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Tobacco firms exploit loophole to save millions

Companies repackage roll-your-own brands as pipe tobacco to avoid taxes

The Associated Press

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WASHINGTON - With a simple marketing twist, tobacco companies are avoiding hundreds of millions of dollars a year in taxes by exploiting a loophole in President Barack Obama's child health law.

Obama and Congress increased taxes on tobacco products earlier this year to pay for expanded children's health insurance, but tobacco for roll-your-own cigarettes saw a disproportionate leap, from $1.10 to $24.78 per pound. Some predicted the tax would kill the roll-your-own industry, which had offered a cheaper alternative to packaged cigarettes.

But tobacco companies quickly adapted. The Associated Press found that as soon as the tax was on the books, companies all but shut down their roll-your-own brands and reinvented them under a less-restricted, less-taxed category: pipe tobacco. It's still destined to be rolled and smoked, but it's taxed at barely a tenth the rate, $2.83 per pound.

Normally, pipe tobacco is coarser and moister than cigarette tobacco. But nothing says it has to be. In fact, the federal government says the only distinction between the two is how it's labeled. That effectively gives tobacco marketing executives an opportunity to shape the company's tax rate.

Nearly overnight, roll-your-own brands like Criss Cross and Farmers Gold came off the shelves, replaced by pipe tobacco with the same names. The cuts may be slightly different, but they're suitable for rolling. Knowing this, retailers steer customers to the new products, sometimes with a wink and a nod, sometimes with outright advertising.

"They tried to make a product within the elements of the law that they could, in fact, market as pipe tobacco," said Scott Bendett, owner of Habana Premium Cigar Shoppe in Albany, N.Y., which advertises the new pipe tobacco for hand-rolled cigarettes.

Huge spike in pipe tobacco

Tobacco companies say they're just trying to find a legal way to stay afloat after being saddled with an enormous tax increase.

Because the small, independent companies in the roll-your-own market are often overshadowed by the huge, publicly held cigarette companies, the sudden shift toward pipe tobacco caught researchers by surprise.

Daniel Morris, who tracks tobacco production data at the Oregon Department of Health, thought he had made a mistake when he saw April's figures. Pipe tobacco production had more than doubled in a single month. After years of producing about 270,000 pounds per month, companies put more than 566,000 pounds of pipe tobacco on the market in April.

Morris called the federal Alcohol and Tobacco Tax and Trade Bureau, which collects the data.

There was no mistake.

Over the next several months, the numbers climbed higher. In August, the most recent data available, pipe tobacco reached 1.7 million pounds, enough to roll more than 42 million packs of cigarettes.

The huge spike in production corresponded with a tremendous drop in the roll-your-own industry. Companies produced 660,000 pounds in August, down from an average of 1.5 million pounds before the tax.

"It really shows how the industry is able to respond to changes in the tax environment," Morris said.

Anti-tobacco groups say it's deception, and not just because of the taxes. While flavored cigarettes are now banned in an effort to reduce the appeal of smoking to children, no such ban applies to pipe tobacco, allowing companies to sell black cherry, vanilla and other varieties.

"This is a direct challenge to the federal government," said Matthew Myers, president of the Campaign for Tobacco Free Kids.

Huge tax implications

The Obama administration says it is working on clearer definitions of pipe and roll-your-own tobacco. Until then, Art Resnick, a spokesman for the Tax and Trade Bureau, said there's no way to know how many companies are reinventing their brands as pipe tobacco, or whether the new offerings are just cigarette tobacco with pipes on the labels.

The tax implications could be huge. As much as $32 million a month could be lost in taxes if the sudden spike in pipe tobacco is just cigarette tobacco in disguise.

Companies say they're just trying to survive within the law. People buy roll-your-own tobacco because it's cheap, so when Washington slapped a 2,000 percent tax increase on the product, producing pipe tobacco became the affordable option. For some companies, it was the only option.

"It allowed companies to stay in business, enough to keep paying the light bills," said Cheryl Turner, vice president of M&R Holdings, a small company in Pink Hill, N.C., that manufactures Farmers Gold.

After the tax increase, the company cut staff from about 40 employees to about a dozen.

Kevin Altman, who represents a handful of small companies with the Council of Independent Tobacco Manufacturers of America, acknowledged that some companies were exploiting the loophole, packaging cigarette tobacco and marketing it as pipe tobacco.

"What are you going to do? You're trying to save the company," Altman said. "And what they're doing ... , as far as I can tell, is within the limits of the law."

Still, Altman said his companies want the government to make the definition clearer. The ambiguity hurts those companies who didn't make the marketing switch and must sell their tobacco at higher prices.

"Many times our government passes things without first taking an extra few days to say, 'What are the unintended consequences?'" Altman said. "That's what happened here."

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