



Explosive Growth of Mislabeled “Pipe Tobacco” Results in \$2.6 Billion in Federal Revenue Losses Since April 2009

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Product Mislabeling and Lack of Regulatory Control Has Created Subsidy for Manufacturers

Many Products Falsely Marketed With Implied Health Claims

Cigarette Industry Volume Declines Overstated

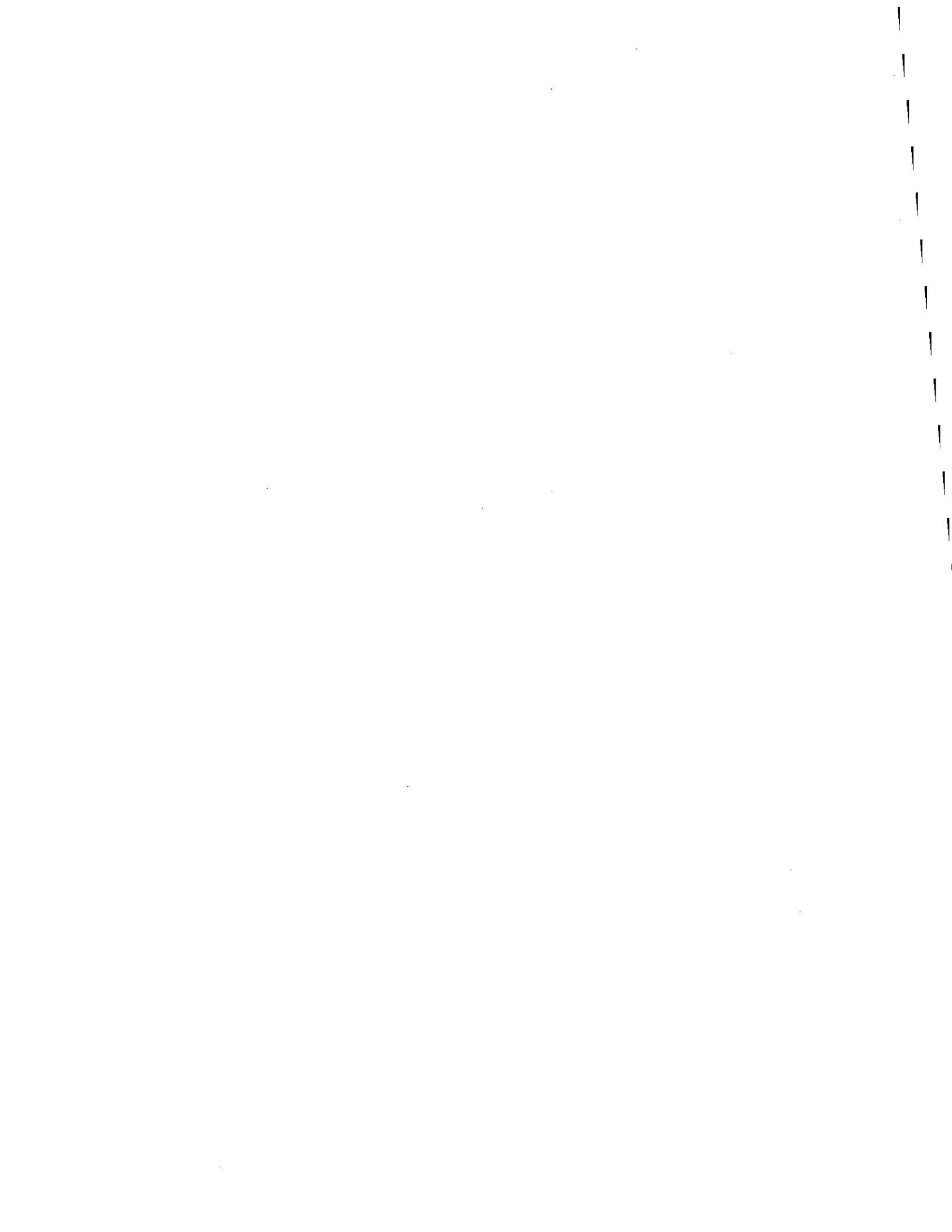
Timely Regulation and Appropriate Taxes Needed to Avoid Similar Results for E-Cigarettes

Overview

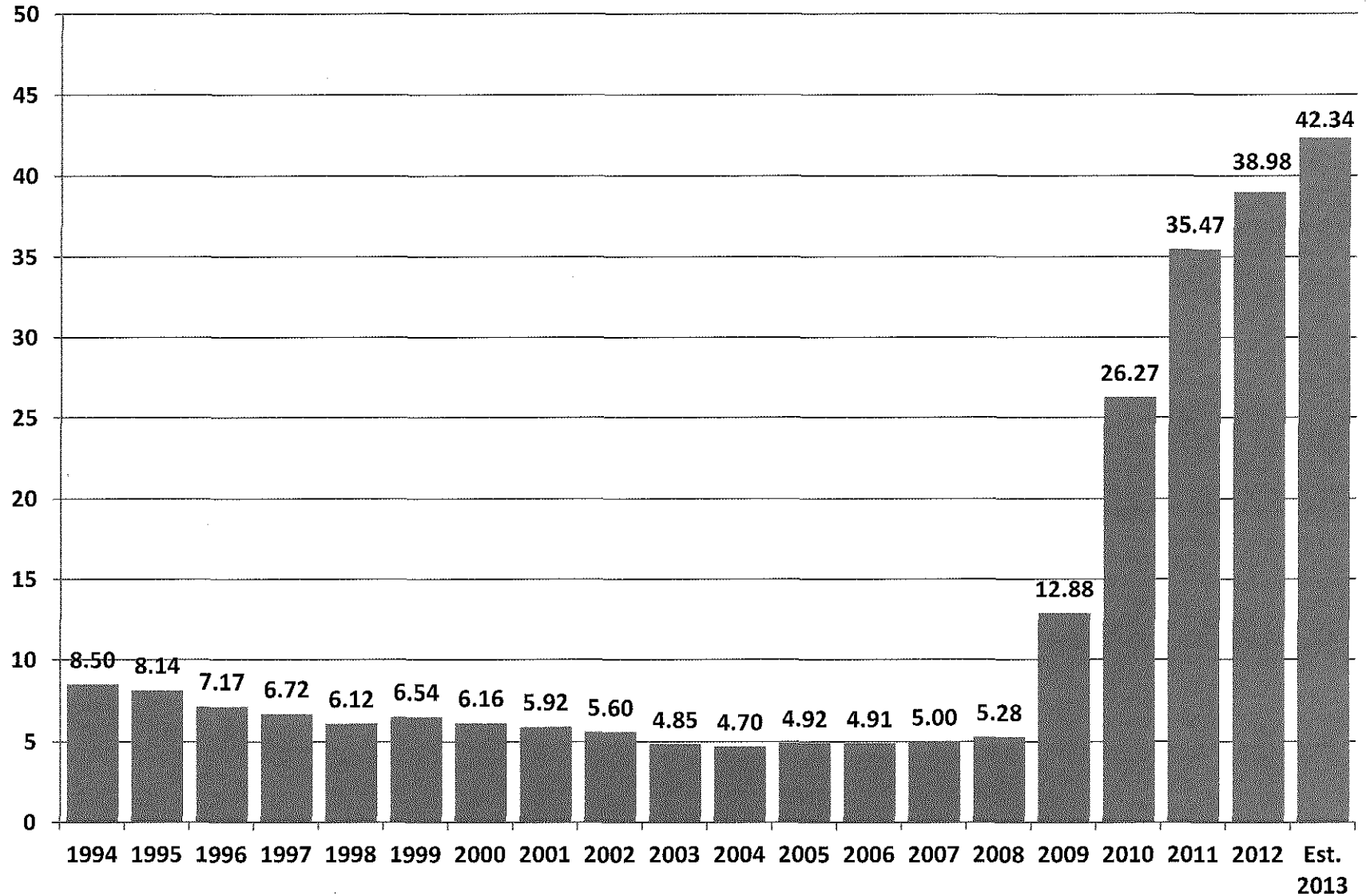
- **Explosion of sales of RYO falsely labeled as “pipe tobacco” and taxed at a fraction of legitimate RYO**
- **Mislabeled “pipe tobacco” accounts for over 6% of total cigarette volume**
- **Mislabeled “pipe tobacco” responsible for loss of \$2.6 billion in FET since April 2009 and projected \$813 million in 2013 alone**
- **Trend shows tax evasion by mislabeled “pipe tobacco” will continue to grow**
- **Sales of leading genuine pipe tobacco brands have been flat to down since 2009**
- **Mislabeled “pipe tobacco” meets definition of RYO under 26 USC § 5702(o) and should be taxed as such**
- **Failure to enforce proper FET rate results in a huge back-door subsidy to self-selected tobacco manufacturers who are flaunting the law**

Overview

- **Manufacturers of falsely labeled “pipe tobacco” are increasingly brazen in making clear to consumers the true intended use of their product through such tactics as:**
 - **Marketing the product with comparisons to cigarettes, including as substitutes for specific brands**
 - **Including cigarette warning labels on their product**
 - **Flavoring their tobacco with menthol — which is only used in cigarettes, not in genuine pipe tobacco**
 - **Using traditional cigarette descriptors such as light and packaging in 16 oz. bags**
 - **Openly marketing their products at trade shows and other venues as tobacco for making cigarettes**

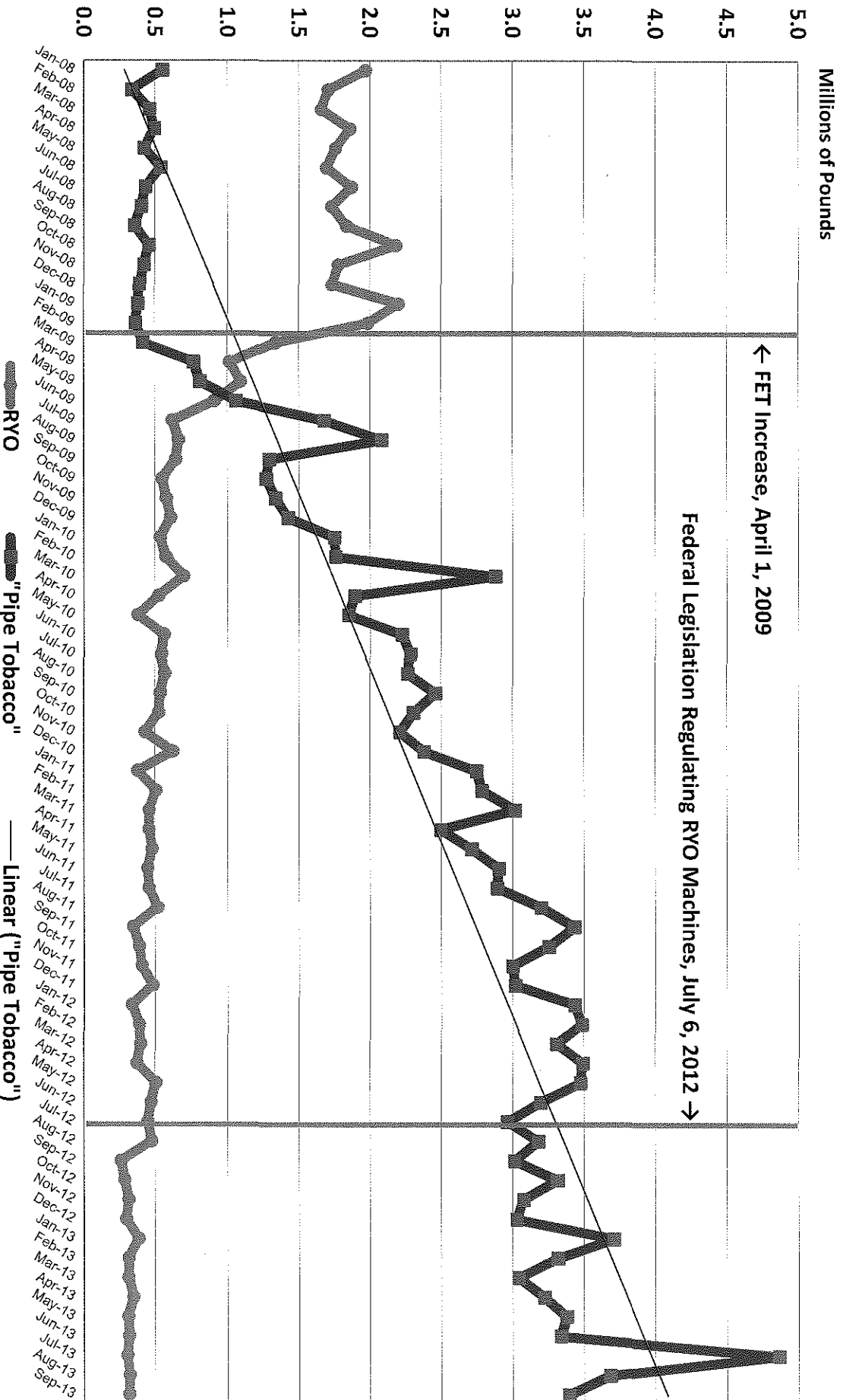


Pipe Tobacco Volume 1994 – 2013 in Millions of Pounds



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

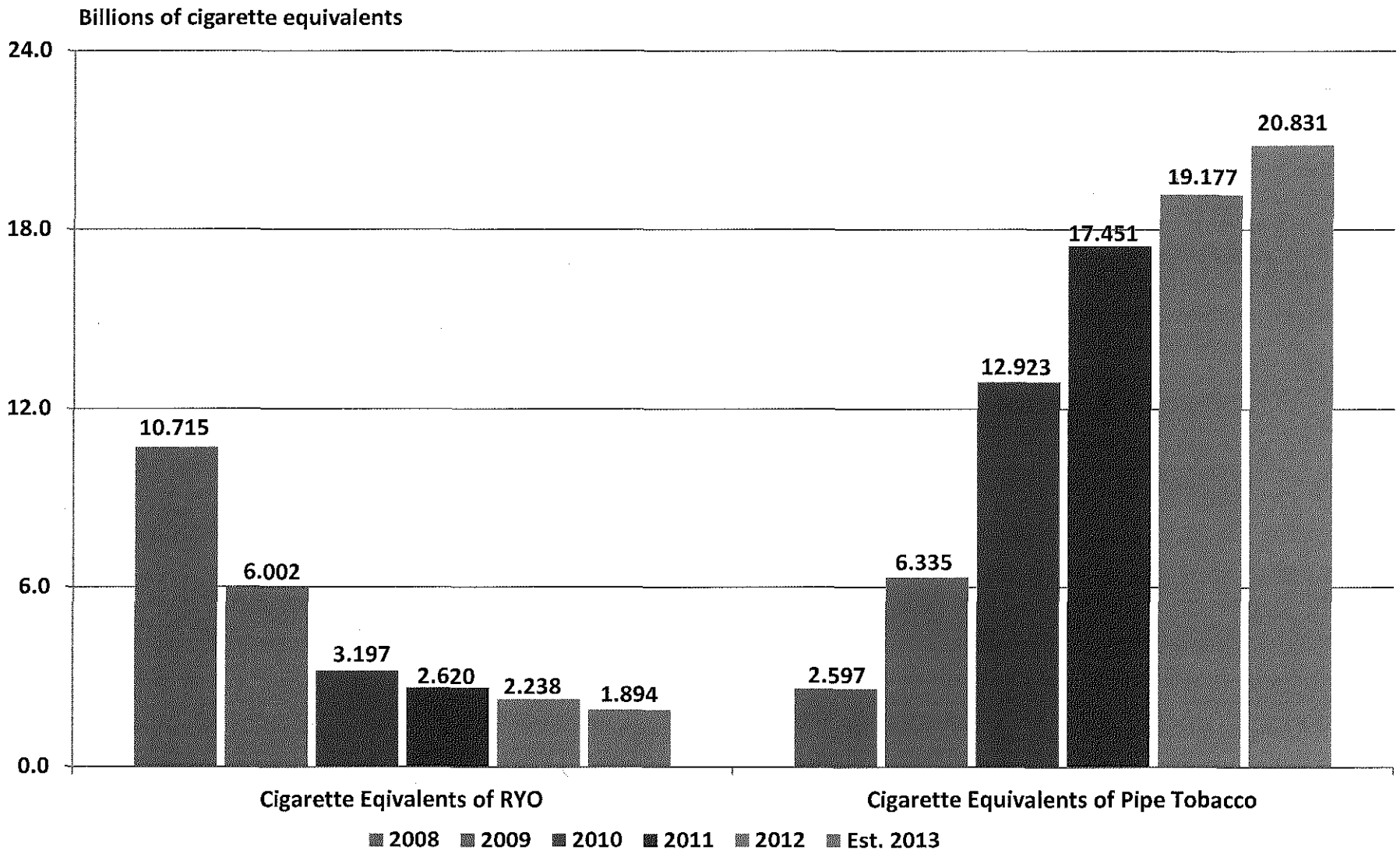
Volume of RYO vs. "Pipe Tobacco" by Month 2008 – 2013



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



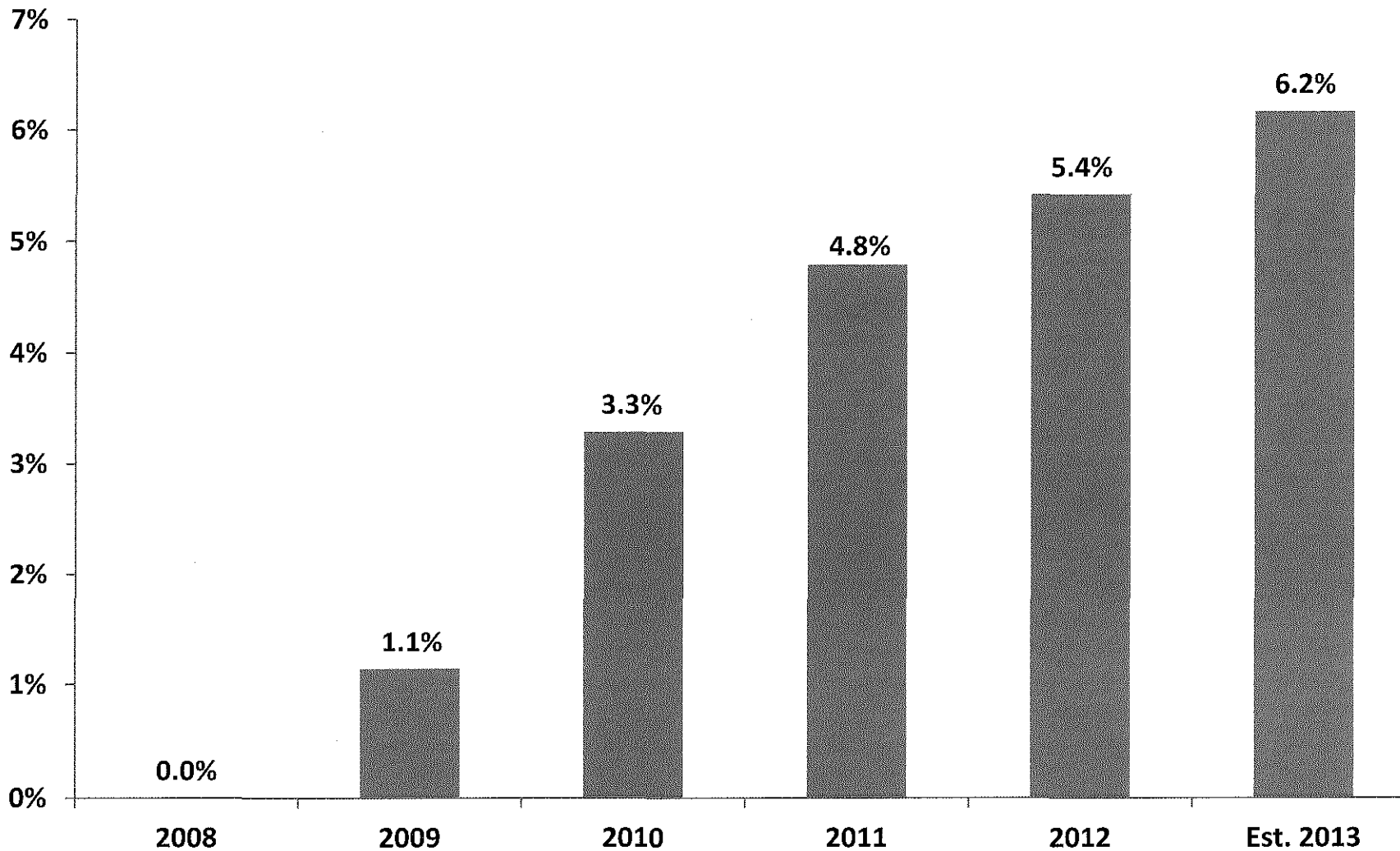
RYO and Pipe Tobacco Volume Changes 2008 – 2013 Expressed in Cigarette Equivalents



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



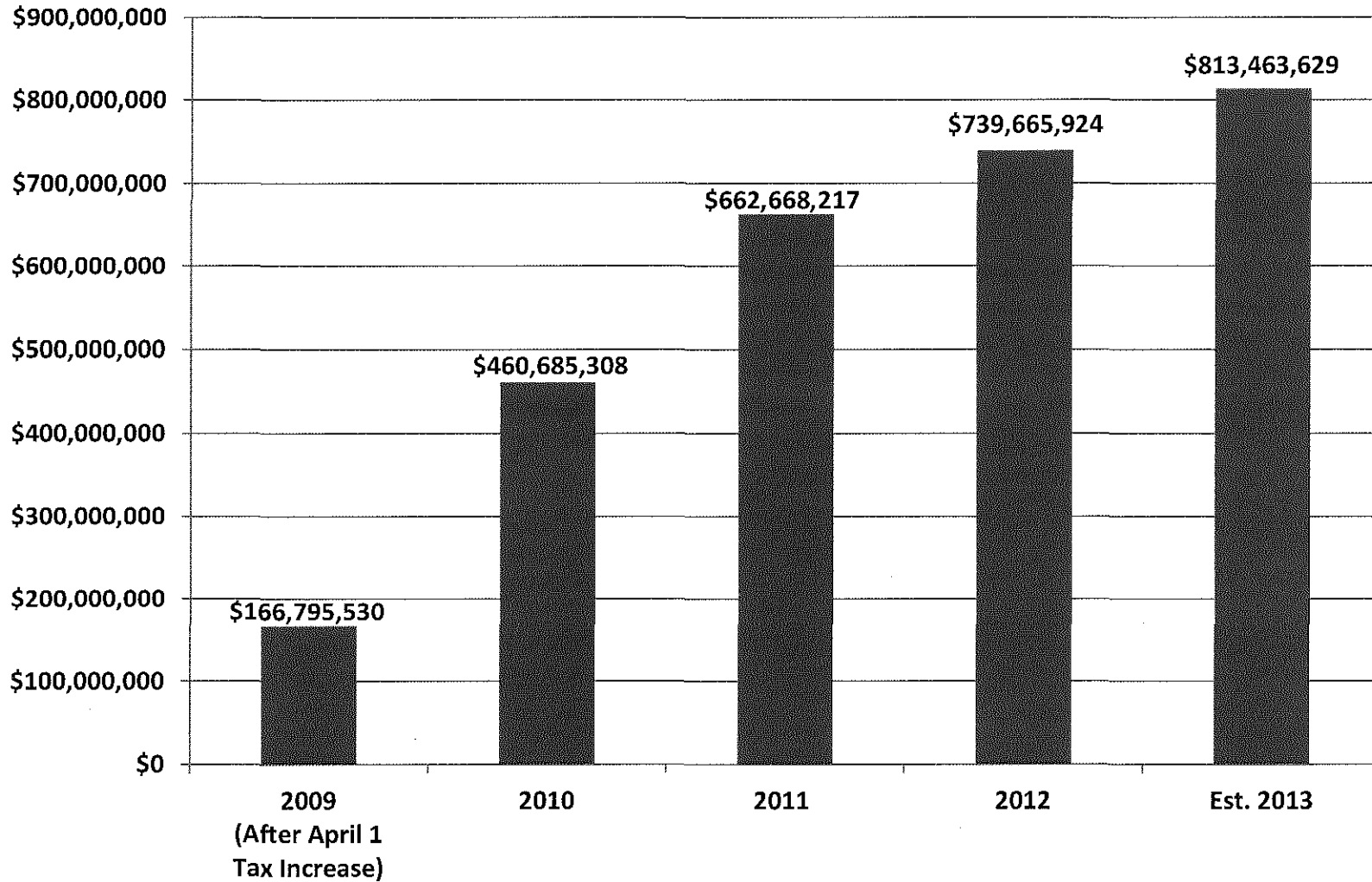
Mislabeled "Pipe Tobacco" Share of Total U.S. Cigarette Market



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

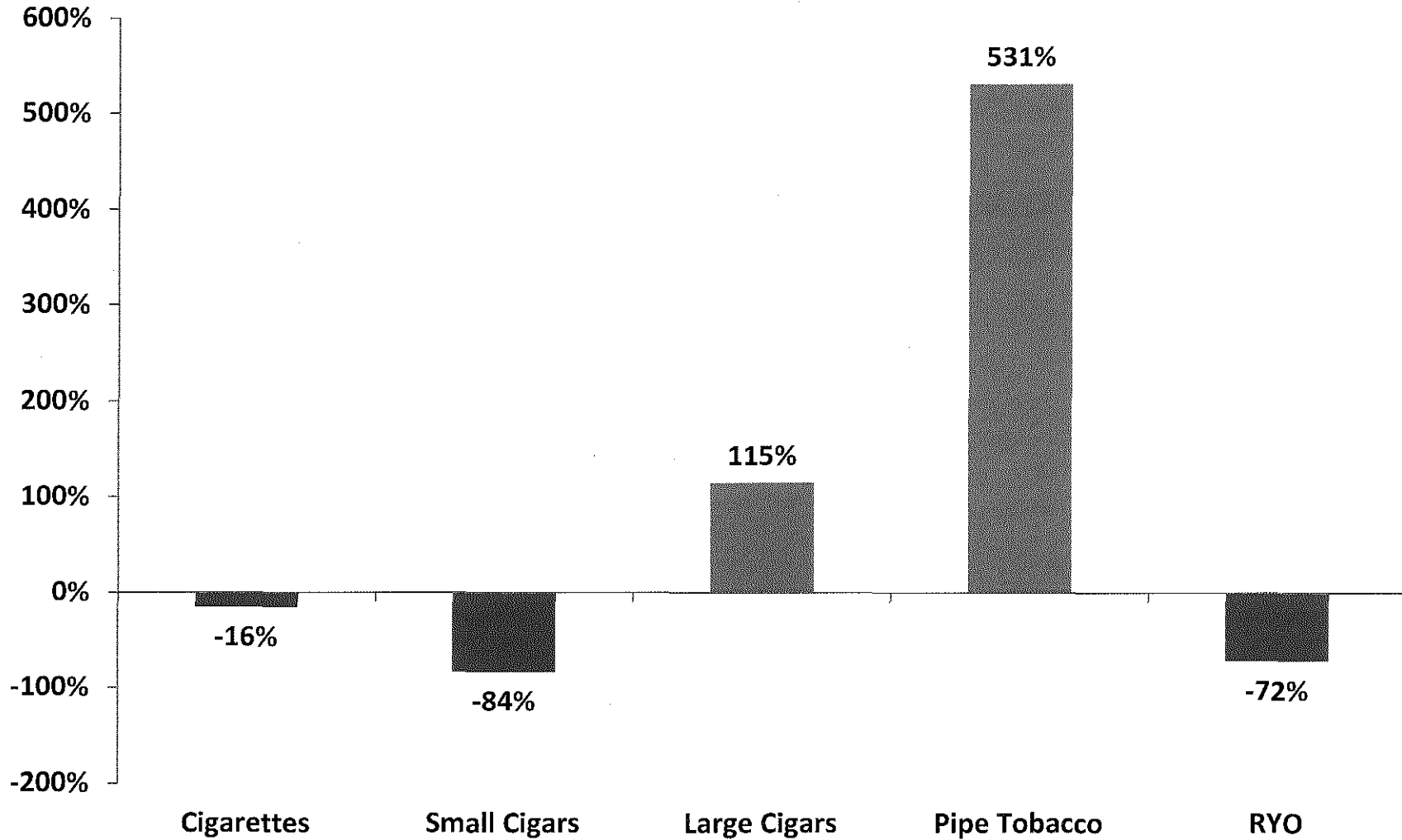


Tax-Evasion FET Revenue Losses From Misabeled "Pipe Tobacco" Not Paying RYO Tax Rate

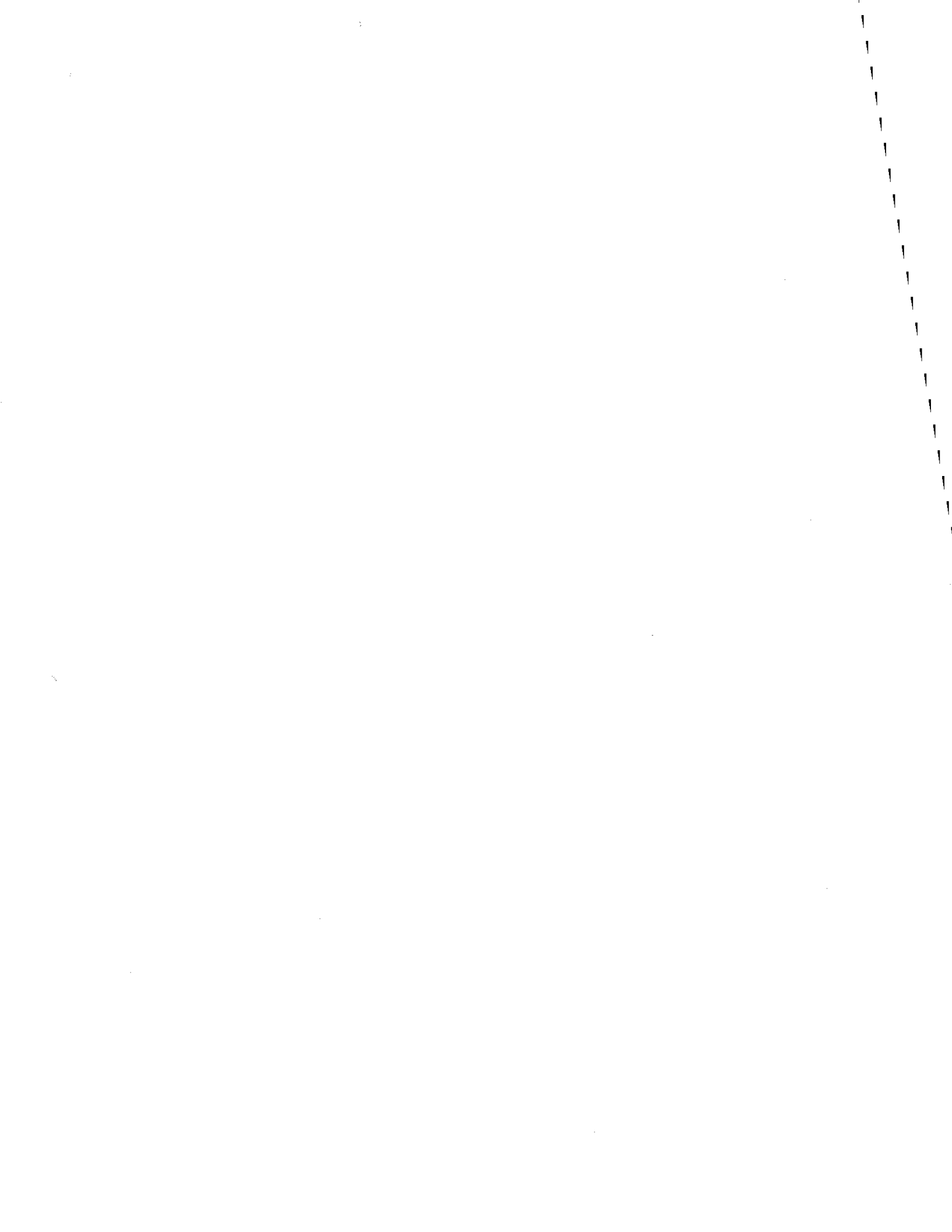


Lack of Tax Equity Promotes Explosive Growth

54 Months After vs. Pre-FET Increase on April 1, 2009



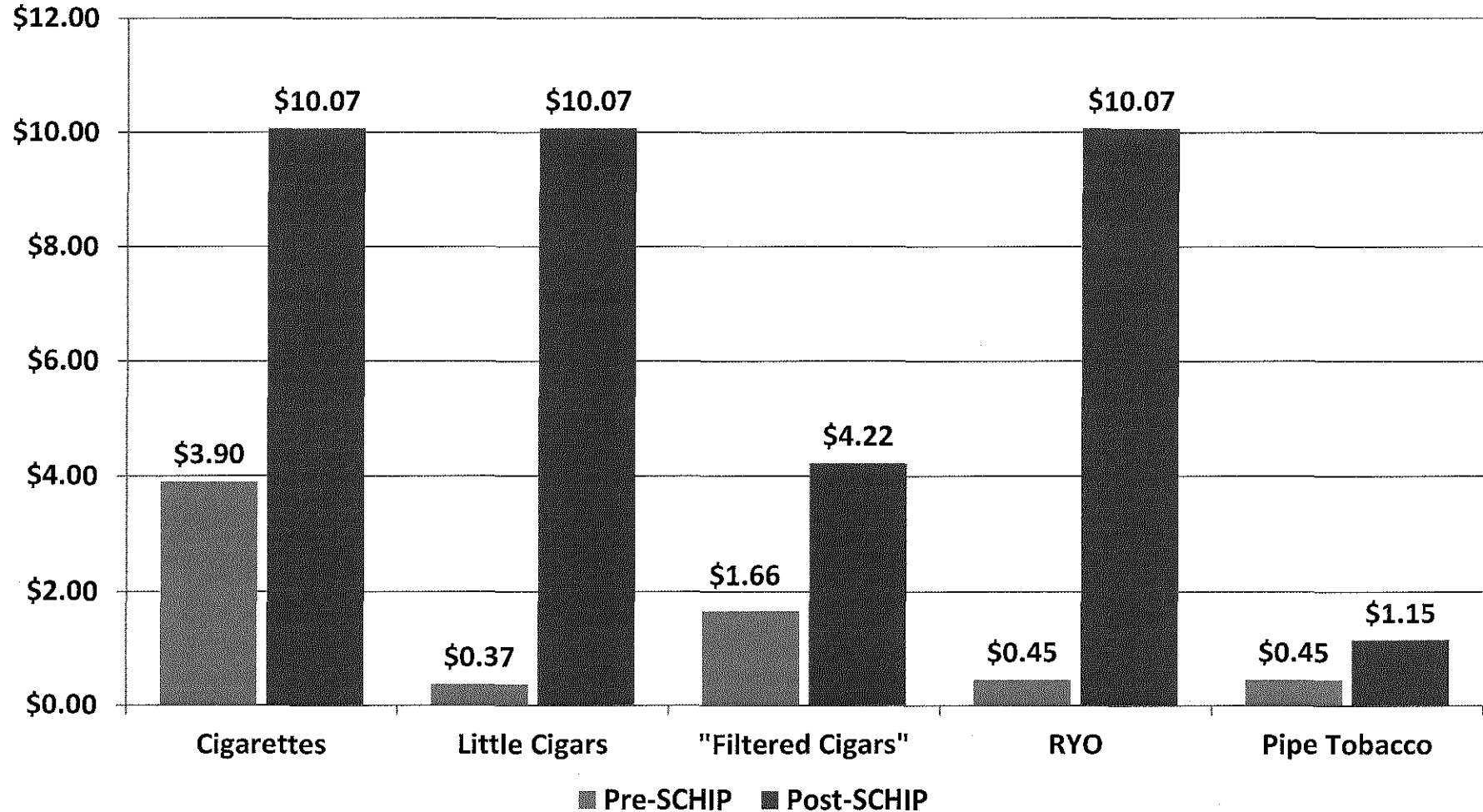
Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau. Pre-FET measurement period is January 1, 2007 to March 31, 2009.



Changes in Federal Excise Tax (FET) on Certain Tobacco Products

Effective April 1, 2009 Pursuant to SCHIP Legislation

FET per carton or carton equivalent



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

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

	<u>Cigarettes</u>	<u>Little Cigars</u>	<u>"Filtered Cigars"</u>	<u>RYO</u>	<u>"Pipe Tobacco" Cigarettes</u>
COG	\$2.45	\$2.45	\$2.45	\$1.00	\$1.00
FET	\$10.07	\$10.07	\$4.22	\$10.07	\$1.15
TQB	\$0.65	\$0.65	\$0.27	\$0.65	\$0.07
FDA	\$0.37	0	0	\$0.37	0
MSA	\$6.20	0	0	\$2.23	0
SET	<u>\$14.80</u>	<u>\$7.02</u>	<u>\$3.70</u>	<u>\$7.39</u>	<u>\$1.19</u>
Total	\$34.54	\$20.19	\$10.64	\$21.71	\$3.41

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

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

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

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

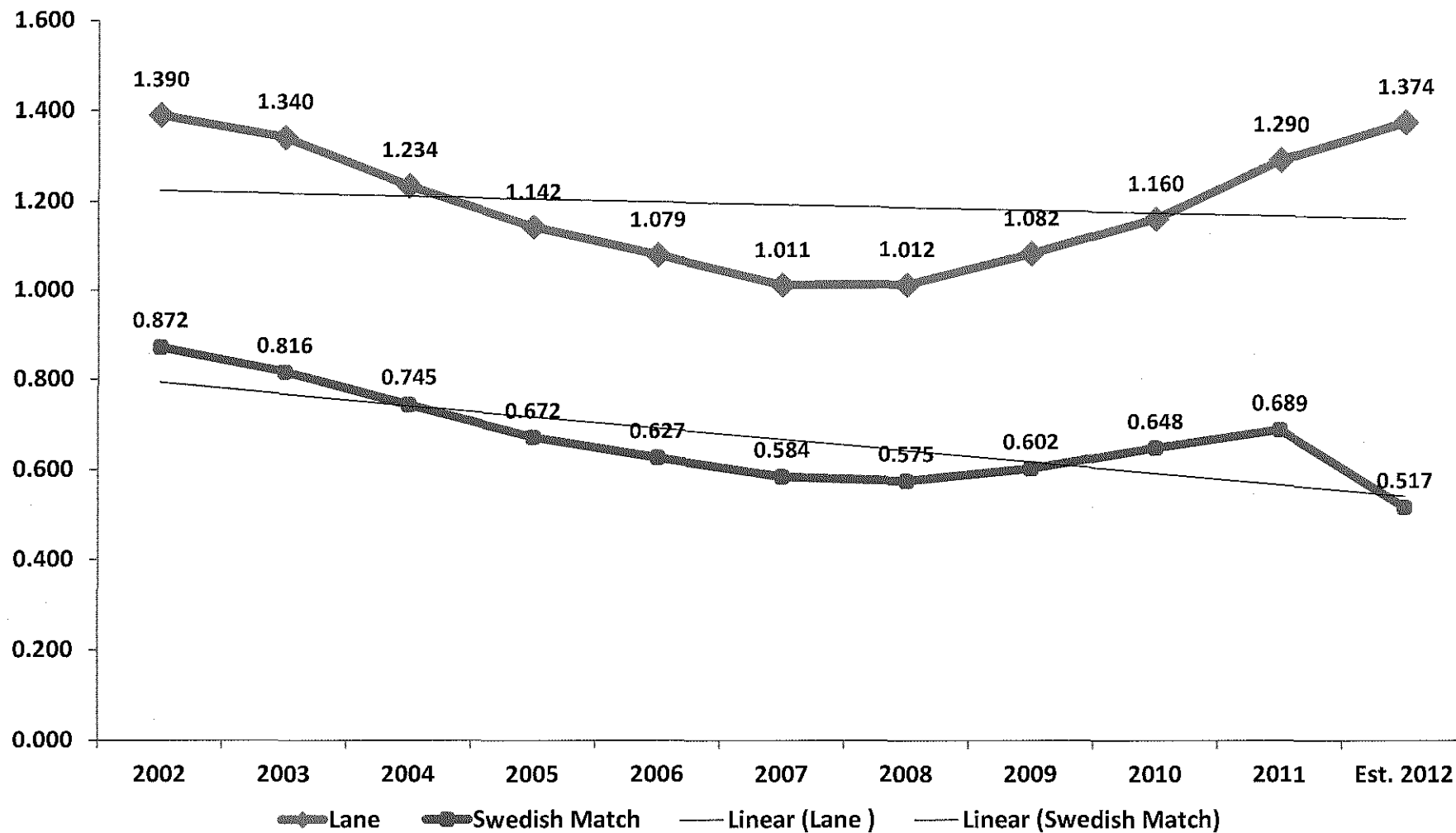
FDA User fees paid to FDA pursuant to Family Smoking Prevention and Tobacco Control Act. Also based on FET paid.

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

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

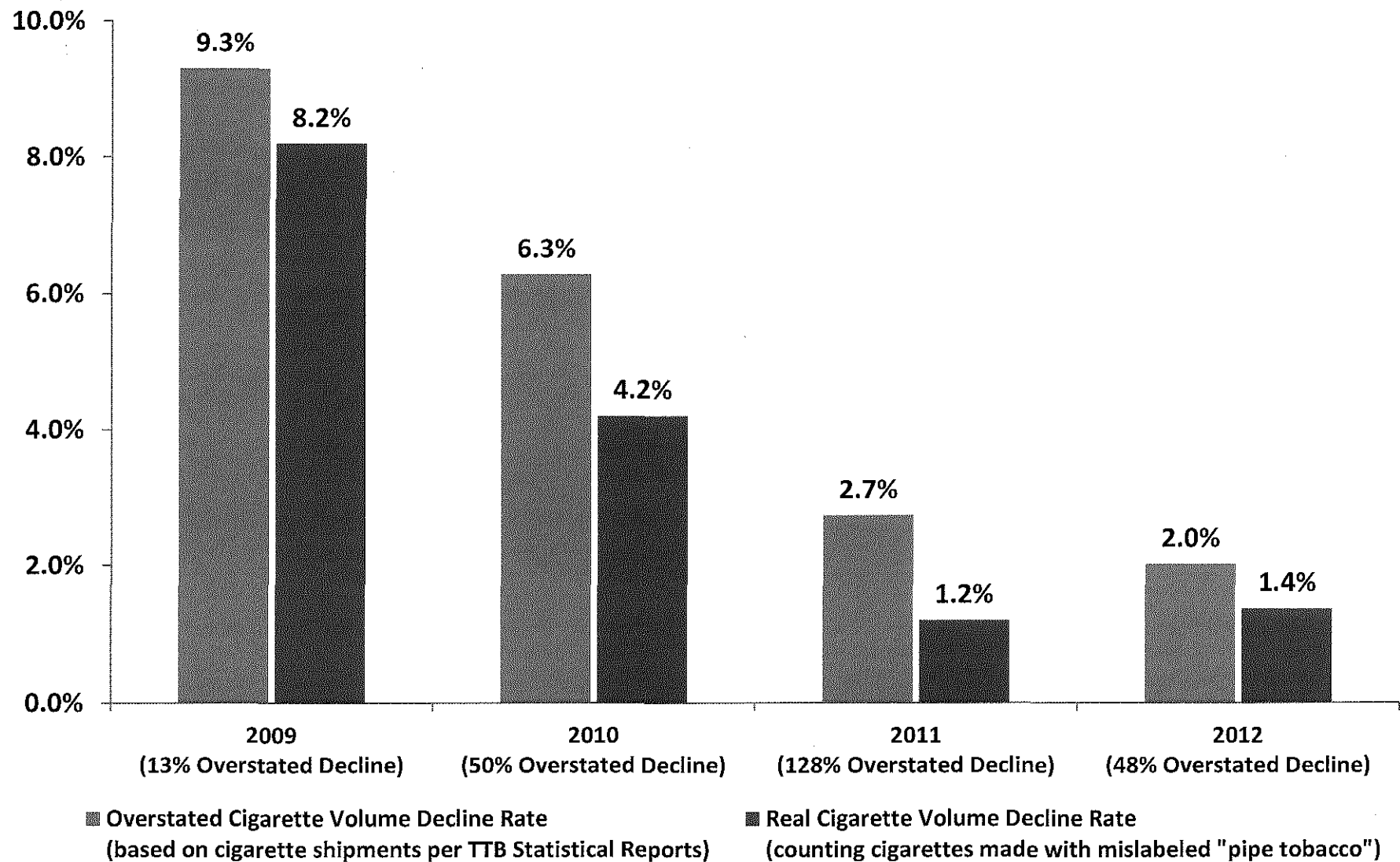
Two Largest Genuine Pipe Tobacco Manufacturers Have Flat or Slightly Declining Volumes Over Past Decade

Millions of Pounds



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

Mislabeled "Pipe Tobacco" Causes Overstated Cigarette Volume Declines

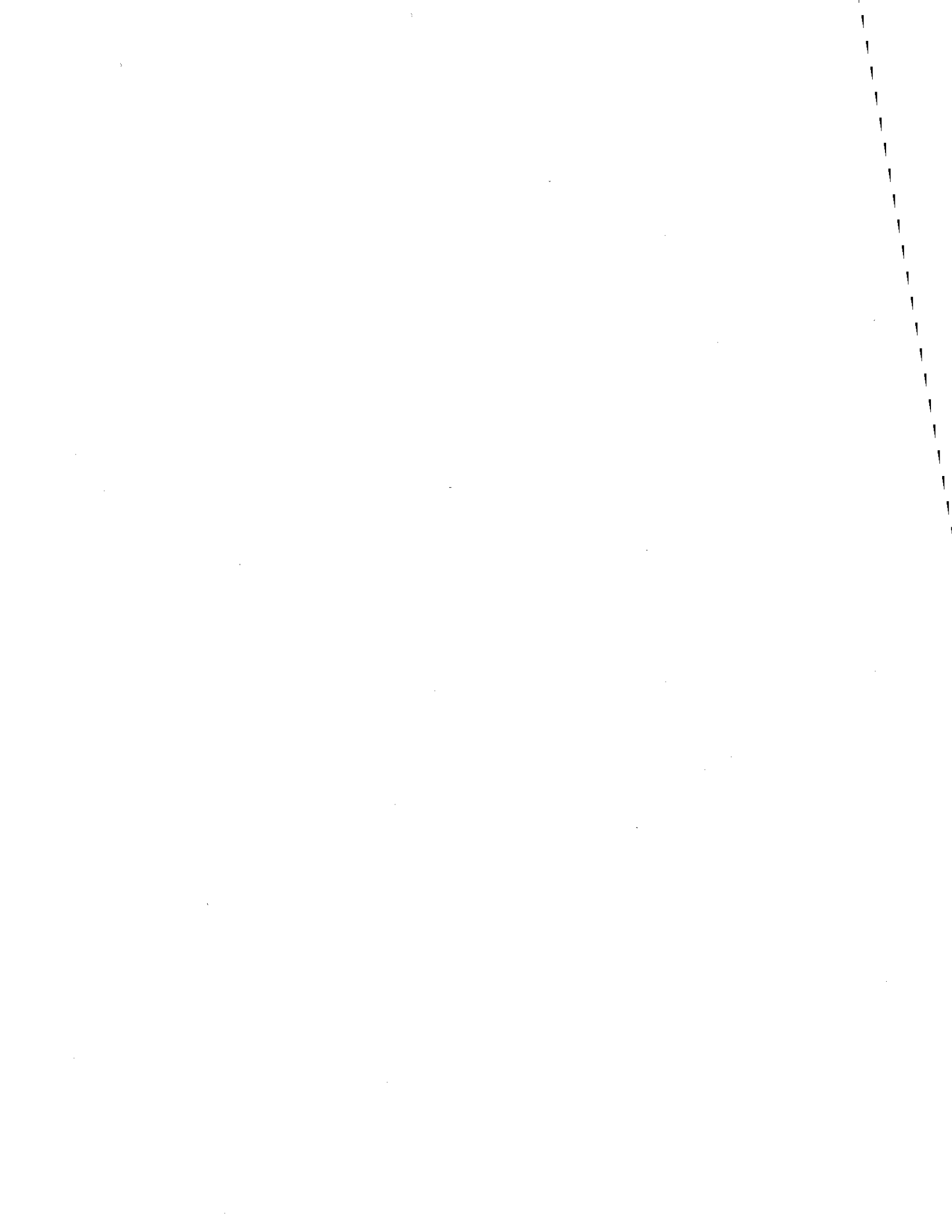


GAO Report Confirms Mislabeling of “Pipe Tobacco”

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

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

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



“Pipe Tobacco” Cigarettes Are Unregulated and Unaccountable

- **Falsely marketed as safer — “organic” “additive-free” “chemical-free” “all-natural”**
- **No health warnings**
- **No fire standard compliant (FSC) cigarette paper**
- **No ban on characterizing flavors**
- **No ban on “light,” “mild” or similar descriptors**
- **No product or manufacturing facility registration filed with FDA**
- **No product ingredients filed with FDA**
- **No substantial equivalence reports filed with FDA**
- **No pre-market clearance of new products by FDA**
- **No MSA or state escrow payments or advertising and marketing restrictions**



Federal Tobacco Product Definitions — Tax Code

- **“Cigarette” means—**
 - (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco, and**
 - (2) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in paragraph (1).**
- **“Cigar” means any roll of tobacco wrapped in leaf tobacco or in any substance containing tobacco (other than any roll of tobacco which is a cigarette within the meaning of [the cigarette definition]).**
- **The term “pipe tobacco” means any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco to be smoked in a pipe.**
- **The term “roll-your-own tobacco” means any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes.**

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

Federal Tobacco Product Definitions — FDA

(3) CIGARETTE.—The term ‘cigarette’—

(A) means a product that—

(i) is a tobacco product; and

(ii) meets the definition of the term ‘cigarette’ in section 3(1) of the Federal Cigarette Labeling and Advertising Act; and

(B) includes 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 as roll-your-own tobacco.

(4) CIGARETTE TOBACCO.—The term ‘cigarette tobacco’ means any product that consists of loose tobacco that is intended for use by consumers in a cigarette. Unless otherwise stated, the requirements applicable to cigarettes under this chapter shall also apply to cigarette tobacco.

Source: Subsections 900 (3) and (4) of Federal Food, Drug, and Cosmetic Act, 21 U.S.C. § 387(3) and (4), as amended by the Family Smoking Prevention and Tobacco Control Act



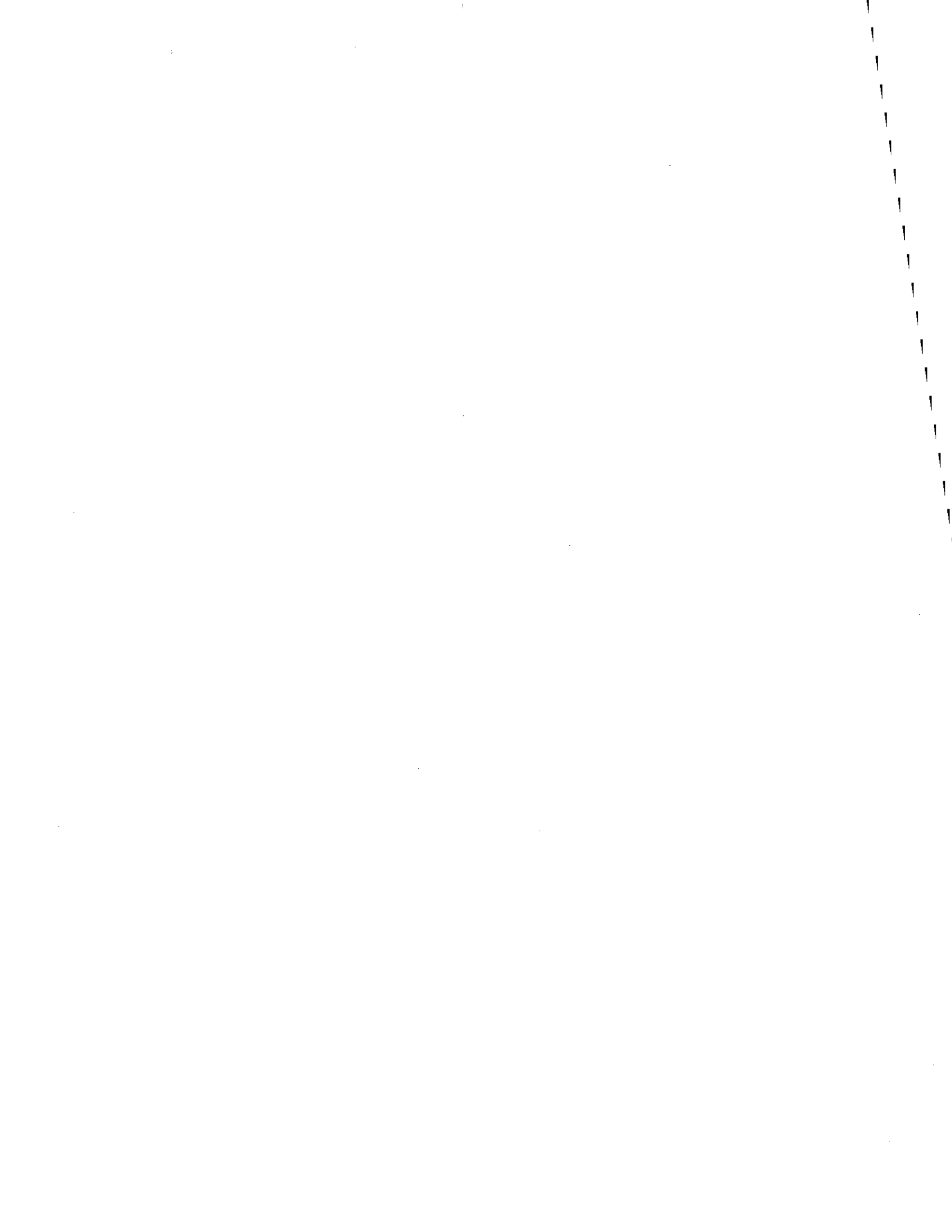
Mislabeled “Pipe Tobacco” Violates Existing Law

- Existing law gives FDA authority to act
 - “Cigarette tobacco” is defined as “any product that consists of loose tobacco that is intended for use by consumers in a cigarette.” FDCA § 900(4)
 - Mislabeled “pipe tobacco” is loose tobacco intended for use by consumers in a cigarette
 - Mislabeled “pipe tobacco” is cigarette tobacco as defined in FDCA
 - Mislabeled “pipe tobacco” also meets definition of RYO because it is suitable for use and purchased by consumers for making cigarettes
 - All FDA requirements for cigarettes also apply to cigarette tobacco and RYO

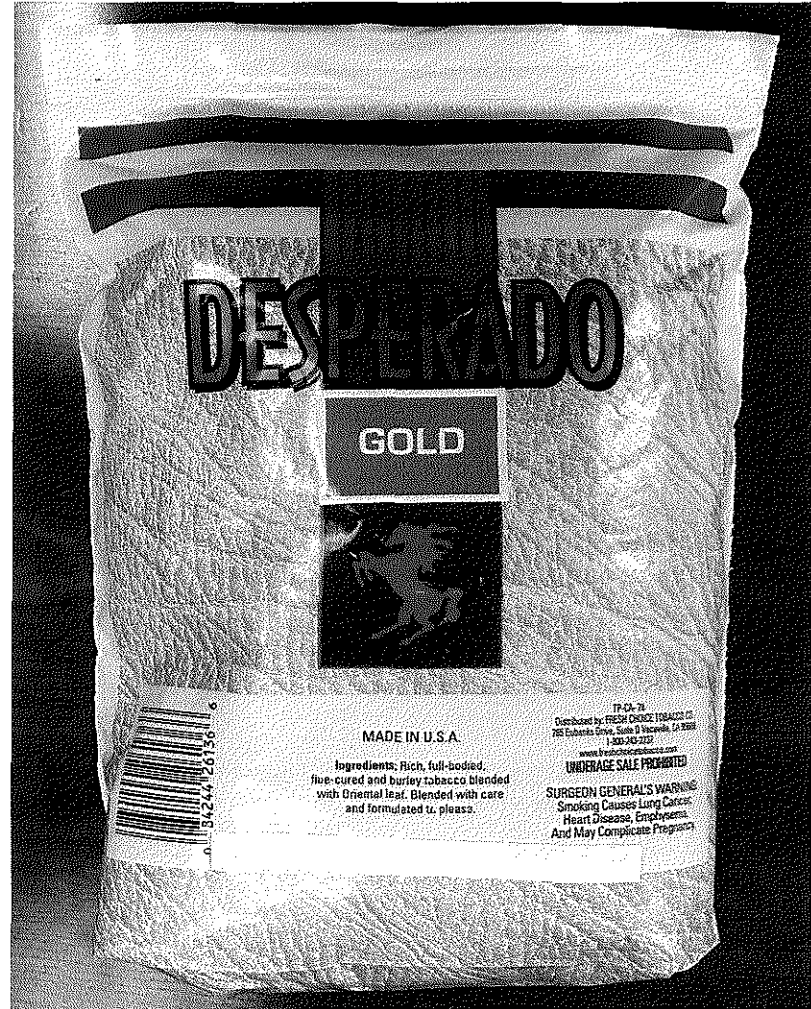
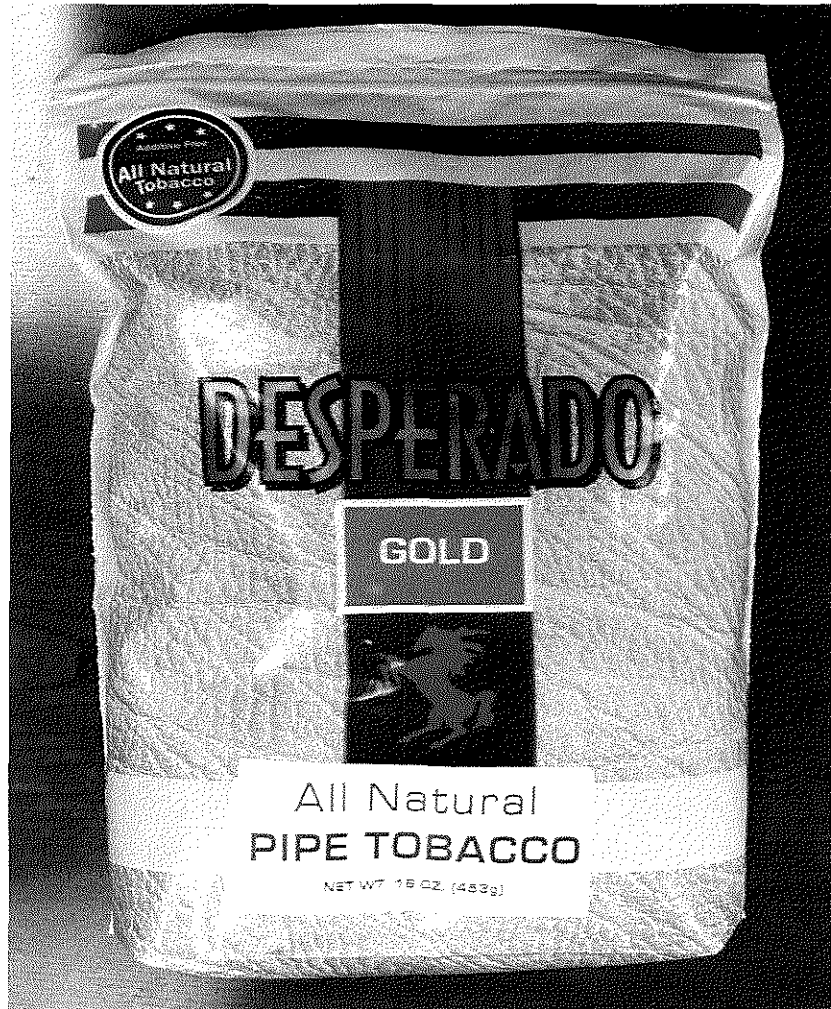


Mislabeled “Pipe Tobacco” Violates Existing Law

- **Mislabeled “pipe tobacco” is misbranded under existing law**
 - **FDCA states that tobacco product is misbranded “if its labeling is false or misleading in any particular”**
 - **Labeling loose tobacco intended for use by consumers in a cigarette as “pipe tobacco” is false and misleading**
- **Also, in-store RYO cigarette machines violate existing FDA regulations prohibiting self-service modes of sale — 21 CFR 1140.16(c)**
 - **Only exception is “adult-only” stores where persons under age 18 are never present**



RYO and “Pipe Tobacco”



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

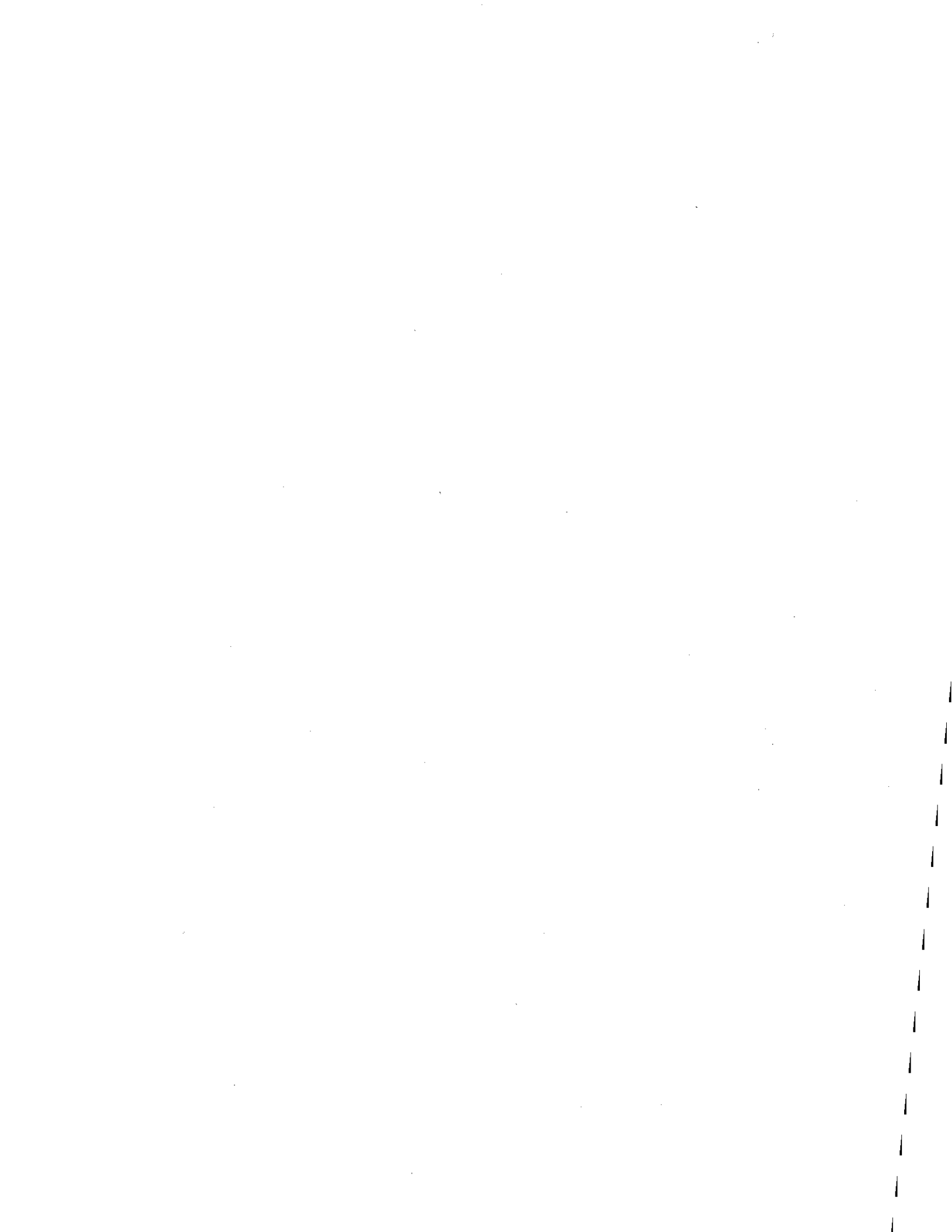
RYO and "Pipe Tobacco"





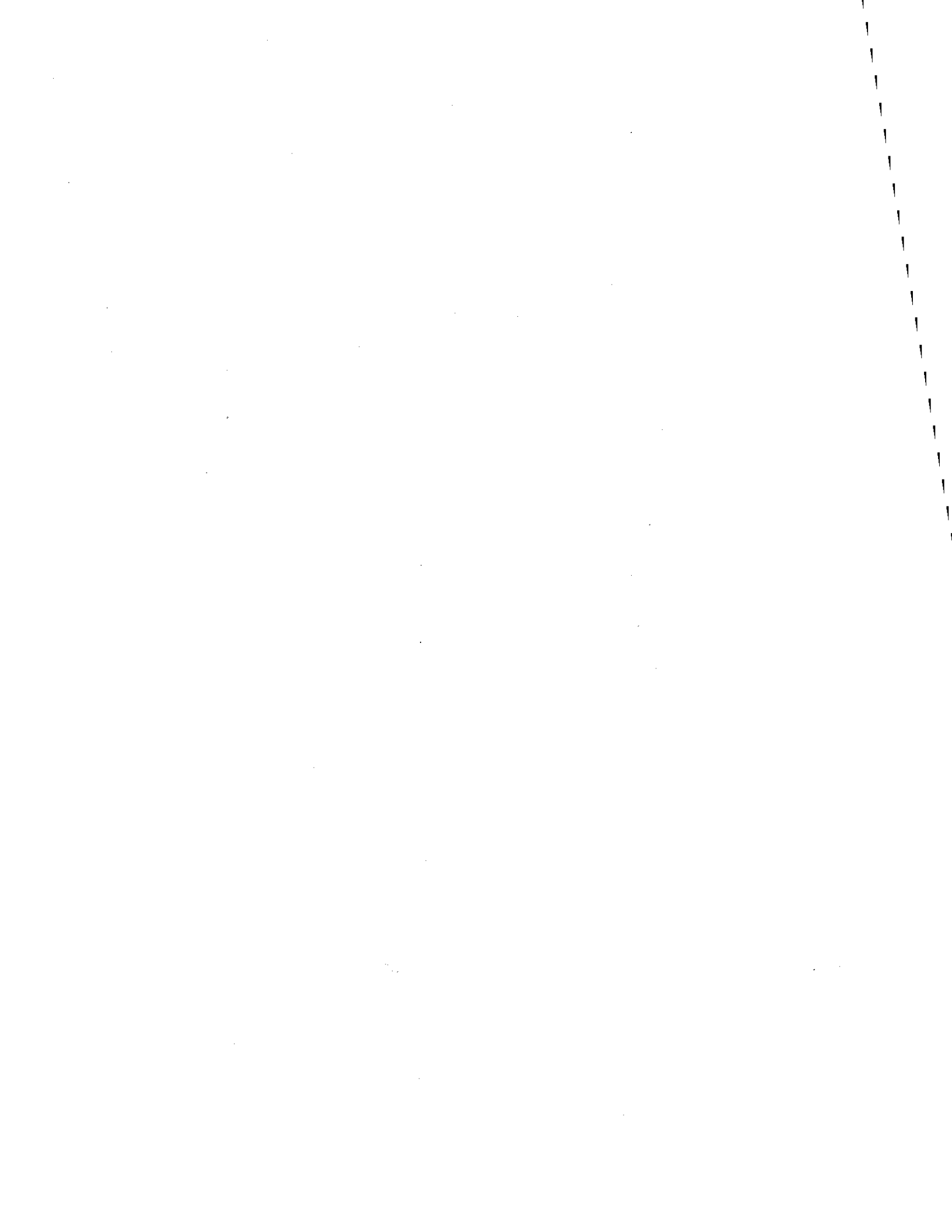
RYO and "Pipe Tobacco"



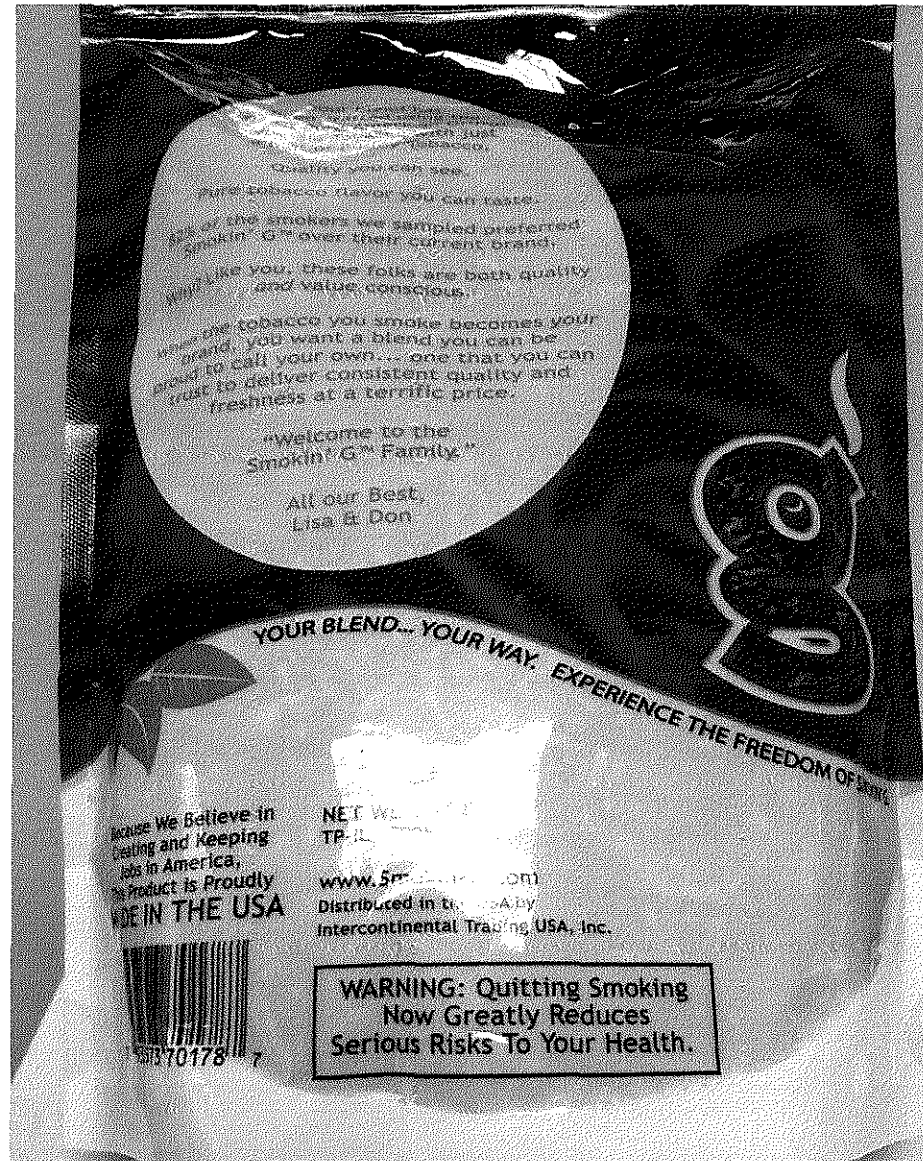
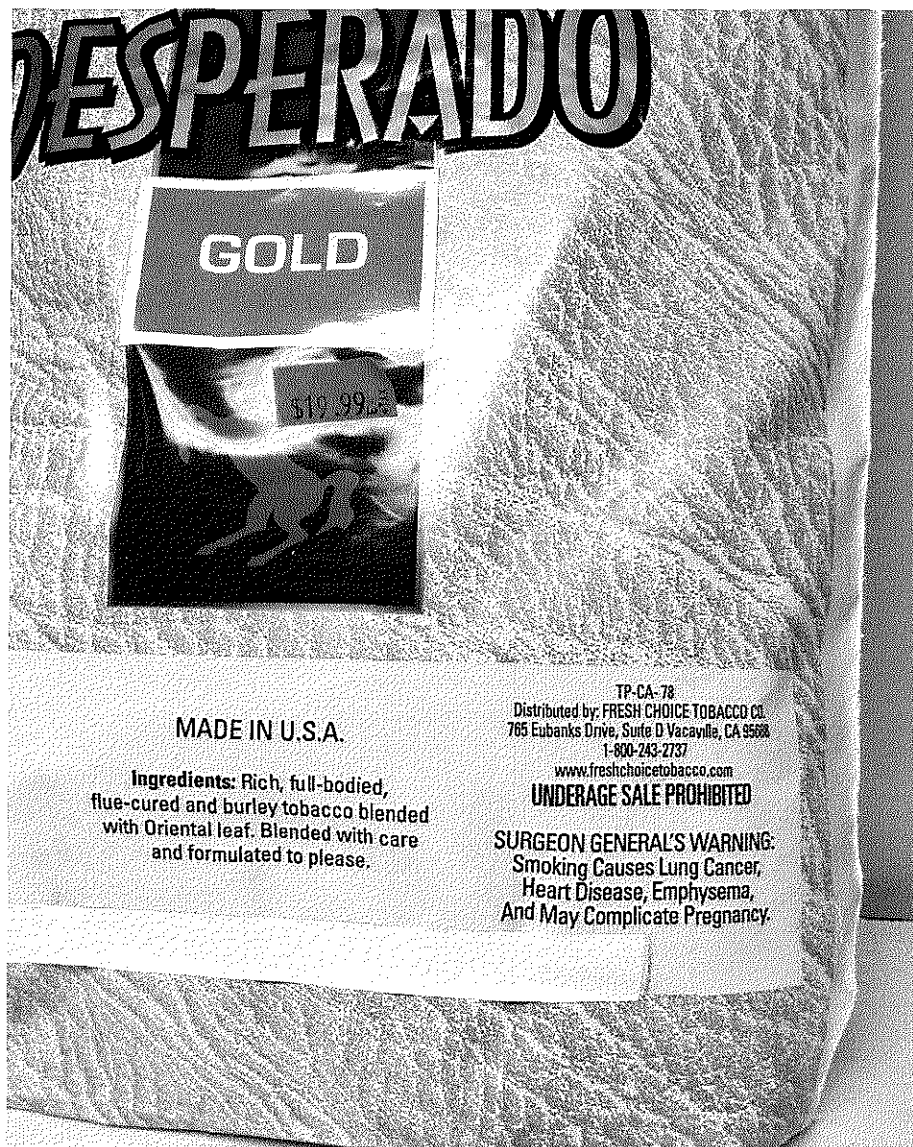


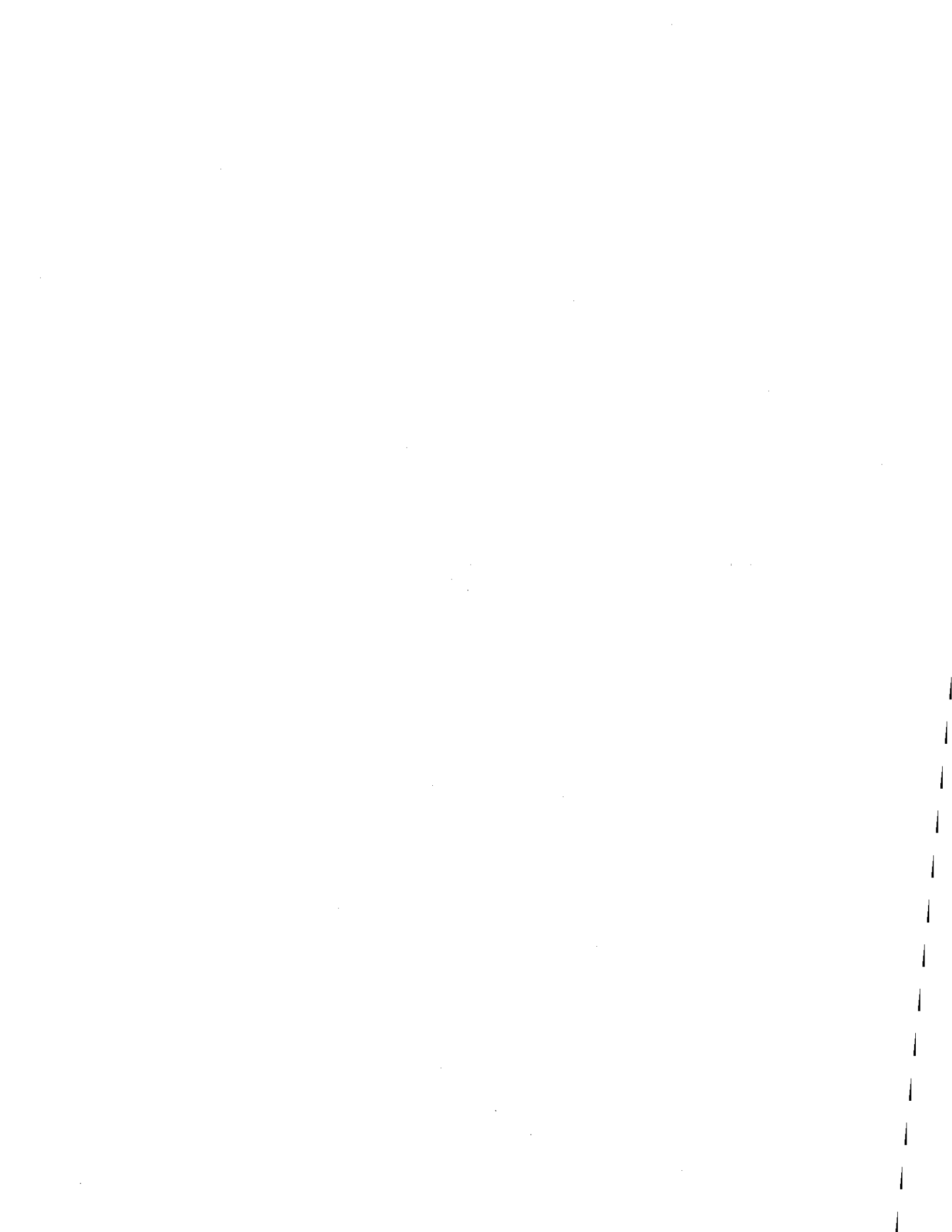
“Pipe Tobacco” Marketed with “RYO Starter Kit”





Cigarette Warning Labels on “Pipe Tobacco”





Cigarette Warning Labels on "Pipe Tobacco"



Effective Regulation and Appropriate Taxes Needed for E-Cigarettes

- **Tobacco Control Act applies to all tobacco products**
- **E-cigs are a tobacco product**
- **E-cigs contain nicotine, which is addictive — same as conventional cigarettes**
- **Much e-cig advertising and marketing appears directed to youth**
- **Recent data show increased use of e-cigs by youth**
- **Inadequate regulation may allow e-cigs to be gateway to regular cigarette use**
- **Inadequate regulation and taxation effectively provide subsidy to e-cig companies**



Effective Regulation and Appropriate Taxes Needed for E-Cigarettes

- **E-Cig regulation should include —**
 - **Same ban on characterizing flavors**
 - **Same ban on certain descriptors**
 - **Same ban on health claims**
 - **Same advertising restrictions**
 - **Same age restrictions**
 - **Appropriate tax**
 - **Same FDA regulatory scheme —**
 - **Facility and product registration**
 - **Ingredient disclosure**
 - **Adulteration and misbranding prohibitions**
 - **Pre-market review**
 - **User fees**
 - **GMPs**

