

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

equivalents.

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

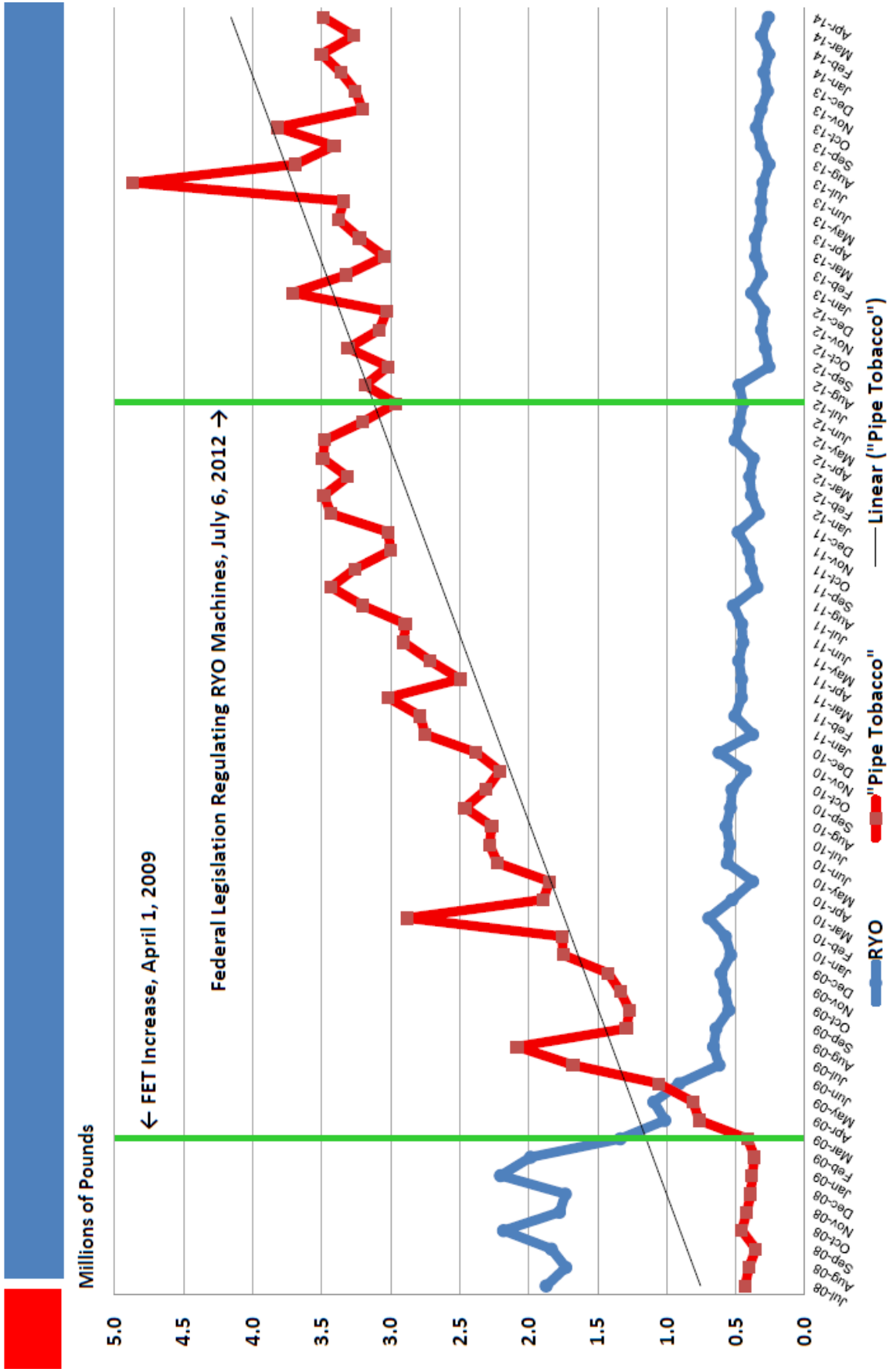
Under the definition of “cigarette tobacco” in the Tobacco Control Act, FDA also has clear authority to treat mislabeled “pipe tobacco” as misbranded and to require it to be properly labeled and regulated as cigarette tobacco. But they, too, have allowed two markets to exist; one regulated and properly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

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


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

Thank you for your attention.

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



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



APPENDIX TO

STATEMENT OF RONALD J. BERNSTEIN
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Federal Excise Tax Evasion Has Driven Explosive Growth of Mislabeled “Pipe Tobacco”

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\$3.1 Billion in Federal Excise Tax Lost Since April 2009

\$812 Million in Federal Excise Tax Lost in 2013 Alone

State MSA and Escrow Payments Greatly Reduced

Overview

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

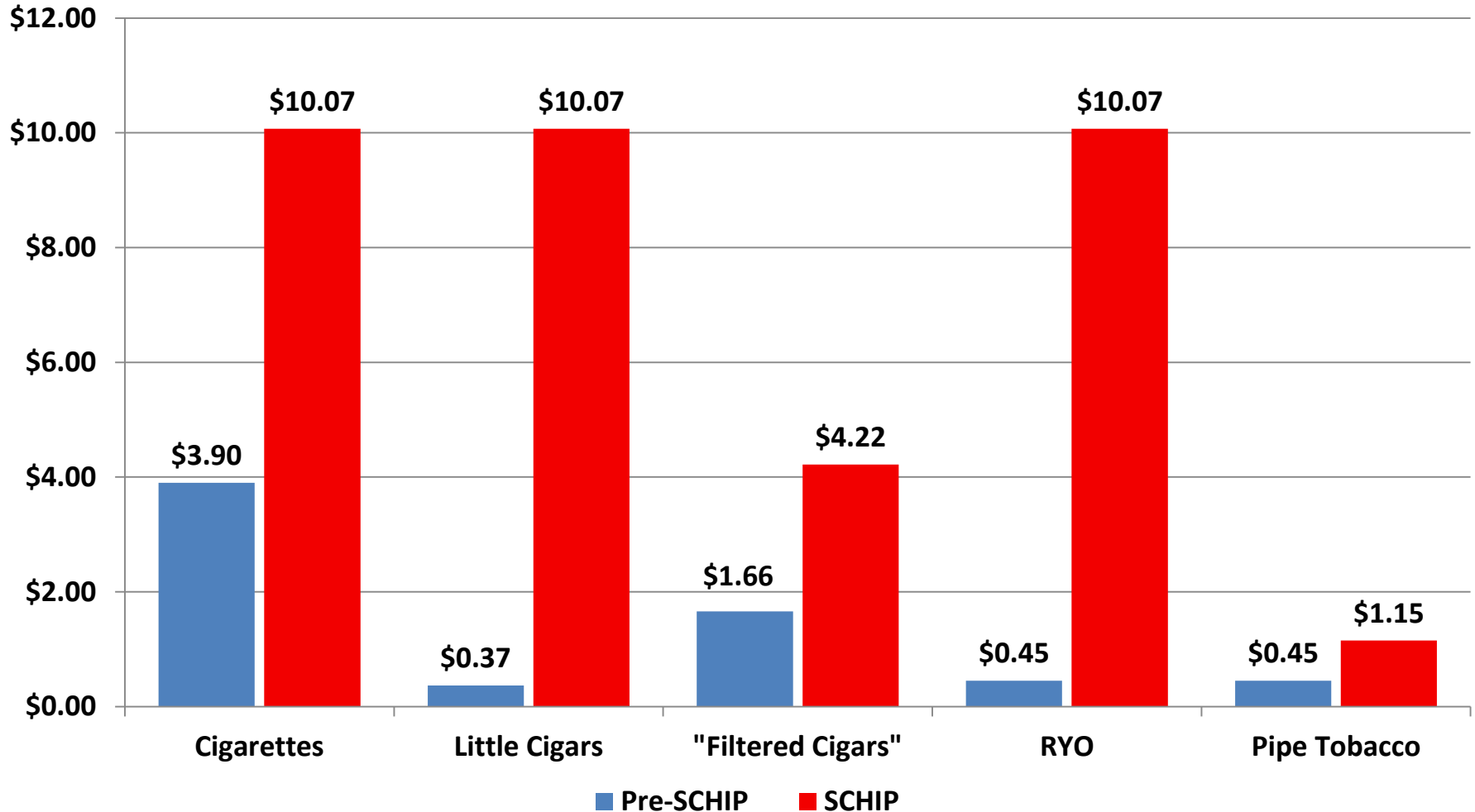
Overview

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

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

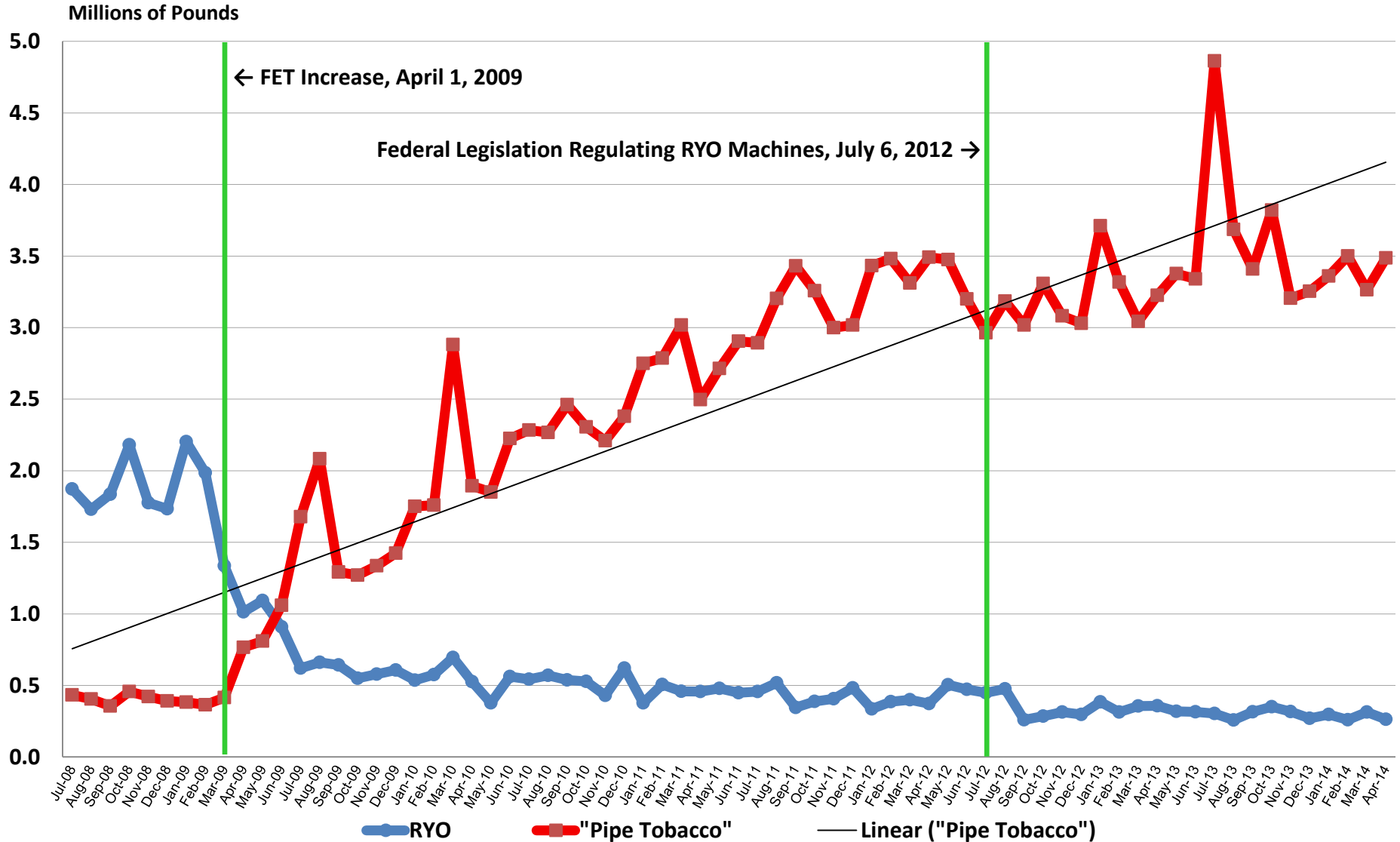
Effective April 1, 2009 Pursuant to SCHIP Legislation

FET per carton or carton equivalent



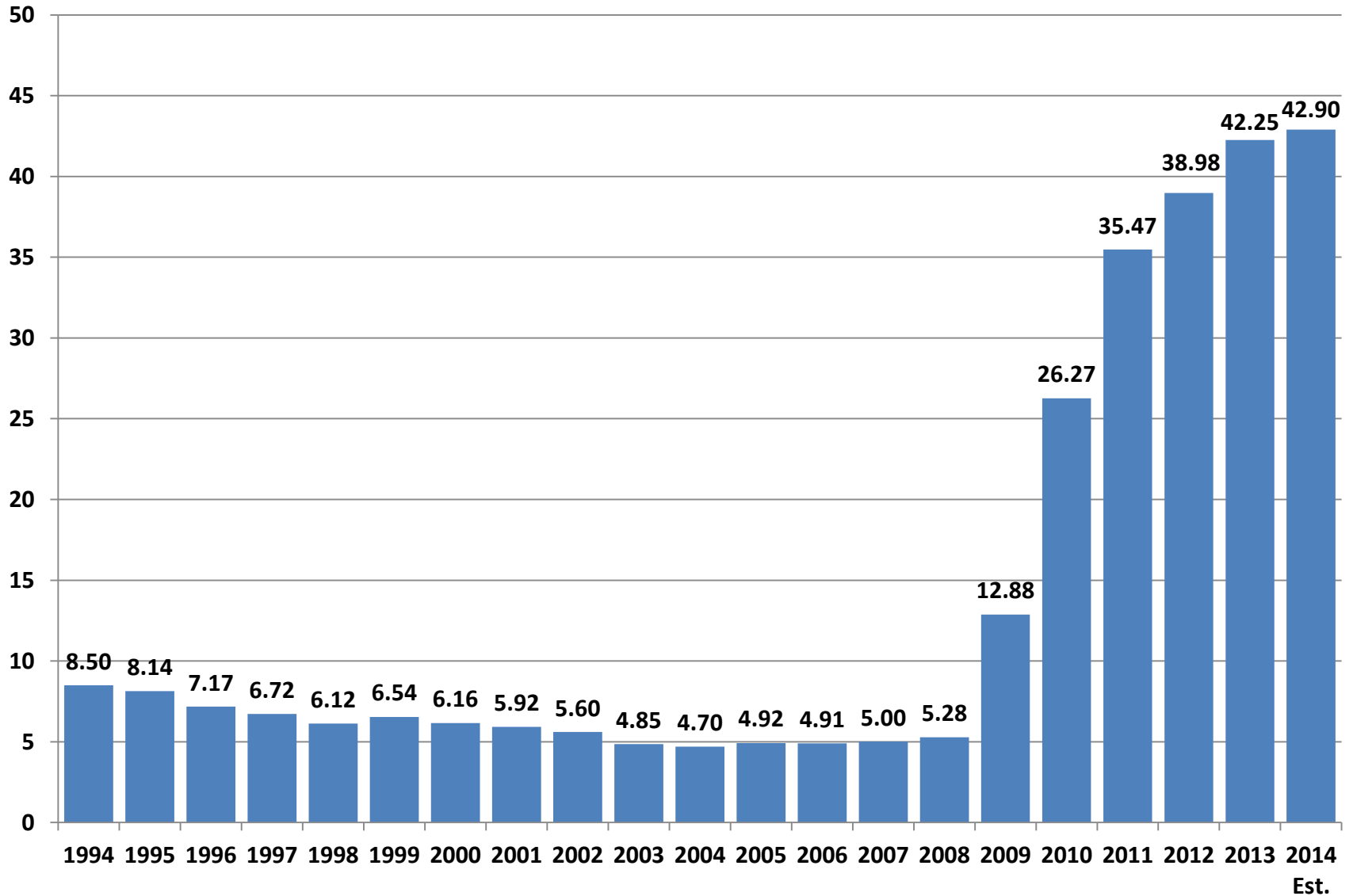
Note: The term "filtered cigars" is used to mean cigars that were classified as "small cigars" for FET purposes (less than 3 pounds per 1000) before the 2009 FET increase, and that thereafter were slightly increased in weight in order to claim classification as "large cigars" for FET purposes, and thereby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

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



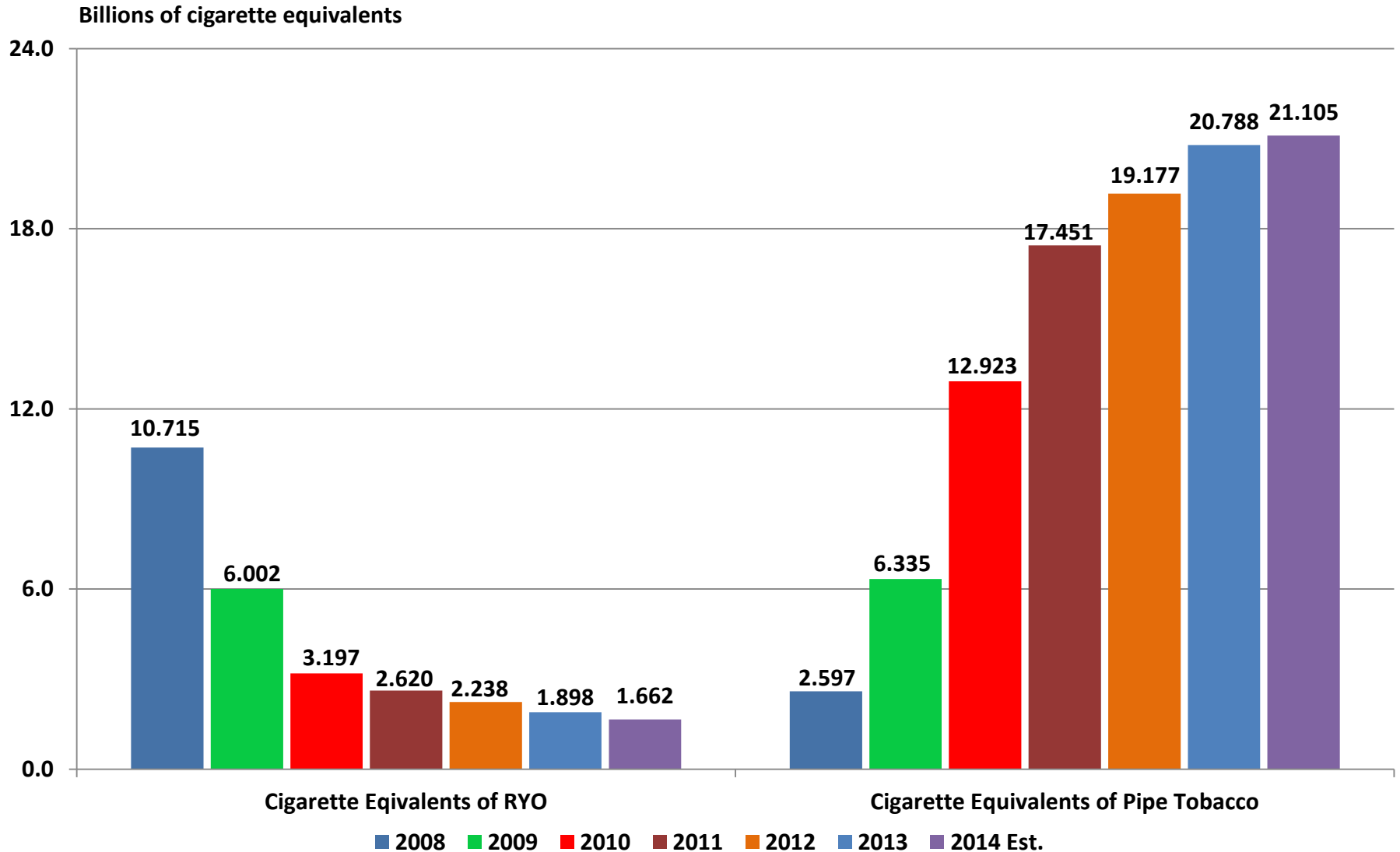
Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau.

Pipe Tobacco Volume 1994 – 2014 in Millions of Pounds



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

RYO and Pipe Tobacco Volume Changes 2008 – 2014 Expressed in Cigarette Equivalents



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

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

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

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

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

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

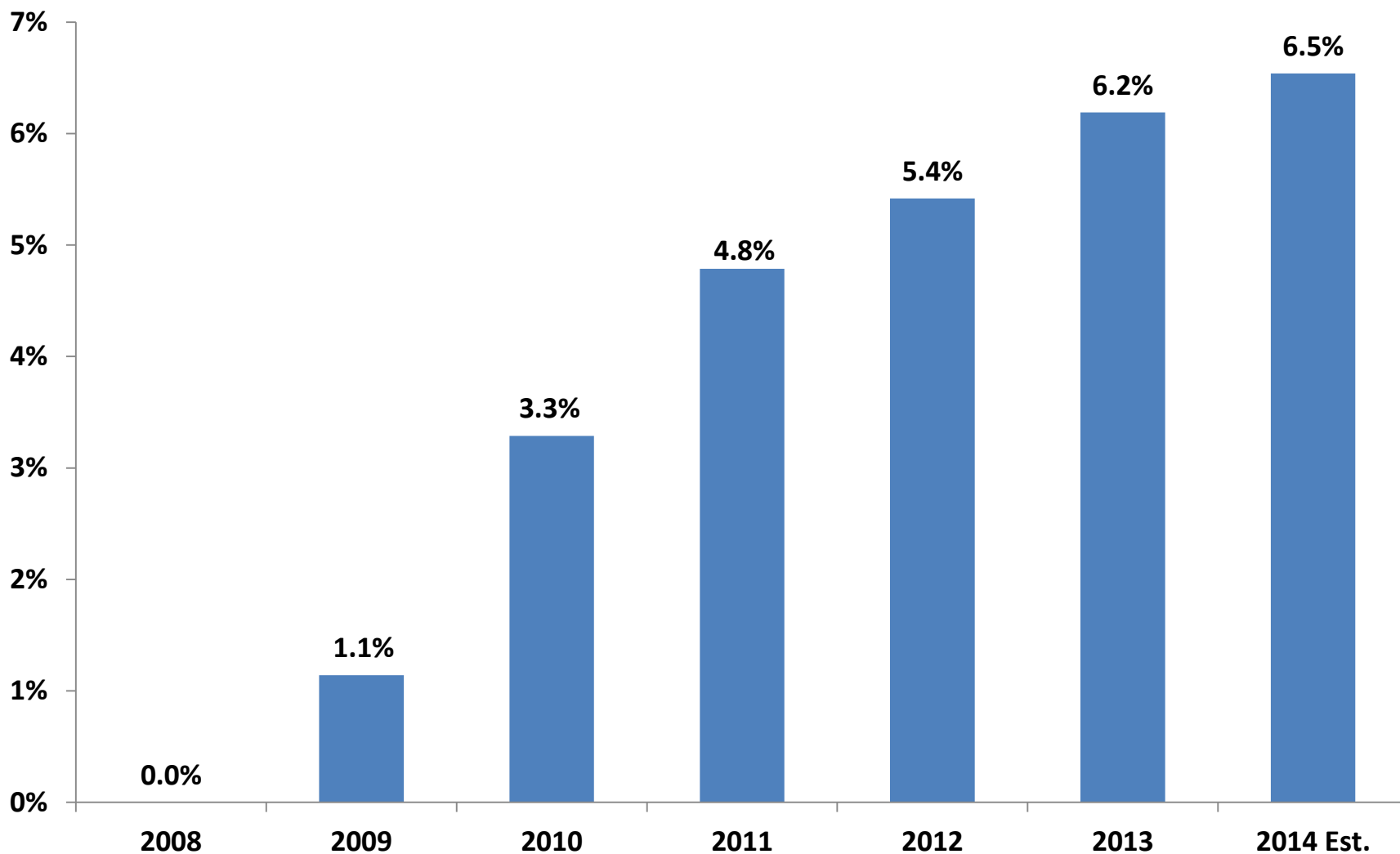
TQB Federal tobacco quota buy-out assessment. Based on FET paid, so products with lower FET rate pay less.

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

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

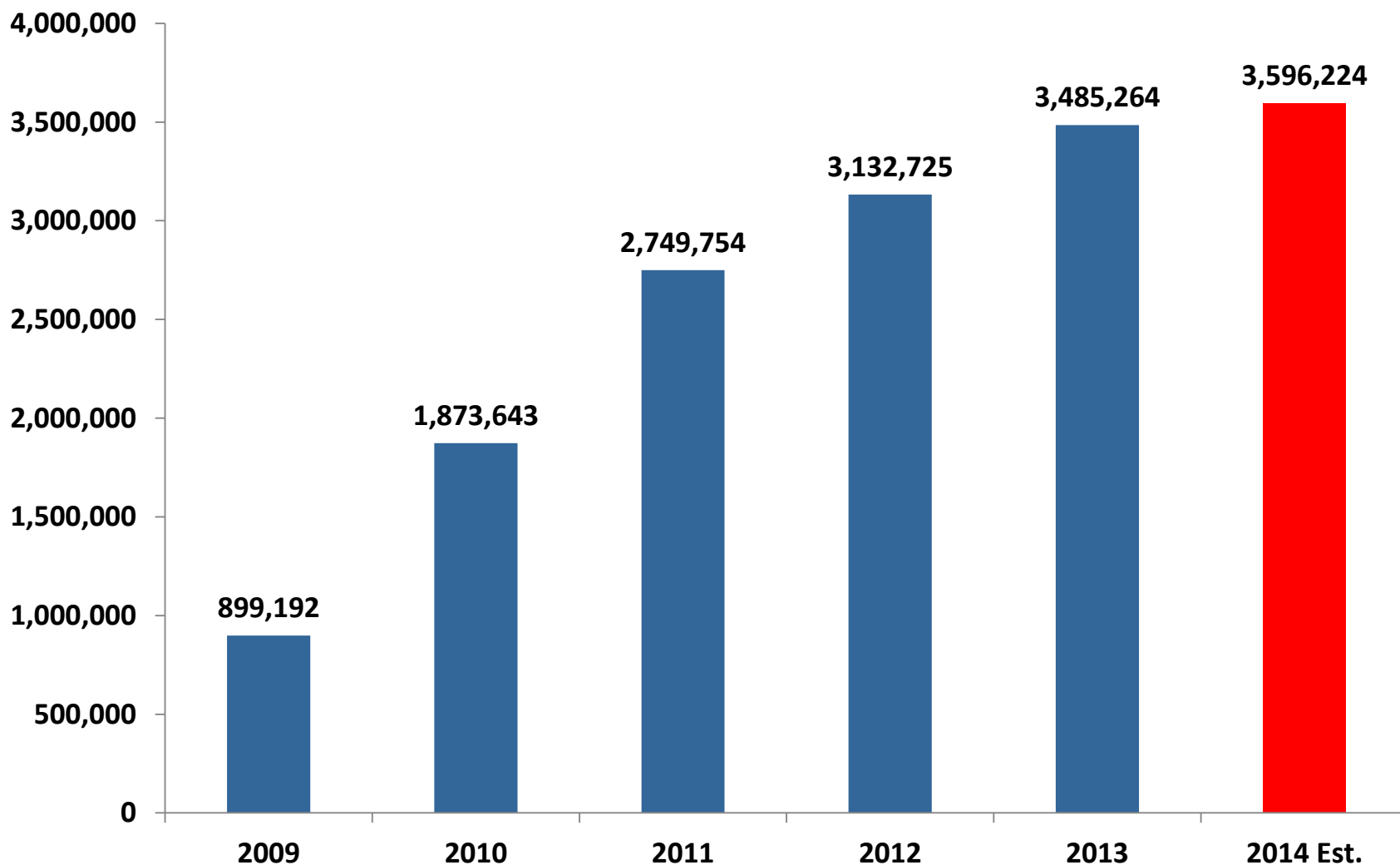
SET National average state excise tax on cigarettes is \$14.80 per carton (www.tobaccofreekids.org/research/factsheets/pdf/0097.pdf) (12/13/12). Most states tax other tobacco products (OTP) as a percent of the manufacturer price to wholesale. State OTP taxes vary, but average is approximately 35%. This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

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



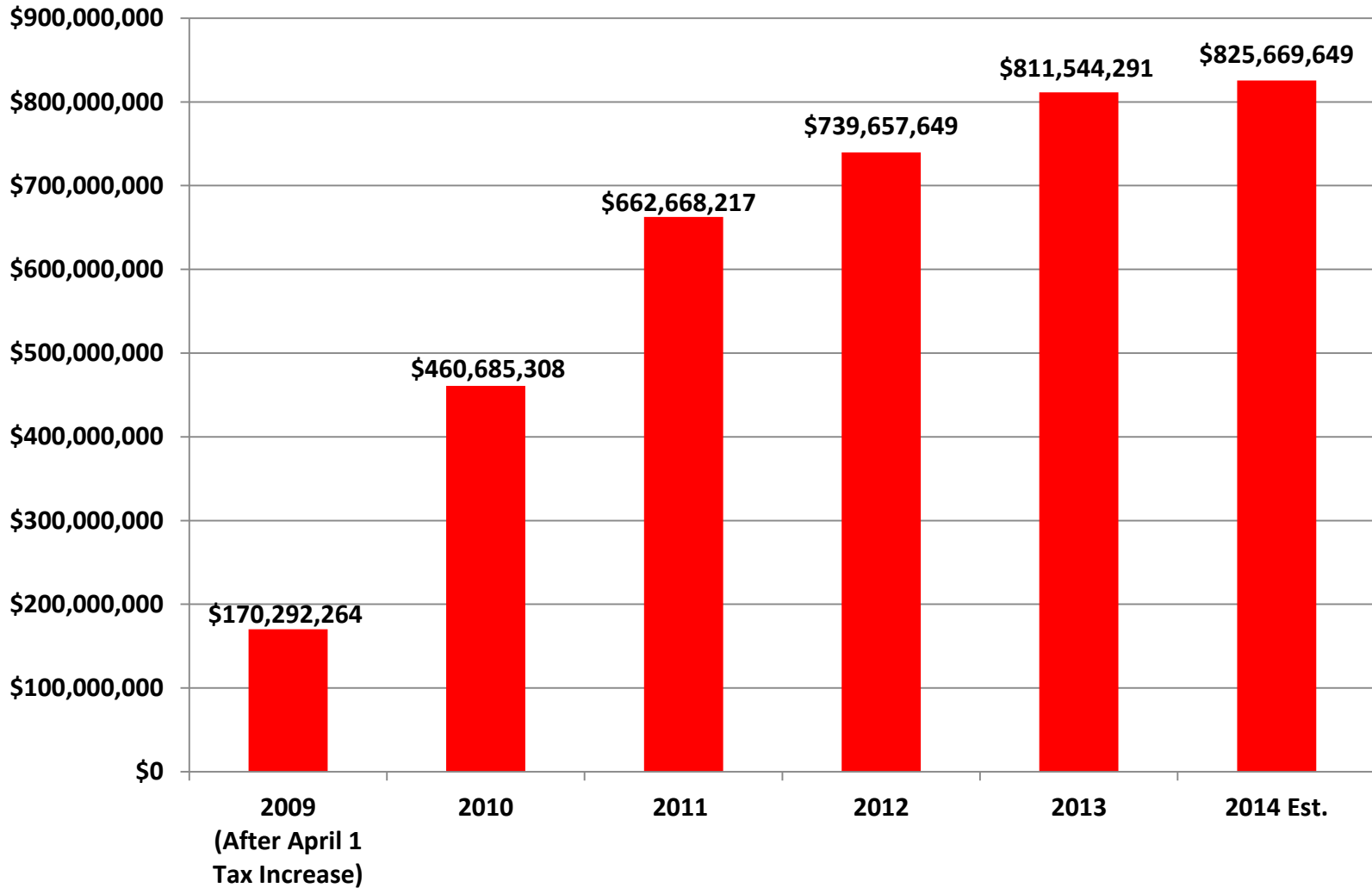
Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau.

Estimated Number of Smokers Using Cigarettes Made with Mislabeled "Pipe Tobacco"



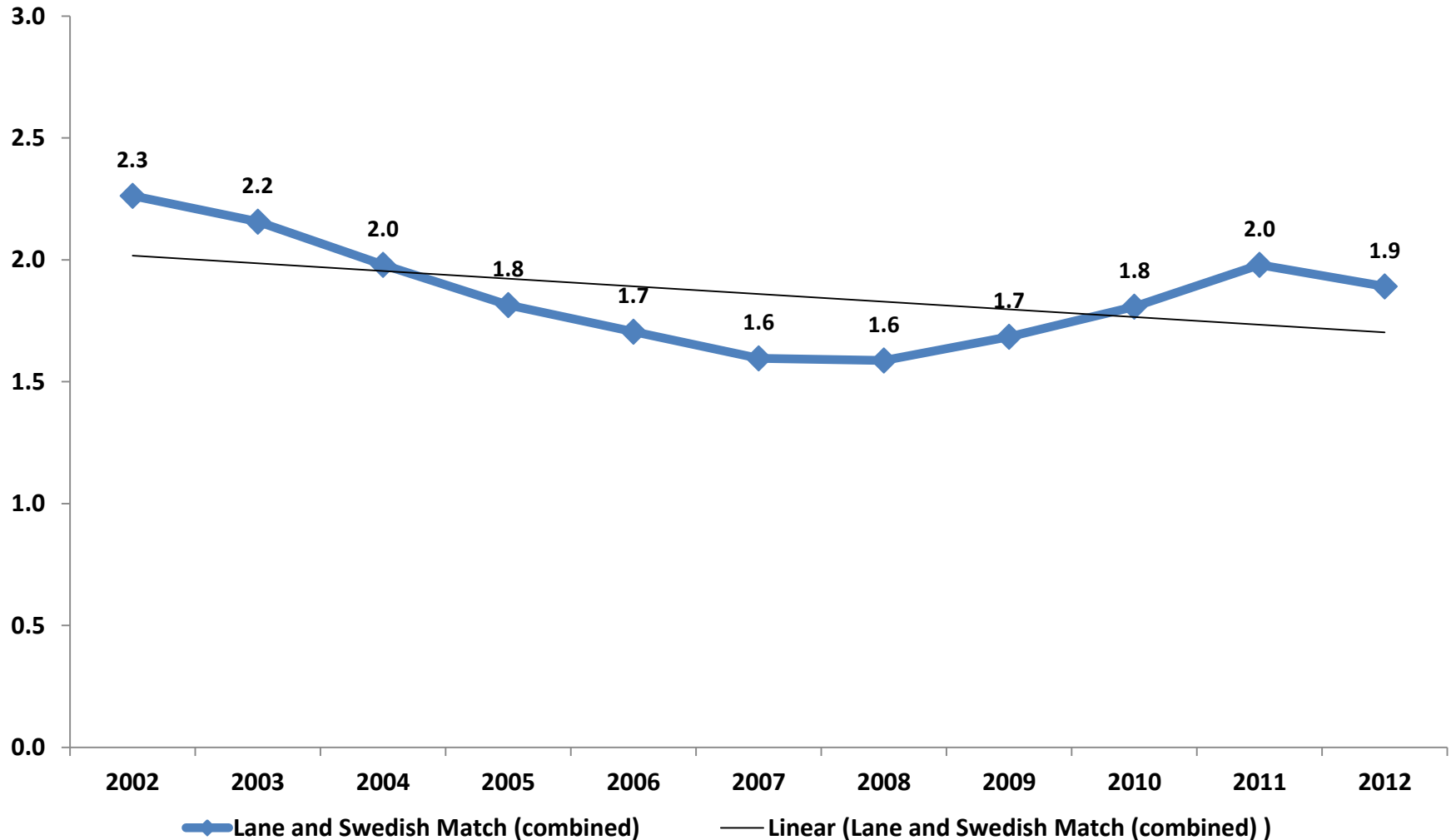
Based on straight-line extrapolation from national mean of 16.7 cigarettes per day (CPD) in 2005 to an estimated 14.2CPD in 2013. See Centers for Disease Control and Prevention, *Morbidity and Mortality Weekly Report*, Sept. 9, 2011, www.cdc.gov/mmwr (Jan. 9, 2012).

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



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

Millions of Pounds



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

GAO Report Confirms Mislabeling of “Pipe Tobacco”

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

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

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

Tax Evasion Revenue Losses are Huge — and Growing

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

Manufacturers Violate TTB Policy — From TTB Website

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

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

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

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

Federal Tax Code Definitions of Tobacco Products

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

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

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



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

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



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



Appearance, Type, Packaging and Labeling — RYO and “Pipe Tobacco”



Appearance, Type, Packaging and Labeling — RYO and “Pipe Tobacco”



Appearance, Type, Packaging and Labeling — RYO and “Pipe Tobacco”



Appearance, Type, Packaging and Labeling — RYO and “Pipe Tobacco”



“Pipe Tobacco,” Cigarette Tubes, and Cigarette Rolling Machines Marketed Together



Janesville, Wisconsin, July 2014

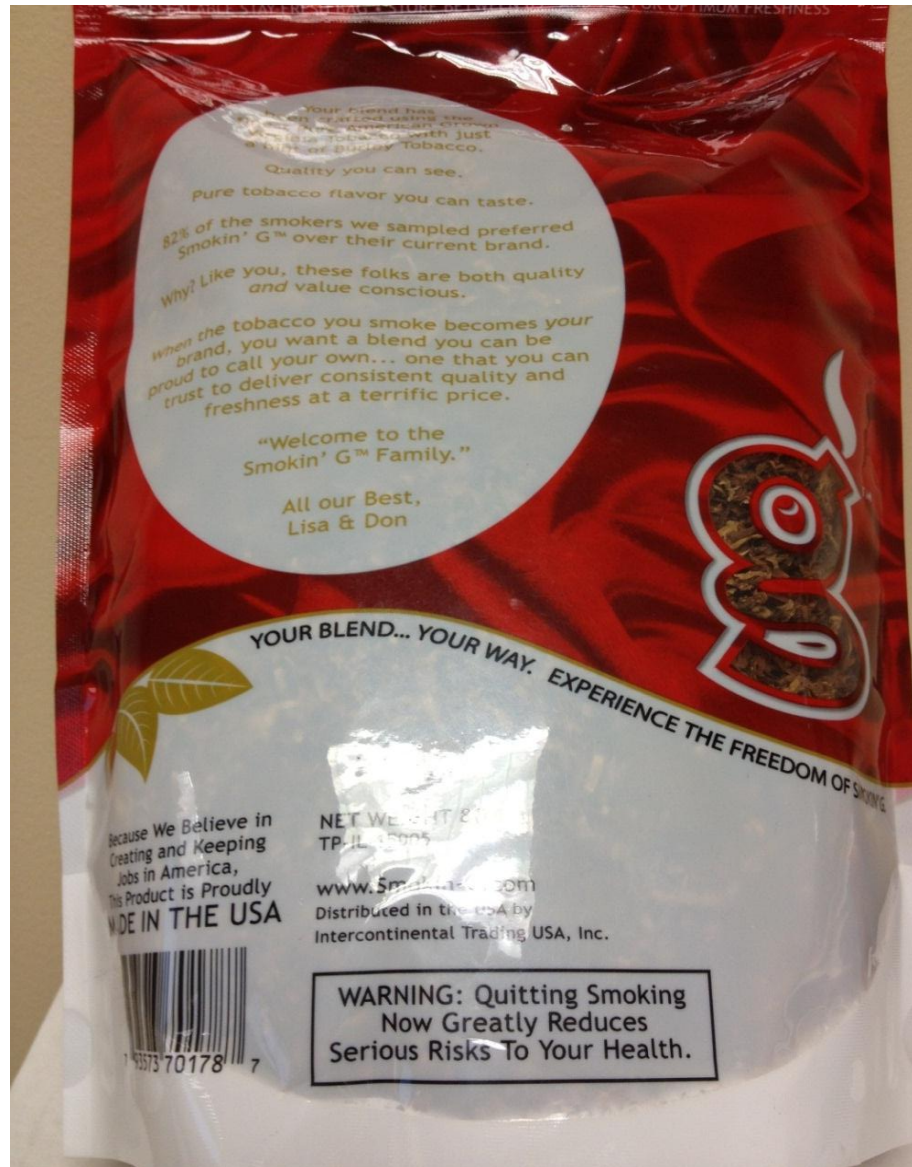
“Pipe Tobacco” and Cigarette Tubes Marketed Together



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



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



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



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



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



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



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

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



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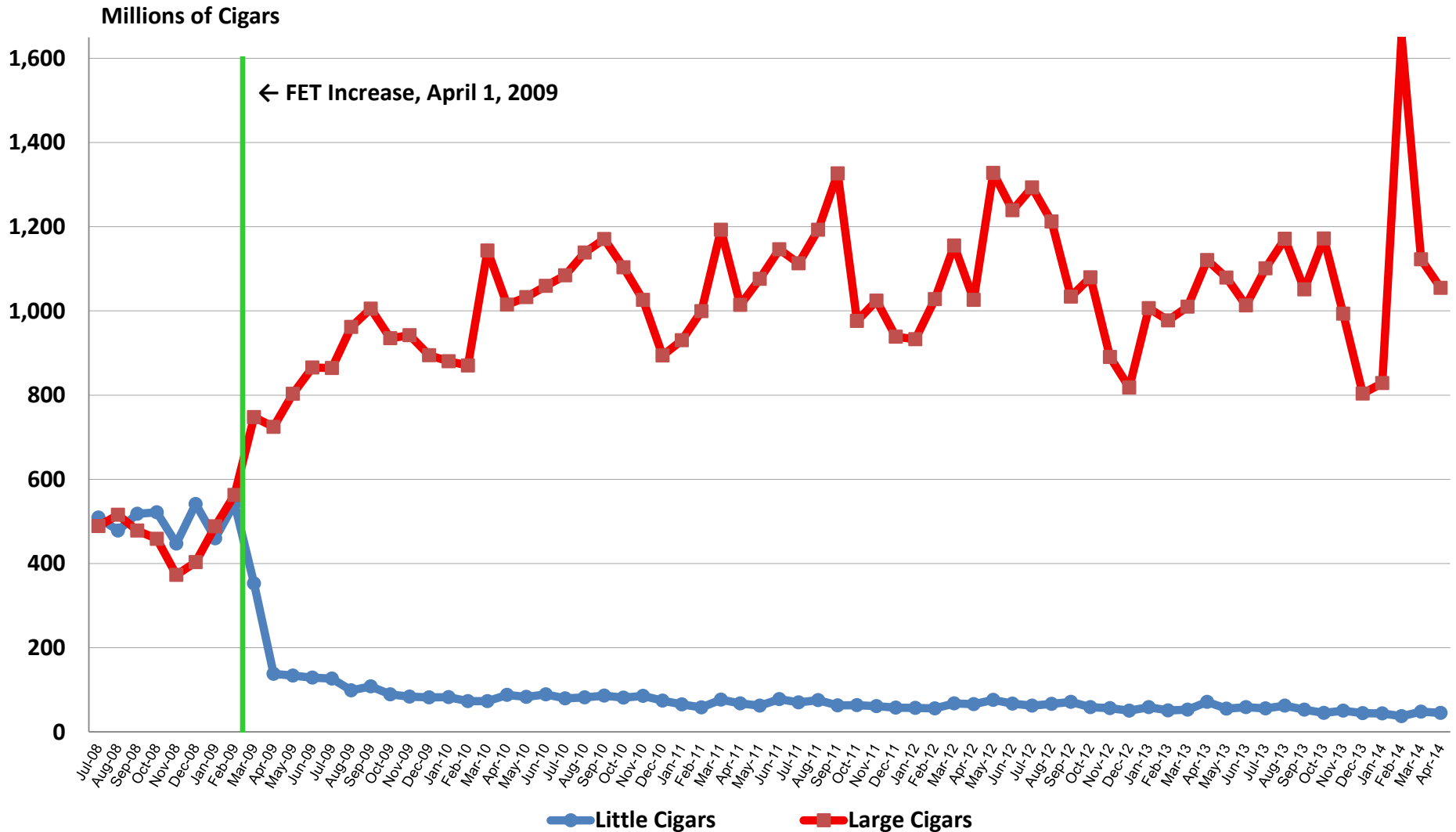


\$14.99 —
Jay's Mini Mart price for pound of RYO.

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

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

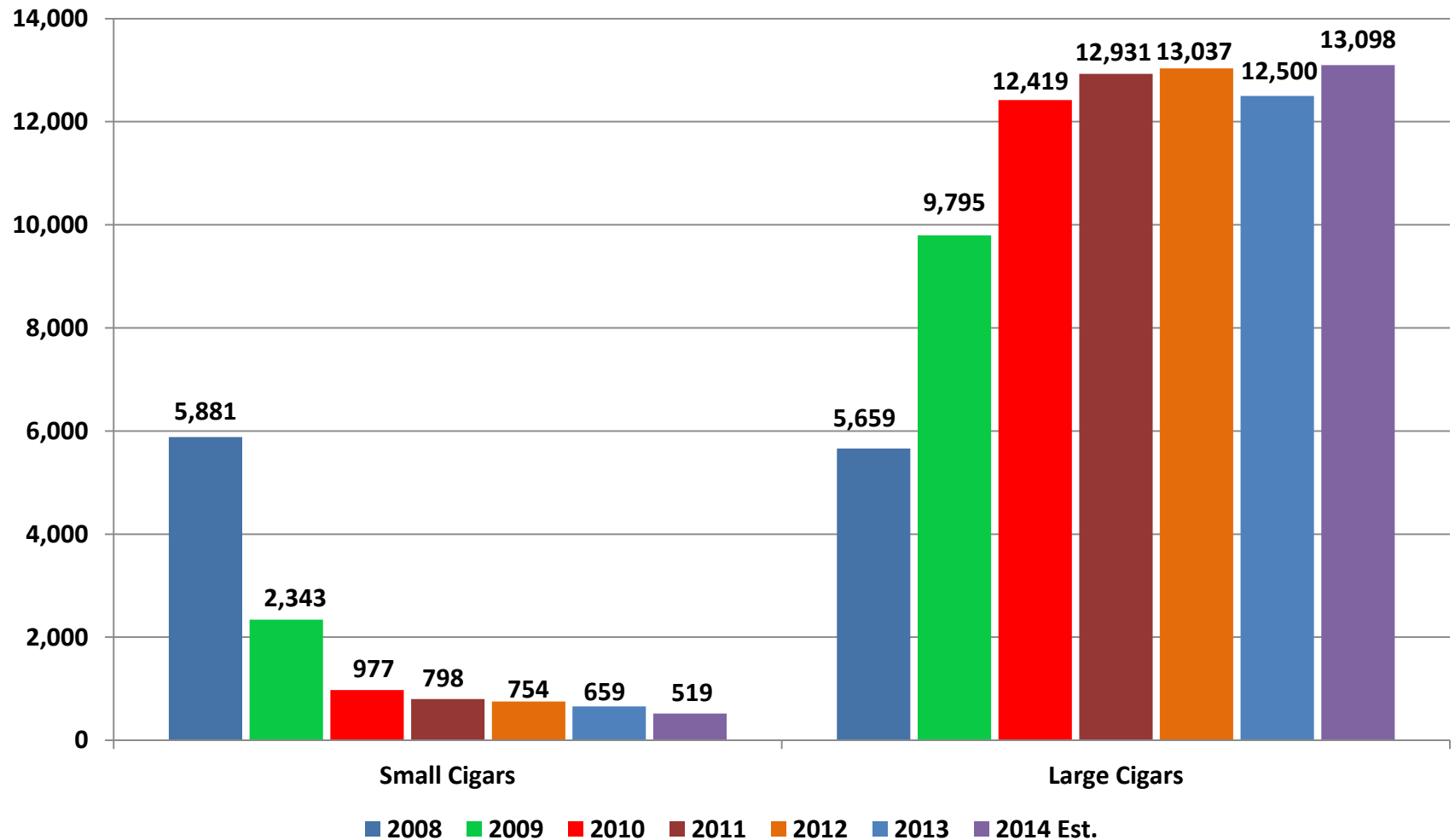
Volume of Little Cigars vs. Large Cigars by Month 2008 – 2014



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

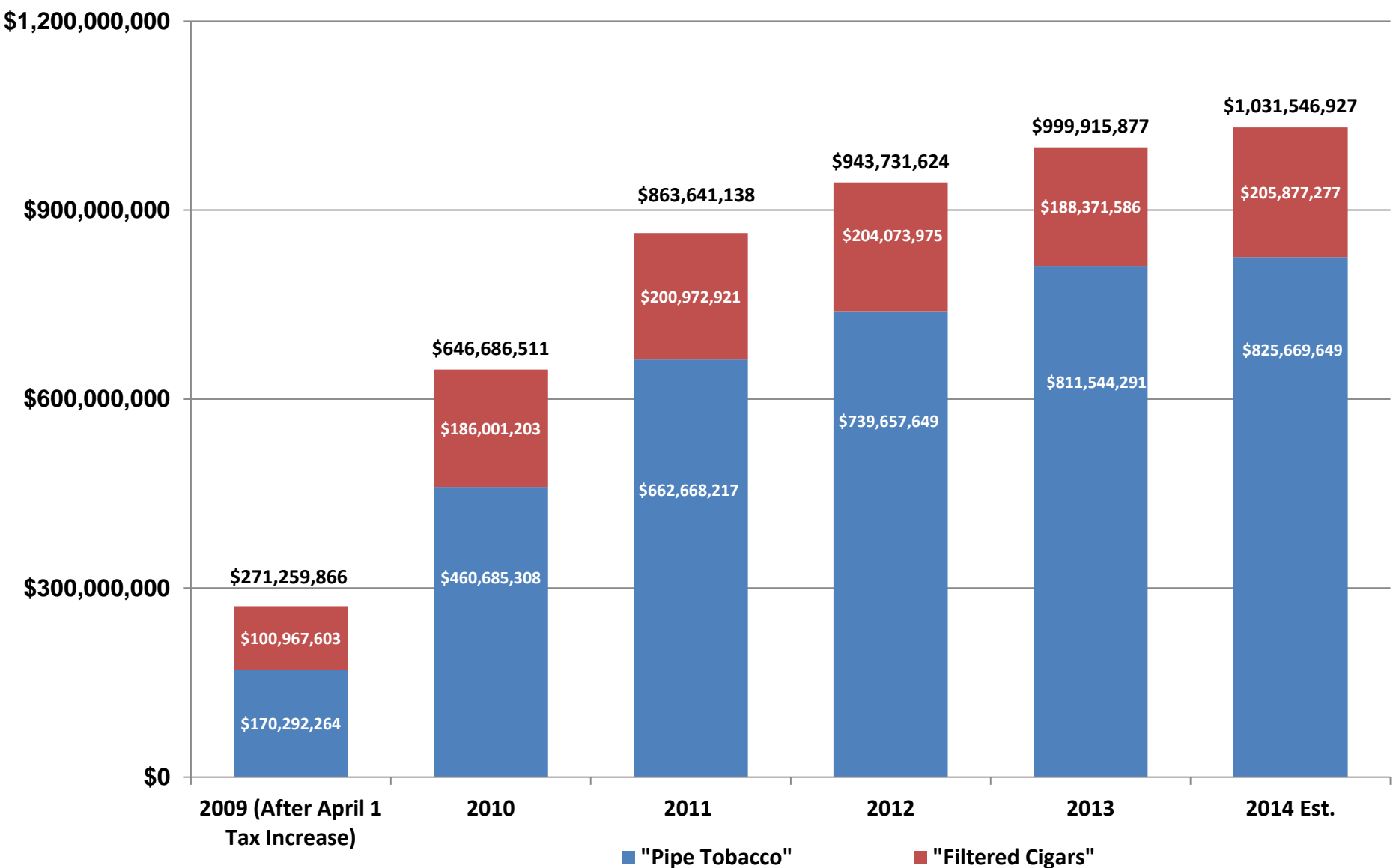
Small and Large Cigar Volume Changes 2008 – 2014

Individual cigars in millions

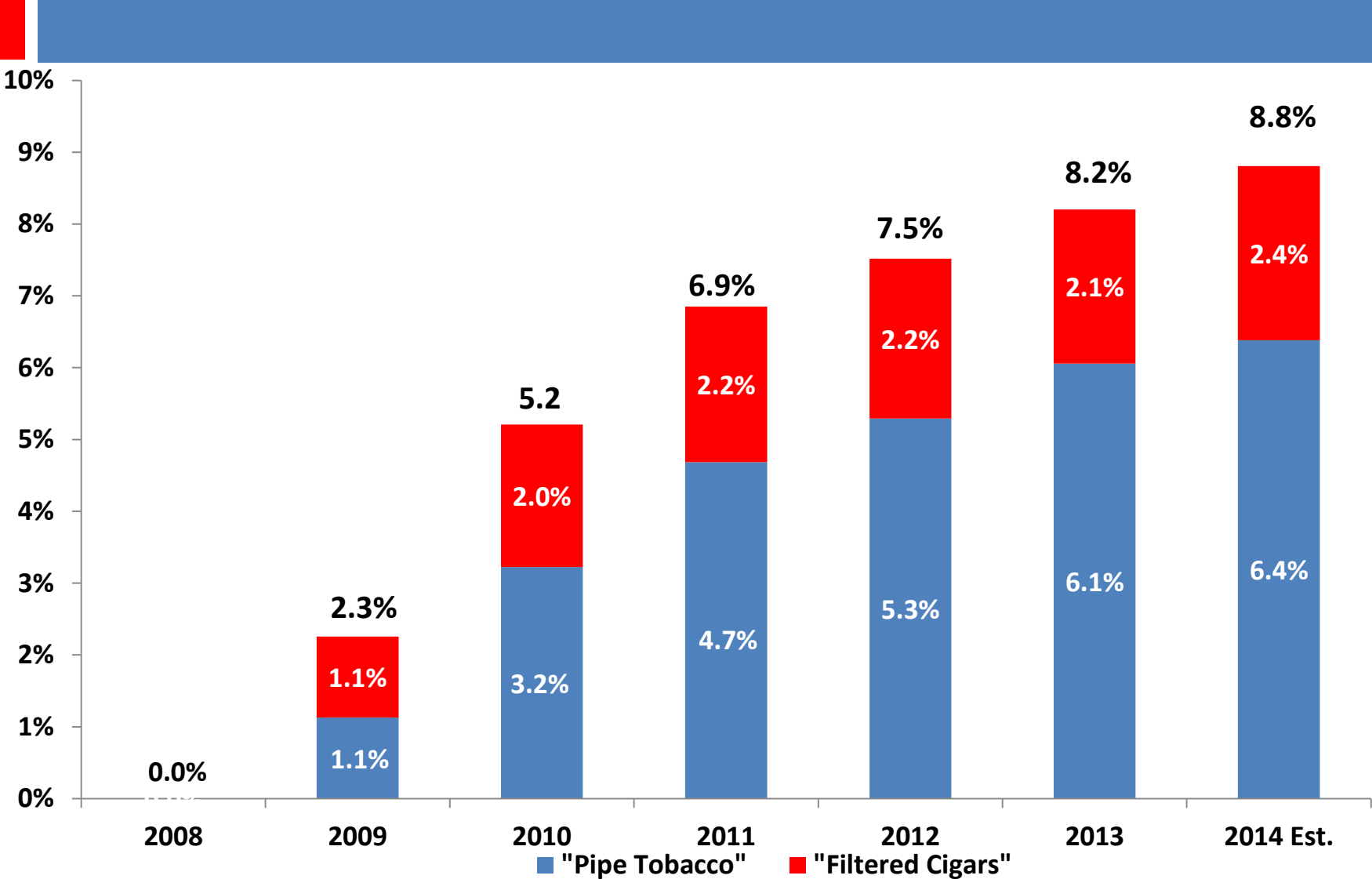


Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau.

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



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



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