- State Taxes
- Master Settlement Agreement
- Alcohol and Tobacco Tax and Trade Bureau Statement on Notice of Proposed Rulemaking Regarding Little Cigars

STATE EFFORTS TO CHANGE DEFINITIONS

- Montana Proposal (7/31/06)
- Product considered a cigarette if it meets two or more of the following eight criteria:

- Sold in packs of 20 or 25
- Available for sale in cartons of 10 packs
- Sold in cigarette-type boxes
- Product is length and diameter of cigarettes
- Product has integrated filter
- Product weighs less than three pounds per thousand sticks
- Product is marketed or advertised as a cigarette or cigarette substitute or
- “other evidence” that product is a cigarette

- Product considered a cigar if it is wrapped in
 - 100% natural leaf tobacco, or
 - Any substance that contains 75% or more tobacco which did not lose its tobacco character
- Result would be to remove majority of all cigars from the cigar category

STATE TAXES

- Individual state legislatures decide how to tax different products
- 21 states currently tax little cigars at a rate equal to or higher than cigarettes
- Montana proposal would effectively increase the tax on almost all little cigars by 23%
- State agencies should not attempt a tax increase by redefining little cigars as cigarettes

MASTER SETTLEMENT AGREEMENT

- Enactment of State Qualifying Statutes
- “Renegade” Provision
- Diligent Enforcement
- Cigarette Companies Withhold MSA Payments

MASTER SETTLEMENT AGREEMENT

- Enactment of “Qualifying Statute”
 - “Qualifying Statute” is a state statute, regulation, law and/or rule that effectively and fully neutralizes the cost disadvantages of the cigarette companies that signed the MSA
 - Requires creation of escrow accounts and payments by cigarette manufacturers that did not sign the MSA

MASTER SETTLEMENT AGREEMENT

- “Renegade” Provision –

Entitles cigarette companies that signed the MSA to reduce payments if they lose market share to cigarette companies that did not sign the MSA

MASTER SETTLEMENT AGREEMENT

- “Diligent Enforcement”

State’s MSA payment does not get reduced if it has a Qualifying Statute in full force and effect during the entire calendar year immediately preceding the year in which the payment in question is due, and it ***diligently enforced*** the provisions of such statute during such entire calendar year.

MASTER SETTLEMENT AGREEMENT

- Cigarette Companies Withhold MSA Payments
 - “Tobacco companies put more than \$700 million aside...rather than hand it over to the states in their battle over how much cigarette makers owe this year under a landmark 1998 settlement.” (Nancy Zuckerbrod, *Cigarette Makers, States Fight Over Money Owed Under Settlement*, Associated Press, April 17, 2006)
 - “The tobacco companies announced that they were withholding a portion of the payment this year because the states had not "diligently enforced" the agreement, causing them to lose market share to smaller companies that were not part of the agreement.” (Amy Worden, *Pa. Files Suit Over Tobacco Payments: Two Top Producers have held Back Over \$47 Million Owed Under the 1998 Settlement, the State Attorney General Says*, The Philadelphia Inquirer, May 2, 2006)

RECENT TTB STATEMENT

- “Over the past several years, TTB has seen an increase in the importation and marketing of tobacco products labeled “**Little Cigars**.” Due to this increase, Federal and State agencies as well as tobacco manufacturers and importers have asked TTB for clarification on the regulations that pertain to these products. Therefore, we are presently reviewing our regulations to determine how best to approach this issue. However, if or until we implement any changes, it is the responsibility of the tobacco manufacturer and/or importer to ensure that their products meet the requirements set forth in the regulations at 27 CFR parts 40 and 275. We also suggest that all responsible parties review the specific requirements that pertain to the packaging and marketing of little cigars as written in ATF Ruling 73-22.”

<http://www.ttb.gov/tobacco/index.htm>

CONCLUSION

- **Continue** to have uniform, consistent product definitions, including for tax and MSA purposes
- **Continue** to have uniform consistent application of the definitions
- Cigar manufacturers on record as recognizing the need for both a clearer method of distinguishing between products and a means of getting the information to state governments