Testimony of

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Owner, Rocky Patel Premium Cigars, Inc.

before the

United States Senate Committee on Finance

Tobacco: Taxes Owed, Avoided, and Evaded

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Introduction

Chairman Wyden, Ranking Member Hatch, and Members of the Committee:
My name is Rocky Patel, and I am the owner and CEO of Rocky Patel Premium Cigars Inc. Founded in Naples, Florida, Rocky Patel Premium cigars are globally known for their premium quality aged tobaccos. Our cigars are the product of a belief that a premium cigar should be the result of artisan craftsmanship, strict quality control, and the use of the finest, aged tobaccos. In fact, over three hundred different hands touch the tobacco used in our product from the time a seedling is planted in the ground to the time a Rocky Patel premium cigar is placed in a box for final shipment; a process that takes 4-5 years Today, we produce more than twenty million cigars annually while maintaining the utmost dedication to producing and offering high-quality premium cigars.

I would like to thank you for this opportunity to participate in today's important hearing. I have been asked to provide an overview of the premium cigar industry and tobacco excise taxes currently applicable to premium cigars under the U.S. Internal Revenue Code. I will also be discussing issues relating to premium cigar tax compliance, as addressed in the GAO report, *Large Disparities in Rates for Smoking Products Trigger Significant Market Shifts to Avoid Higher Taxes*[1], and potential ways to work together on these issues. I will be pleased to do so.

Background on the Premium Cigar Industry

Premium cigars are not defined under the Internal Revenue Code, but they are typically considered to be high grade tobacco products wrapped in one hundred percent leaf tobacco with one hundred percent tobacco filler, containing no filter, tip or non-tobacco mouthpiece, and weighing in at least at 6 pounds per 1,000 count. The closest approximation to a premium cigar in the Internal Revenue Code is the "large" cigar, which is a cigar that weighs at least 3 pounds per 1,000 count. Besides weight, the Internal Revenue Code does not have additional requirements for a cigar to be considered a large cigar. As a result, there are physical weight differences between what is considered a large cigar under the Internal Revenue Code and what we consider a premium cigar for large cigars that weigh between 3 and 6 pounds per 1,000 count.

In addition to its distinctive physical characteristics, premium cigars are also unique in their culture, business model, and consumer base. The premium cigar culture is distinctive and is rooted in the social and leisurely nature of premium cigar consumption. The typical cigar shop is a small, family owned brick-and-mortar store that directly distributes its products and is the modern day equivalent of a general store or barbershop, where men and women of all demographics who share a passion for premium cigars can enjoy each other's company, share common

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[1] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-475, TOBACCO TAXES: LARGE DISPARITIES FOR SMOKING PRODUCTS TRIGGER SIGNIFICANT MARKET SHIFTS TO AVOID HIGHER TAXES (2012).

interests, and discuss the issues of the day in a relaxed, comfortable environment.

Importantly, premium cigar stores are a destination-only retail sales venue. The majority of customers at premium cigar stores do not come from "off the street" type traffic. Consumers generally do not enter premium cigar stores without first knowing that premium cigars are sold there. Consider that not only is selling tobacco to minors forbidden in every jurisdiction in the United States where a cigar shop exists, but many shops mandate you be 18 years old just to enter the premises. Moreover, premium cigars are enjoyed in moderation, with the majority of premium cigar smokers smoking less than 1 cigar per day.

In sum, premium cigars occupy a unique niche within the overall cigar and tobacco market, serving an adult consumer base with a complex palate and appreciation for high quality tobacco products.

<u>Background on Premium Cigar Taxes</u>

Congress has taxed tobacco products since its inception as a means to raise revenue and to discourage consumption. Since the 1970s, cigars have been classified as either small or large, based upon their weight, and taxed differently based on this classification. Large cigars are defined as weighing more than 3 pounds per thousand; all cigars that weigh less than 3 pounds per thousand are considered "small" cigars.[2] Premium cigars are lumped into the large cigar category under the Internal Revenue Code.

In February 2009, the enactment of the Children's Health Insurance Program Reauthorization Act[3] ("CHIPRA") fundamentally transformed tobacco taxation by significantly raising the federal excise taxes ("FET") on both small and large cigars, along with other tobacco products, including cigarettes, pipe tobacco, and roll-your-own ("RYO") tobacco.

Before CHIPRA, premium and large cigars were taxed at the larger amount of either 20.719 percent per each cigar or not more than 4.875 cents per cigar. After CHIPRA, taxes on premium and large cigars rose to the larger amount of either 52.75 percent per each cigar or not more than 40.26 cents per cigar. This resulted in as much as a 726 percent tax increase on premium and large cigars per thousand "sticks." This represents one of the highest increases in the history of the IRS tax code. By comparison, taxes on small and large cigarettes increased by approximately 158% per thousand sticks after CHIPRA.

These increases have had a significant impact on the premium cigar community. While manufacturers or importers of premium cigars usually pay the applicable FET, the tax is passed on to premium cigar retailers when purchasing inventory. In

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[2] *See* 26 U.S.C. § 5701(a).
[3] Pub. L. No. 111-3, 123 Stat. 8.

addition to paying a price that includes the cost of the FET, premium cigar retailers must also pay a state "Other Tobacco Product," or OTP, tax. Such taxes can go as high as 95% of the wholesale price. OTP taxes are generally based on the price for which the cigars are sold by the manufacturer or importer to the retailer, which includes the FET.[4] In effect, this means that a premium cigar retailer pays a "tax on a tax" as a basic cost of doing business. Paying both FET and OTP taxes has a significant impact on the premium cigar retailer, requiring a significant up-front investment that retailers must carry in inventory until, and if, the cigars are sold.

As a result, premium cigar retailers must carefully plan their purchases and strictly control their inventories. The cost of insuring the cigars is also artificially inflated as a result for both the wholesaling importer as well as the retailer.

Premium cigar retailers are generally required to remit applicable tobacco taxes to state governments once a month, placing a constant strain on cash flow. Moreover, remitting taxes once a month means that most premium cigar retailers have had to adopt costly accounting and inventory systems to keep track of taxes that are due to the federal and state governments. Consequently, premium cigar retailers face a costly and challenging business environment well before they sell their first cigar.

While excise tax costs are eventually passed down to the consumer, it should be stressed that the up-front timing of FET and OTP taxes makes a premium cigar less attractive as a product, hurting the bottom line of the premium cigar retailer. This is particularly true because premium cigars are luxury items that are often foregone during economic downturns.

Consequently, as the Committee considers the concerns raised by the GAO Report, we encourage you to consider the significant tax burden resulting from FET and state OTP excise taxes on the premium cigar industry, and how these taxes impact the primarily small, family-owned businesses that sell these products. As discussed further in my testimony, we believe that creating a new definition of premium cigar under the Internal Revenue Code and replacing the current ad valorem tax with a flat tax would allow the regulators to focus their resources on incidences of tax avoidance while also reducing the tax burden on small businesses.

Avoidance of Tobacco Excise Taxes

The GAO report highlighted an important tax avoidance issue that reduces federal tax revenue and tarnishes the reputation of the premium cigar industry: the migration of small cigars to large cigars by manufacturers that are seeking the benefit of a lower tax rate. After the enactment of CHIPRA, price sensitive manufacturers and consumers began substituting higher-taxed products with lower-taxed products. On the margins, some participants in the tobacco industry

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[4] *See* Large Cigar Taxes on and after January 1991, Industry Circular 91-3, Department of the Treasury, Alcohol and Tobacco Tax and Trade Bureau (March 19, 1991).

took steps to avoid taxes by reclassifying or repackaging their products as lower-taxed goods.

The premium cigar industry understands Congress' concerns about these practices and desire to address these issues. However, we believe that any measures adopted, whether through legislation or administrative action, should respond to particular problems posed by specific tobacco products. Such actions should also recognize substantial differences in revenue lost due to these practices and how limited resources at the regulatory level can be used most productively. As compared to all other tobacco products, cigars, both large and small, represented less than 4% of federal excise tax revenue from all tobacco products in 2012. [5] This suggests that public policies adopted in response to the compliance issues identified in the GAO report should focus on key sources of revenue loss and not be so broad as to cover tobacco products that are not the source or cause of tax avoidance.

Moreover, we believe that tax compliance can be achieved without additional tax increases on premium cigars. Instead, we believe that steps can be taken at the administrative or legislative level to clarify differences in tobacco products, including the specific qualities of premium cigars, and to address the incidence of taxation, that will increase simplicity, provide certainty, and improve compliance.

Certain tobacco manufacturers have taken steps to make "small" cigars qualify as "large" cigars, despite several differences in characteristics, quality, distribution and marketing, and the targeted consumer. As the GAO reported, some small cigar manufacturers added an incremental amount of tobacco to make their products slightly heavier. Other manufacturers have used non-tobacco filler or stuffing to increase the weight of a small cigar.

As noted previously, the premium cigar industry takes great pride in quality cigars that are symbols of good taste, passion, and high craft and believes that cigars should be classified by more than just weight. Important qualities that distinguish premium cigars from other tobacco products include one hundred percent tobacco binder, and filler, a lack of a filter or non-tobacco tip, and a wrapper that is made from one hundred percent leaf tobacco. Small cigar and other machine made tobacco manufacturers that avoid taxes by taking actions to reclassify their products as large cigars are producing and marketing cigars that have no relationship to premium cigars or the premium cigar industry.

In fact, this type of activity hurts the image of the premium cigar industry by association - implying that all cigar manufacturers, including premium cigar manufacturers, value tax savings over the quality of their product. The exact opposite is true, as our entire business model relies upon providing a high quality product and superior experience to our consumer base.

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[5] IRS, Statistics of Income Division, Historical Table 20, *available at* http://www.irs.gov/uac/SOI-Tax-Stats-Historical-Table-20

The premium cigar industry would like to work with Congress and regulators on this issue. One constructive approach would be to define "premium cigar" in the Internal Revenue Code, which would distinguish between non-premium, "lighter" large cigars and premium cigars. This would allow Congress and the regulators to appropriately focus on tax avoidance issues occurring on the border between small and large cigar classifications

For purposes of the Internal Revenue Code, we urge you to consider specifying that premium cigars should be defined according to several unique factors, including the fact that premium cigars are unfiltered products that are wrapped in leaf tobacco and weigh more than 6 pounds for every 1,000 cigars. Although weight is a part of this definition, the 6 pound mark is significantly more than the 3 pound weight threshold that currently defines a large cigar; further, the weight requirement is combined with other distinguishing characteristics, making it impossible to game the definition based on weight alone. We believe adding a new definition of premium cigars under the Internal Revenue Code along these lines would more accurately reflect the distinctions between premium and non-premium cigars while also reducing incidences of tax avoidance.

We also support a flat tax for premium cigars. As noted previously, large cigars are currently taxed at the higher amount of either 52.75 percent per each cigar or not more than 40.26 cents per cigar. We believe that a flat tax applied to premium cigars could and should be lower than the current rate applied to large cigars to more appropriately calibrate the relative difference between the tax rates on premium cigars and small cigars. A flat tax would have the added benefit of simplicity and certainty, reducing the compliance burden on the premium cigar industry and reducing the enforcement burden on the Alcohol and Tobacco Tax and Trade Bureau, or the TTB.

<u>Conclusion</u>

Whatever actions that are taken to address these issues should be consistent with sound tax policy and not be driven by the need to raise revenues. Any increase in premium cigar excise taxes disproportionately hurts small businesses that are carrying a considerable amount of excise taxes already paid in an inventory that hasn't yet been sold. For many retailers, higher tobacco excise taxes on premium cigars may make the difference between surviving or shutting their doors. While the concerns in the GAO report should be addressed promptly, we urge the Committee and Treasury to consider the source of such problems when determining appropriate remedies.

In closing, I want to thank you for the opportunity to provide an overview of the tobacco excise taxes applicable to the premium cigar industry and proposed solutions to these problems. The premium cigar industry stands with Congress and recognizes the importance of limiting opportunities and discouraging efforts to circumvent federal excise taxes, not only from the standpoint of lost federal tax revenue, but also as a responsibility to protect the quality of premium cigars and reputation of the premium cigar industry.