March 23, 2007 Comment 16

VIA E-MAIL (nprm@ttb.gov)
(Original Sent By Regular Mail)

Director
Regulations and Rulings Division
Alcohol and Tobacco Tax and Trade Bureau (Attn: Notice No. 65)
P.O. Box 14412
Washington, DC 20044-4412

Re: Tax Classification of Cigars and Cigarettes

Dear Sir or Madam:

This letter includes comments to the proposed regulations that govern the classification and labeling of cigars and cigarettes for U.S. federal excise tax purposes, as proposed by the U.S. Department of Treasury and the Alcohol and Tobacco Tax and Trade Bureau ("TTB"). We have also included a few narrow changes to the proposed rule for your consideration that would address the problems highlighted in our comments. While these suggested revisions are narrow, the failure to adopt them would eliminate, intentionally or unintentionally, most little cigar products manufactured by Cheyenne International, LLC (Cheyenne) and the dozens of other large and small businesses making and selling little cigars in the U.S. We appreciate the TTB's careful consideration of these comments and the proposed changes.

A. Executive Summary

1. Significant little cigar maker. Cheyenne makes and sells a significant number of little cigars for sale in the US market and for foreign export.

2. Size and shape dictated by IRC. The current size and shape of "little cigars" are required in order to comply with the federal tax definition of little cigars; weighing no more than 3 lbs. per 1,000 sticks. Manufacturing equipment has been built at great expense to produce product as rapidly and efficiently as possible to meet existing statutory requirements and interpretations.

3. Filters used for decades. Cellulose acetate filters have been used in little cigars for decades because they are preferred by consumers to prevent tobacco filler from getting into their mouths, are light thereby preserve existing federal weight restrictions, and can be added using manufacturing equipment operated by little cigar makers.

4. No evidence consumers misled. Cheyenne and other manufacturers label their products conspicuously and prominently as "Little Cigars" on the front, back, bottom (and top if sold in hard packs) of product packaging parallel to the trade name wherever it appears. There is no evidence that consumers are misled into purchasing or using these products believing them to be cigarettes, or that these products are substitutable. If that were true, little cigars sales would have displaced a major share of the cigarette market because of their lower price rather than posting approximately 1% of total cigarette sales in the U.S.

5. Cheyenne meets all statutory requirements. The products contain harsher low sugar leaf tobacco filler commonly used in cigars. Their brown wrappers are composed of 2/3 reconstituted tobacco. Cheyenne little cigars meet all federal statutory requirements, all ATF Rulings, and have been audited and classified by TTB as little cigars prior to marketing and sale.

6. Unfair to change interpretation. Cheyenne has always sought to be a good corporate citizen by making and marketing its tobacco products in compliance, not only with the letter of the law, but with the spirit of the law as interpreted by implementing government entities. It would be unfair, and likely illegal, to dramatically alter that interpretation now without any credible rationale when relied upon by so many businesses and consumers.

7. Millions invested in reliance. Like many other small businesses and larger businesses making these products, Cheyenne has invested many millions of dollars in reliance on TTB advance rulings. This investment created jobs and helped bring economic resurgence to parts of rural North Carolina.

8. Preamble inconsistent with rule. Despite language in the proposed rule stating that "TTB is in substantial agreement with the standards and statements contained in ATF Ruling 73-22" and "proposes to incorporate the substance of the ruling in the regulation," the language of several sections of the rule will, intentionally or unintentionally, eliminate Cheyenne little cigar products and virtually all little cigar products from the marketplace.

9. Single attribute test not factually-justified. Through proposed §40.12(b)(3)(ii) (as restated in §41.12(b)(3)(iii) and §44.12(b)(3)(i) and §45.12(b)(3)(iii)), TTB concluded, for the fist time, that a product was likely to be offered to, or purchased by, consumers as cigarettes if it was either: (a) the size and shape of a cigarette; (b) contained a cigarette-

type filter; or (c) was in a cigarette size package without labeling as "little cigars." There is no discussion in the preamble to the proposal, or any facts that justify this conclusion.

10. Exports precluded. The proposed rule would also require products made in the U.S. for export to contain American labeling and packaging. Many American requirements are inconsistent with foreign requirements. This provision would, therefore, preclude the sale of U.S. made little cigars abroad.

11. Proposal violates law. Cheyenne proposes several simple changes that should accomplish TTB's expressed objectives and would make the rule consistent with existing law. In the event that TTB opts not to correct the problems identified herein in the final rule, Cheyenne believes that the rule will violate the statutory definitions, the Administrative Procedure Act, the Regulatory Flexibility Act and Executive Order 12866.

12. Suggested changes. These suggested changes include the following:

    a. Reclassification based on all three characteristics. The "or" in §40.12(b)(3)(ii), §41.12(b)(3)(ii), §44.12(b)(3)(i) and §45.12(b)(3)(iii) should be changed to an "and" (requiring three common characteristics of a cigarette's appearance to exist together).

    b. Delete "burley" restriction. Delete the listing of "burley" tobacco in §40.12(b)(3)(iii), §41.12(b)(3)(iii), §44.12(b)(3)(i) and §45.12(b)(3)(iii) since it is a common component of air-cured cigar tobacco blends.

    c. Limit to U.S. sale. Delete proposed changes to §44.186 and §44.253 so that reclassification and labeling rules apply only to products for U.S. sale and not to products for export.

    d. Limit scope of proposals to "little cigars."

    e. Clarify "package" to mean "pack." Clarify use of the term "package" in the notice and labeling rules to refer to either packs or cartons that are the words commonly used in the trade.

B. Cheyenne International

We thank the TTB and the Department of Treasury for their hard work in drafting and publishing the proposed changes to the federal excise tax regulations. We believe that the existing classification guidance of tobacco products under ATF Ruling 73-22 was clear. It

resulted in absolutely no documented confusion in the marketplace, either by consumers or businesses. While we believe that 73-22 was administered relatively easily, more objective regulations could better enable manufacturers, as well as government at all levels, federal, state and local, to properly classify products for taxation, and to administer existing requirements more easily. These standards are better served in the form of regulations as opposed to rulings and procedures on which the public cannot comment. The narrow changes we propose provide even more objective standards and will, thereby, reduce the administrative burden on TTB to make subjective determinations.

Cheyenne International, LLC is a Grover, NC company that manufacturers "little cigars." We employ approximately 50 individuals in an area of the state that has lost thousands of manufacturing jobs. These jobs were lost over the last decade or more with the exodus of textile, apparel, furniture and other manufacturers traditionally located in the South.

Cheyenne's little cigar products are the size and shape of cigarettes. The statute requires that rolls of tobacco weigh no more than 3 lbs. per 1,000 sticks in order to qualify for federal excise tax treatment as small cigars or small cigarettes.[1] There is virtually no other size and shape at that weight that can be made using existing technology and tobacco wrapper that also has the characteristics of smoke and taste based on consumer preference.

Most little cigars are packaged in a pack with 20 sticks to a pack and 10 packs to a carton. All packaging is conspicuously labeled as "little cigars" in large type parallel to the Cheyenne brand name on the front, back, top and bottom of each pack and carton. The roll of tobacco in each stick is the harsher traditional air-cured cigar tobacco that is not intended to be inhaled. It is composed of blends with less than 3 percent by weight of total reducing sugar (TRS). The cigars do not include any flue-cured or aromatic (Oriental) tobaccos which are the primary constituents of cigarette filler commonly inhaled by consumers. They contain a low percentage of burley tobacco which is air-cured, as do many cigars. The product contains a brown banded cellulose acetate filter that can be attached using existing manufacturing equipment. The primary purpose of this light weight filter is to prevent loose tobacco from migrating into the mouth of the consumer while retaining the requisite weight (less than 3 lbs. per 1,000 sticks) mandated by the federal excise tax classification statute. The little cigars are wrapped in distinctive brown wrappers two-thirds of which are comprised of reconstituted tobacco. Little cigars have been sold in this manner for over 40-years by dozens of large and small domestic and foreign manufacturers. Cheyenne has sought and obtained all testing and classifications from TTB designating these products as little cigars. It has invested many millions of dollars in this market place based on these certifications and on existing law.

[1] 26 U.S.C. §5701(q)(1).

C. Definition of Cigarette

The governing tax statute provides, based on the wrapper, 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].[2]

According to TTB, the 1973 ATF Ruling (73-22) updated the statutory interpretation for determining whether a tobacco product wrapped in a substance containing tobacco is a cigar or cigarette for tax purposes.[3] It refined the three elements viewed by the Agency to make these determinations; wrapper, filler and packaging/labeling. The Ruling stated that a product wrapped in a substance containing tobacco could still be a cigarette if it contained traditional cigarette filler (e.g., flue-cured or aromatic (Oriental) tobaccos). It provided further:

> "and if the product also is of the typical cigarette size and shape, has a typical cigarette-type filter, and is in a cigarette-type package, the inclusion of these tobaccos could cause the product to be classified as a cigarette rather than a cigar. Conversely, if a product is made predominantly of cigar-type tobacco with distinctive cigar taste and aroma, if it does not resemble a cigarette (such as most large cigars do not), and if it is not to be marketed in a cigarette-type package, it would probably be classified as a cigar.[4]

1. Intent to Codify ATF Ruling 73-22

TTB intended to codify the standards and statements of ATF Ruling 73-22 in this new proposed regulation. The preamble to the proposed regulation reads as follows:

> With the exception of the reference to the advance ruling and procedure, TTB is in substantial agreement with the standards and statements contained in ATF Ruling 73-22. However, as noted above, it is preferable to have tax classification standards reflected in the text of a regulation rather than in a guidance document that was not the subject of public notice and comment procedures. Accordingly, we propose to incorporate the substance of ATF Ruling 73-22 in the regulations, with the result that ATF Ruling

[2] 26 U.S.C. §5702(b)(2).
[3] 71 *Fed. Reg.* 62506, 62507, Oct. 25, 2006.
[4] ATF Ruling 73-22 (1973) (emphasis added).

> 73-22 will be superseded in its entirety upon adoption of the proposed regulatory changes as a final rule.[5]

2. Effect of Proposal

Unfortunately, the regulation, as currently drafted, does not codify ATF Ruling 73-22. In fact, products that have been properly classified as little cigars under ATF Ruling 73-22 and preceding rulings for over 40 years would be classified as cigarettes for the first time under the current draft of the proposed regulation. This approach was taken, perhaps unintentionally, despite an accurate new system to classify the type of tobacco filler used in little cigars based on objective sugar content (e.g., which is an accurate measure of the harsher cigar tobacco that is not generally inhaled, vs. the sweeter and milder tobaccos used in cigarette products).

The complete reversal of ATF Ruling 73-22 is found in §40.12(b)(3) (as repeated in 41.12(b)(3)(ii), §44.12(b)(3)(i) and §45.12(b)(3)(i)) of the proposed regulation. A product is classified as a cigarette if:

> "It consists of a roll of tobacco wrapped in a substance containing tobacco; and- -
>
> (ii) It has a typical cigarette size and shape, has a cellulose acetate or other cigarette-type integrated filter, or is put up in a traditional cigarette-type package that does not bear all of the notice requirements for cigars specified in Sec. 40.214 . . ." [emphasis added]

As drafted, the regulation would classify as a cigarette any roll of tobacco wrapped in a substance containing tobacco (as defined in §40.11) if either: (i) it has a typical cigarette size and shape, or (ii) has a cellulose acetate or other cigarette-type integrated filter, or (iii) is put up in a traditional cigarette-type package that does not bear all of the notice requirements for cigars under §40.214 of the proposed regulations (e.g., conspicuous little cigar designation). This provision of the proposed regulation would overturn the long-standing guidance of ATF Rulings and is contrary to TTB's and Treasury's stated position in the preamble of codifying the guidance of ATF Ruling 73-22.

The preamble is so clear regarding the intent of Treasury/TTB to merely codify existing Rulings that it appears that someone substituted an "or" for an "and" in §40.12(b)(3)(ii), and the parallel provisions, late in the review process before publication. The language of the preamble was not similarly changed to document the need to dramatically alter the existing regulatory

[5] *Supra* note 3 at 62517.

scheme. Many small companies, including Cheyenne, will have their low sugar, tobacco wrapped little cigar products taxed as cigarettes for the first time in history. This change will increase the tax on each pack 10-fold based on the federal excise tax alone. If classified as "cigarettes," these products will, no doubt, be pushed into the state Master Settlement Agreement and its multiple financial, marketing and other requirements although none of these cigar manufacturers were parties to the cigarette-industry litigation. Many states will also require that these "cigarettes" exchange their tobacco wrappers for low ignition propensity paper (LIP) wrappers changing the content of the product entirely. This will occur merely because they have the size and shape of a cigarette, or have a filter, or are packaged in 20s without conspicuous disclosure. Indeed, it seems inconsistent that the proposed rule not need detailed requirements regarding the content of the wrapper since any roll in the size and shape of a cigarette would already be reclassified as a cigarette regardless of the wrapper content.

The more logical and consistent approach, as discussed later, would be to mirror existing rulings. In order to avoid potential consumer confusion, a product should be required to possess all three characteristics; (1) typical cigarette size and shape; (2) cigarette-type integrated filter; and (3) traditional cigarette-type packaging without the requisite notice requirements. It should not to be treated as a cigarette if it possesses any single characteristic.

3. No consumer confusion

The standard in the statute is whether the product "is likely to be offered to, or purchased by, consumers as a cigarette…" TTB has traditionally not concluded that such consumer confusion was possible unless these three attributes of a cigarette were present together. Now, any one of these attributes in isolation would apparently cause this confusion in the consumer's mind despite nearly 40 years of contrary experience. TTB offers no discussion of this change of view in the proposal. It offers no evidence. Indeed, the evidence is completely opposite. In 2005, 381 billion cigarettes were sold in the U.S. and only 4.0 billion little cigars. That number of little cigars sold was above the 2004 sales of 2.9 billion, but those numbers have fluctuated on an annual basis.[6] However, if a little cigar was "likely to be offered to, or purchased by, consumers as a cigarette" because of its appearance, packaging and labeling, that is the statutory standard the TTB must meet to reclassify it, why were 100-times more cigarettes sold in the U.S. than little cigars? This is especially perplexing because little cigars are taxed less and are, therefore, cheaper per pack? The answer is obvious to industry experts. Cigars smoke differently than cigarettes. They have different consumer demographics. They are not mistaken by consumers for cigarettes.

If TTB has its own data to refute this conclusion, it should have reported it in the preamble. It is in the best position to accurately gauge the extent of consumer confusion. TTB

[6] According to TTB's own statistics concerning taxes paid on removals of cigarettes and little cigars, the percentage of little cigar sales to cigarette sales has varied from 0.2% in 1990 to 1% in 2005,

visits retail stores where it purchases and tests most little cigar and cigarette products. If a significant number of those products were, in fact, cigarettes disguised as little cigars, or packaged in a manner likely to deceive consumers, those results would have been included in the proposal to substantiate the need for creating the single criteria classification standard. Based on the absence of this information, we must conclude either: (1) that the evidence is not sufficient to conclude that consumer confusion is likely; or (2) that the proposal is based primarily on the need to create a regulatory standard of differentiation and reduce TTB's advisory role (as is stated repeatedly in the preamble).

Cigars that have: (i) a typical cigarette size and shape; (ii) a cellulose acetate or cigarette-type integrated filter; and (iii) are packed in cigarette-type boxes have existed for nearly 40 years. In fact, Cheyenne and other cigar manufacturers received advanced rulings from the TTB (or the ATF) under the guidance of ATF Ruling 73-22. Those rulings have consistently provided that products with integrated cigarette-type filters and with a cigarette size and shape are properly classified as cigars for U.S. tax purposes.

In addition, ATF Revenue Ruling 66-123 holds that a cigar may contain a permanent tip/filter with some paper wrapping to incorporate the tip or filter to the cigar. The cigar industry has long relied upon Ruling 66-123 to manufacture cigars with integrated filters. This Ruling holds that a cigar which has a paper band to join the cigar to the tip that is no larger than necessary for the purpose of joining the tip and cigar is <u>not</u> considered part of the wrapper. Its use (that is, the use of the paper) would not preclude the classification of the products as a cigar. The preamble of the proposed rule does not discuss any rationale in the administrative record, for revoking the long-standing holding of ATF Ruling 66-123. If the proposed regulation is finalized, the language of §40.12(b)(3)(ii) (and parallel provisions) will effectively reverse the TTB's long-standing advance rulings concerning these products and the guidance of ATF Rulings 73-22 and 66-123.

4. <u>Product line eliminated</u>

The preamble to the proposed regulation is silent concerning the justification for classifying a product as a cigarette simply because it meets one of those three criteria. This change alone is so significant that it will completely eliminate this class of little cigar product. The size and shape of the product would have to change to not resemble a cigarette. This would require either expensive hand rolling or the purchase of new manufacturing equipment.[7] As a "cigarette," Federal and state excise taxes would increase 10-100 times. Manufacturers would

[7] It is theoretically possible to create a skinnier spiral wrapped 100% tobacco leaf product that could remain under the statutory weight definition. However, the manufacture of this product would not be practical. It would still resemble the size and shape of cigarettes and would cost at least three-time more to make each stick. Manufacturers would also be required to discontinue use of existing manufacturing equipment or retrofit equipment at significant cost.

have to comply with all the financial and regulatory requirements of the Master Settlement Agreement. The product could not even use the familiar brown wrapper sheets of reconstituted tobacco since "cigarettes" are required, in a number of states, to use LIP paper in order to reduce possible fires. Since little cigars, reclassified by TTB as cigarettes, would be required to be paper wrapped, they could never again become cigars. These reformulated products would also, themselves, create consumer confusion since they would be altered dramatically from the products on which consumers have come to rely over the past 40 years.

5. Inconsistent with statute

Finally, a sound argument exists that such a fundamental rethinking of the rulings that defined the little cigar industry since the 1960's is inconsistent with the governing statute under which ATF Ruling 73-22 was established. Were a court to review§5702(b)(1) and (2) which define cigars and cigarettes, it would see the standard. If a consumer would not be likely to purchase a product wrapped in reconstituted tobacco mistaking the cigar for a cigarette, the statute does not allow TTB to reclassify the product based on any physical characteristics.[8] At any rate, the characteristics TTB is permitted to use under the tax statute is wrapper, filler and packaging/labeling. In the case of little cigars, the wrapper already must be 2/3 reconstituted tobacco (proposed §41.12(b)(3)). The filler must be low sugar content tobacco (3.0 percent by weight TRS)(proposed §41.12(b)(2)).

We believe that this new TRS test eliminates the need to also regulate the blends of tobacco used in the product (e.g., not flue-cured, burley, oriental, or unfermented tobaccos (proposed (3)(iii)). Cheyenne little cigars contain a small mix of burley tobacco, as do many other cigar blends. The burley we use is air-cured, not flue-cured and is of lower TRS content. Yet, based on the language of proposed §41.12(b)(3)(iii), even if the filler is less than 3% TRS by weight, the product can still be classified as a cigarette if it "has filler primarily consisting of flue cured, burley, oriental, or unfermented tobaccos or has a filler material yielding the smoking characteristics of any of those tobaccos." This requirement should be eliminated. Tobacco blends are proprietary. This requirement cannot be adequately monitored or audited by TTB. It is unnecessary given the more objective TRS criteria that accomplishes TTB's clear quantitative standards and renders the blend less significant. In the alternative, if TTB opts to keep this unnecessary "belt and suspenders" approach, it should omit "burley."

Even given these requirements, TTB is required by the statute to determine that the consumer would "likely purchase this little cigar as a cigarette" merely because it had a filter, was the same size and shape as a cigarette, or was packaged in 20s in a cigarette-type box not conspicuously marked as a little cigar. There is no market research or any fact in the preamble providing the basis of this conclusion by TTB.

[8] *See Nippon Steel Corp. v. U.S.*, 26 C.I.T. 1416, 1419-20 n. 3 (Ct. Int'l Trade 2002) which defines "likely" as "probable."

D. Legislative Nature of Proposed Regulation

TTB should consider the legislative effect of the proposed regulation in eliminating the separate small cigar tax classification. As we mention above, little cigars have existed in compliance with current law for nearly 40 years. They have retained a cigarette size and shape, integrated filter and 20-count packaging in large part to comply with the weight classification of "small cigars" under 26 U.S.C. §5701(q)(1). The proposed regulation would eliminate the product-type by reclassifying and taxing it as a cigarette. This would dramatically increase the price to consumers and likely subject the product class, if it continued, to all the obligations of states MSA. A large number of these products have long been classified as "small cigars" as set forth in Section 5701 of the Internal Revenue Code (IRC). Had Congress intended to eliminate the separate tax classification of "small cigars" under the IRC, it would certainly have done so legislatively in the past 40 years by amending IRC §5701. We believe that virtually all little cigars will be taxed as cigarettes under the proposed regulation. A very large number of these products have cigarette size and shapes, integrated filters and/or twenty-count packaging, a few with labeling that TTB might consider insufficient. Once they are deemed "cigarettes' for this purpose, a growing number of states will likely require their reformulation to include LIP paper. This will eliminate, by definition, the category of little cigars wrapped in tobacco.

There is a body of case law that addresses the debate about whether agencies have, or should have, independent legislative power. In "delegation" disputes, the United States Supreme Court has repeatedly held that "when Congress confers decision-making authority upon agencies, *Congress* must 'lay down by legislative act an intelligible principle to which the person or body authorized to [act] is directed to conform.'"[9] Therefore, TTB is required to conform to the framework designed by Congress. While it may offer reasonable interpretations of Congress' framework, it may not reinvent Congress' intent.

In addition, the Administrative Procedure Act grants reviewing courts the authority to set aside or find unlawful any agency action that is "not in accordance with law," i.e., acts which are ultra vires.[10] In the landmark case of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, the Supreme Court explained the two-part test for determining whether an agency action is "not in accordance with law."[11] First, the court must ask whether Congress has spoken on the precise issue. If Congress' intent is "unambiguous," then the agency, and the court, must give effect to that intent. Where Congress' intent is ambiguous, the court must review the agency's action and ask whether the agency's action is supported by a "permissible construction of the statute." Since Congress has already identified a tax category for the treatment of "small cigars" (see 26 U.S.C. § 5701(a)(1)), TTB cannot ignore Congress' clear intent on this issue.

[9] *Whitman v. American Trucking Assns., Inc.*, 531 U.S. 457, 472 (2001) (quoting *J. W. Hampton, Jr., & Co. v. United States*, 276 U.S. 394, 409 (1928)) (emphasis in original).
[10] 5 U.S.C. § 706(2)(A).
[11] 467 U.S. 837, 842-44 (1984).

The proposed rule effectively converts the excise tax classification of most small cigars into cigarettes regardless of the type of tobacco they contain, their wrapper or their labeling. Most of those little cigars maintain a cigarette-like shape, size, filter or packaging or labeling according to the new criteria contained in the rule. Therefore, the language of the rule, if retained, would arguably create confusion regarding the distinction created by Congress in §5701(a)(1) of the Internal Revenue Code. We believe that a strong case can be constructed that if this language is retained in the final rule, the rule could be legally void using the *Chevron* analysis.

It is difficult to perform a full *Chevron* analysis of the proposed rule. TTB does not attempt to substantiate the conclusion that it is likely (probable) that a consumer would purchase a little cigar thinking it was a cigarette simply because it was the size and shape of a cigarette, or simply because it had a filter, or simply because it was packaged in 20s in a cigarette box that lacked conspicuous labeling --- even if the stick itself contained cigar tobacco filler and had a reconstituted tobacco wrapper. TTB says only that it "has the authority to interpret those definitions and determine how they are applied to specific products." [12] It states further that it "is in substantial agreement with the standards and statements contained in ATF Ruling 73-22." That is the same document under which TTB certified the entire line of little cigar products by dozens of manufacturers, and upon which those companies relied in making substantial investments over a lifetime.

TTB's determination must be grounded in evidence that will be reviewed by the court. It may not be based on mere speculation.[13] Any change to existing law as significant as the total elimination of the existing class of cigarette-sized little cigars must be based on evidence included in the rule. This evidence must overcome the fact that little cigar sales remain at approximately 1% of cigarette sales per year. If the products were offered to, or purchased by, consumers as cigarettes, as is the purpose of the statute, the products would have to be substitutable in some sense. The sale of the cheaper little cigars should be much larger. TTB must produce evidence that this statutory standard is met. TTB must demonstrate that because of the size and shape of little cigars, or because of the filter, or because of the packaging alone, consumers were offered the products or buy them as cigarettes, despite the harsher low TRS non-flue-cured tobacco, and despite the brown tobacco-content wrapper. Without this evidence, the section of the rule as proposed is arbitrary, capricious and an abuse of the Agency's discretion.

[12] *Supra* note 2 at 62516.
[13] *Cabo Distribution Co., Inc. v. Brady*, 821 F.Supp 582, 595-97 (N.D. Cal. 1992)(ATF determination that a vodka label would likely mislead consumers was deemed arbitrary and capricious because it lacked a rational factual basis).

E. Our Proposal

The proposed rule is intended primarily to provide a new clearer regulatory standard to differentiate little cigars from cigarettes. It is not intended to eliminate consumer confusion. There is no support or allegation that consumer confusion exists in the marketplace (e.g., that consumers buy and use little cigars believing them to be cigarettes).

We believe TTB can achieve its goal of providing objective criteria for evaluating the three key components of a cigar (the wrapper, the filler and the product packaging and labeling) without completely overturning nearly 40 years of certifications and guidance provided by the ATF Rulings. TTB will satisfy its objectives stated in the preamble to the proposed regulation, and the long-standing guidance of ATF Ruling 73-22 will be codified into the regulation, by amending Section 40.12(b)(3)(ii) to read as follows:

> **(ii) It has a typical cigarette size and shape, has a cellulose acetate or other cigarette-type integrated filter, and is put up in a traditional cigarette-type package that does not bear all of the notice requirements for cigars specified in Sec. 40.214.**

The regulation with this narrow change (i.e., changing the word "or" to "and") maintains TTB's objective to ensure that manufacturers retain the right to objectively evaluate the three key components which distinguish a cigar from a cigarette - the wrapper, filler and product packaging/labeling.

1. The Wrapper

We agree with TTB when it states in the preamble that the cigar industry has become accustomed to the two-thirds rule (e.g., two-thirds by weight of the wrapper consists of tobacco leaf or other fibrous material from the plant) since it was adopted in the ATF's Ruling 73-22. Little cigars have been manufactured and sold under this standard for over 33 years. Cigar manufactures and vendors that provide wrappers can objectively determine whether the composition of the wrapper complies with this standard without resorting to subjective interpretation requiring TTB intervention. Therefore, Cheyenne supports amending the proposed rule to provide that if a wrapper two-thirds or more tobacco content it is, by definition, a little cigar.

2. The Filler

The filler is appropriately addressed in §§40.12(a)(1)(ii) and 40.12(b)(3)(iii) of the proposed rule. Section 40.12(a)(1)(ii) requires that a cigar consist of "a roll of tobacco that contains no more than 3.0 percent by weight of total reducing sugars." This is an objective

standard which cigar manufacturers can use to determine whether a product is a cigar and is consistent with the objective of ATF Ruling 73-22. This rule should not significantly affect products that have been properly classified as little cigars under ATF Ruling 73-22.

Section 40.12(a)(2)(iii) also provides tests for classifying a product as a cigar based on its tobacco filler. This rule would classify any product as a cigarette that is wrapped in a substance containing tobacco if that product has a "filler primarily consisting of flue-cured, burley, oriental, or unfermented tobaccos or has a filler material yielding the smoking characteristics of any of those tobacco."

As noted previously, the new TRS test eliminates the need to also regulate the blends of tobacco used in the product. Cheyenne little cigars contain a mix of burley tobacco, as do many other cigar blends. The burley we use is air-cured and of lower TRS content. Yet, based on the language of proposed §41.12(b)(3)(iii), even if the filler is less than 3% TRS by weight, the product can still be classified as a cigarette if it "has filler primarily consisting of flue cured, burley, oriental, or unfermented tobaccos or has a filler material yielding the smoking characteristics of any of those tobaccos." This requirement should be eliminated. Tobacco blends are proprietary. This requirement cannot be adequately monitored or audited by TTB. It is unnecessary given the more objective TRS criteria that accomplishes TTB's clear quantitative standards and renders the blend moot. In the alternative, as mentioned earlier, if TTB opts to keep this unnecessary "belt and suspenders" approach, it should omit "burley," or require that the burley be "flue-cured."

The only reference in the preamble to a product containing a cigarette-type filter and being of a typical cigarette size and shape is in the evaluation of a product's filler. The preamble discusses ATF Ruling 73-22's classification of a product as a cigarette if its filler includes flue-cured or aromatic (Oriental) tobaccos "and if the product also is of the typical cigarette size and shape, has a typical cigarette-type filter, and is in a cigarette-type package" [emphasis added]. The preamble does not state that maintaining a cigarette size and shape, an integrated filter or cigarette-type packaging alone should cause a product to be classified as a cigarette. It is only when combined with cigarette-type filler tobacco and put in a package labeled as a cigarette does a cigarette-sized, shaped and filtered product resemble a cigarette. There is very little chance, and no evidence, that any consumer would be otherwise confused unless these elements exist contemporaneously. Therefore, the proposed rule contradicts the logic of its own preamble. Certainly, the administrative record as reviewed in the preamble contains absolutely no evidence or justification for changing existing law to tax a product as a cigarette just because it has a cigarette size, contains a filter, or is packaged in 20s in a hard box with insufficient labeling. At a minimum, those elements should exist together, especially for a product that contains the harsher lower-sugar cigar-type tobacco and the 2/3 tobacco content wrapper.

3. Product Packaging and Labeling

Finally, the packaging and labeling of a product would be adequately addressed if §40.12(b)(3) of the regulation is redrafted as we propose above. A redrafted §40.12(b)(3), and the parallel provisions in §41.12(b)(3)(ii), §44.12(b)(3)(i) and §45.12(b)(3)(i), containing the "and" instead of the "or," would require any cigar product with a typical cigarette size and shape, and an integrated filter to be classified as a cigarette only if it is put in a traditional cigarette-type package that does not bear the notice requirements of §40.214. This language would follow ATF Ruling 73-22. Section 40.214 provides ample notice to consumers that the products contained in the packaging are cigars.

The preamble to the proposed rule states that ATF Ruling 73-22 looks to the product package to determine whether it is likely to be offered to, or purchased by, consumers as a cigarette. The preamble quotes ATF Ruling 73-22 in this respect as follows:

> 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. . . . 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" or "little cigars" must appear in direct conjunction with, parallel to, and in substantially the same conspicuousness of type and background as the brand name each time the brand name appears.
>
> The preamble goes on to state:
>
> Finally, the new paragraph (b) added to the cigar notice requirements in the four parts reflects primarily the terms of ATF Ruling 73-22. These additional notice requirements are intended to ensure that cigar is fully and clearly marked as such, so that it would not be "likely to be offered to, or purchased by, consumers as cigarette" within the meaning of the second cigarette definition.

Section 40.214 requires that "cigars," "small cigars" or "little cigars" be conspicuously displayed on front, back and bottom of any packaging for the cigars. In addition, where the brand name appears on the packaging, the declaration "cigars" should only apply to "small cigars" or "little cigars." It must appear in direct conjunction with, parallel to, and in the same conspicuousness of type and background as the brand name each time the brand name appears. "Packaging" should be redefined more precisely to refer to either the "pack" or the "carton;" whichever is intended by TTB, since that term "package" is ambiguous in the trade.

Consumers cannot be confused that they are purchasing little cigars that are labeled under the requirements of §40.214. Additionally, manufacturers can satisfy the packaging and labeling requirements based on objective standards stated in §40.214 of the proposed regulation.

F. Exportation

Again, TTB's assurance in the preamble that "we propose to incorporate the substance of ATF Ruling 73-22 in the regulations…"[14] is not completely accurate. The tobacco export rules were also changed to classify most little cigars currently marketed as cigarettes in proposed §44.12 if they are either a typical cigarette size and shape, have a cigarette-type integrated filter, or have a traditional cigarette-type package that does not bear all required notice requirements for export as well as for import, or manufacture and sale in the U.S.

The proposed rule goes further in proposed §44.253 to dictate that this U.S. labeling must be included on all products exported to foreign countries. The American labeling is inconsistent with labeling required for little cigars in most other foreign countries.[15] Such a requirement would, therefore, prevent the export and sale of U.S. made goods to any other country. This cannot be the intent of the proposed rule; especially a rule designed to merely upgrade existing rulings into regulations. The rule is inconsistent with the treatment of cigarettes that do not bear equivalent export labeling requirements. This parallel requirement for imports and exports is even more unwarranted given the express rationale of the rule; to reduce possible revenue losses through misclassification. Little cigars dedicated for export are exempt from the federal excise tax.[16]

The exclusion of American little cigars from foreign markets such as Canada would further compound the already devastating economic impact of the proposed rules on U.S. little cigar manufacturers. No rationale or evidence is provided to support this change in the law. Such change is, therefore, arbitrary, capricious and an abuse of the Agency's discretion under the precedent cited previously. It is also likely a violation of the North American Free Trade Agreement as applied to non-tariff trade barriers for goods shipped to Canada.[17]

G. Limiting the Final Rule to Little Cigars

The rule should be limited to "little cigars," since those products are the basis for the expressed need for clarification as described by the petitions cited by TTB.

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[14] *Supra* note 3 at 62517.
[15] *See*, for example, Tobacco Products Information Regulations (Tobacco Act) SOR/2000-272 (Can.); Consumer Packaging and Labeling Regulations, C.R.C., c. 417 (Can.).
[16] *U.S. v. Int'l Business Machines, Corp.*, 517 U.S. 843 (1996).
[17] *See North American Free Trade Agreement* (NAFTA), 32 I.L.M. 605 (1993).

H. Application of Regulatory Flexibility Act

In its analysis of the impact of the proposed rule on small businesses, as required by the Regulatory Flexibility Act (5 U.S.C. Chapter 6), and Presidential Executive Order 13272, TTB certifies that "this notice of proposed rulemaking will not have a significant economic impact on a substantial number of small entities."[18] This unequivocal conclusion was reportedly based on no facts or any attempt to analyze the impact of the proposed rule on the external business community. TTB admits that no regulatory flexibility analysis was conducted, since "a regulatory flexibility analysis is not required."[19] TTB states that "the proposed regulations primarily codify and clarify existing administrative tax classification principles and practices. Accordingly, a regulatory flexibility analysis is not required."[20] This is not true. If it were true, the products for which we received advance rulings from TTB under existing classification principles and practices would continue to be classified as little cigars.

Inaccurate statements like this lead Cheyenne to conclude that the proposed tax classification rule in §41.12((b)(3)(ii) must have been changed in a final stage of review to substitute "or" for "and." The rest of the *Federal Register* document was not similarly altered including the preamble explanations or required rulemaking certifications. In addition, TTB must have been unaware of the potential impact of requiring all exports to contain U.S. packaging and labeling in §44.253(a).

Cheyenne personally visited the drafters of the proposed rules prior to issuance. It communicated regularly including sharing samples of its products as well as seeking TTB review and certification of each "little cigar" product prior to marketing and sale. Therefore, it cannot be said that TTB was not aware that reclassifying a little cigar as a cigarette based exclusively on its typical cigarette size and shape, or entirely on its integrated filter, or entirely on its packaging would eliminate this line of products from the marketplace. As discussed above, little cigar makers cannot compete head-to-head with the cigarette industry. Reclassification eliminates these products---period. In Cheyenne's case alone, as one of dozens of small businesses making little cigars, this means that millions of dollars in 2006 gross sales revenue will be eliminated along with approximately 50 jobs in Grover, NC, an already economically depressed area of the State. These 2006 sales represent many hundreds of millions of little cigars that represent a significant percentage of the American "little cigar" market.

The provisions of 5 U.S.C. §604 require preparation of an accurate analysis by TTB for submission to the Small Business Administration (SBA). The analysis must: (1) justify the need for the rule and state its objectives, including the need for the major changes detailed herein; (2) summarize of significant issues raised in public comments; (3) describe and estimate the number

[18] *Supra* note 2 at 62519.
[19] *Id.*
[20] *Id*.

of small entities to which the rule will apply; (4) describe the steps taken to minimize the significant economic impact on small entities, etc.

Cheyenne believes that the TTB certification contained in the proposed rule would be accurate as written and that no detailed regulatory flexibility analysis should be required if the changes are made as described herein.

I. Application of Executive Order 12866-- Regulatory Planning and Review

Finally, for the same reasons stated in Section G above, TTB's certification that the "proposed rule is not significant regulatory action as defined by Executive Order 12866,"[21] and, therefore, requires no regulatory analysis, is false. "Significant regulatory action" is defined by the E.O. as meaning any regulatory action that is likely to result in a rule that may "[h]ave an annual effect on the economy of $100 million or more or adversely affect in a material way…a sector of the economy, productivity, competition, jobs…." etc.[22] Other grounds within the definition include "[r]aising novel legal or policy issues arising out of legal mandates…"[23] The bottom line is that the Office of Management and Budget (OMB) that administers Federal rulemaking and the application of E.O. 12866 does not want to be surprised in its role of coordinating agency action.

As noted above, the likely impact of the rule constitutes significant regulatory action based on the lost sales of this product class alone which exceed $100 million a year. It is not known, of course, how many little cigar smokers would buy cigarettes or large cigars instead. This type of precision is not normally required to trigger OMB review. The economic impact of any increased cigarette or large cigar sales is more than offset by the potential impact of closing down dozens of little cigar manufacturers, distributors, vendors, retailers and the resulting loss of jobs.

Significant regulatory action requires the preparation of a detailed cost-benefit analysis by TTB which seeks to justify the need for the legal change and analyze ways to reduce this potential economic effect. As stated above, Cheyenne believes that the TTB certification contained in the proposed rule would be accurate as written, and that no detailed cost-benefit analysis should be required, if the changes are made as summarized above.

J. Conclusion

Our company and other similarly situated small tobacco manufacturers will suffer severe adverse consequences if the proposed regulation is finalized. We are a small cigar manufacturer

[21] *Id.*
[22] E.O. 12866, Section 1, (f)(1), 58 *Fed. Reg.* 51735, 51738, Oct. 4, 1993.
[23] *Id.* at (f)(4).

located in a small town; Grover, North Carolina. We employ approximately 50 people. We have invested significant amounts of capital in reliance on advance rulings from TTB under the guidance of ATF Ruling 73-22, and subsequent TTB certification. If the proposed regulation is finalized, we will likely dismiss most of our employees and lose a significant amount of capital that was invested in reliance on current law.

If the changes recommended above are not implemented in the final rule, and current classification requirements are not maintained, the Treasury Department and the TTB should compile and evaluate, with objective data, the severe negative impact the proposed regulation would have on small businesses. There are dozens of small businesses that manufacture little cigars and the various components of little cigars (e.g., filler tobacco, packaging materials, and wrapper material). It is apparent that the small business impact section of the Regulatory Flexibility Act, and the evaluation of "significant regulatory action" under E.O. 12866, were put together without sufficient (if any) research of its effect (as likely modified in final review) on small businesses such as ours.

All cigarettes and little cigars are cylinder-shaped and between 85-100 mm in length. The weight requirements of §5701(q)(1) permit little flexibility. In addition, a large volume of little cigar products have been manufactured with cellulose acetate or other similar integrated filters. These products will be classified as cigarettes under the proposed regulation. We believe TTB would effectively amend a statute, IRC Section 5701, if the proposed regulation is finalized. A federal agency cannot overturn nearly 40 years of U.S. federal law with the promulgation of an interpretative regulation. We believe the proposed regulation would ultimately be struck down through the U.S. judicial process if it is allowed to become final in its proposed form.

We appreciate your careful consideration of our comments. The solution we outlined above would create an easy and workable solution to the problems presented by the proposed regulation. These simple wording changes would also likely return the rule to the format originally drafted by TTB, that would again honor prior Agency rulings and be consistent with the statutory intent.

Again, the rule must:

- Accept that its objective is to clarify existing law through regulation; not eliminate consumer confusion where none exists;
- Preserve the "little cigar" tax classification by focusing on filler, wrapper and appearance;
- Acknowledge that reclassification based on appearance cannot be based on size, shape, filter or packaging alone;

- Eliminate TTB's obligation to monitor tobacco filler blend, or eliminate burley tobacco, when an objective TRS testing standard can accomplish the same objective;
- Limit the rule to "little cigars;" and
- Eliminate the requirement that exports must conform to the classification and labeling rules.
- Clarify use of the term "package" in the notice and labeling rules to refer to either packs or cartons that are the words commonly used in the trade.

Please contact me directly with any questions at 704-937-7200; billgreiwe@cheyenneintl.com.

Sincerely,

Bill Greiwe

Bill Greiwe
President and Chief Executive Officer