

## DAILY NEWS CLIPS

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### CONGRESS CONTEMPLATES ACTION ON ROLLING MACHINES

by Seth A. Mailhot, Sheppard Mullin Richter & Hampton LLP  
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As part of Sheppard Mullin's monthly blog on tobacco retailer issues, we are taking a look at the possible future of retailer-operated rolling machines. On March 8, 2012, the U.S. Senate adopted an amendment to the federal highway bill "Moving Ahead for Progress in the 21st Century Act" (MAP-21) that included a provision impacting retail establishments that offer rolling machines for use to customers. The provision would have changed the definition of "manufacturer of tobacco products" in section 5702(d) of the Internal Revenue Code of 1986 to "include any person who for commercial purposes makes available for consumer use . . . a machine capable of making cigarettes, cigars, or other tobacco products."

The bill containing the provision was never passed by the House. Instead, Congress voted on March 29 for another short-term extension of highway funds. This short-term extension lacked the provision changing the definition of a manufacturer of tobacco products. Regardless, retailers should be wary that this provision may reappear again in future legislation, transportation or otherwise.

The provision was offered by Senators Baucus, Murkowski, Bingaman, Crapo, Wyden, Risch, Merkley, Tester, and Bennet as part of an amendment to extend the Secure Rural Schools and Community Self-Determination Act of 2000 for one additional year. The amendment was adopted by the Senate in a vote of 82 to 16, demonstrating clear bipartisan support. There is no suggestion that the provision regarding rolling machines had any bearing on the overall fate of MAP-21.

Reports indicate that Congress views the change to the definition as an easy way to help balance costs associated with a bill or amendment. It is easy to see why. The provision was estimated to raise \$99 million in Federal excise taxes. As noted in a recent article by The Washington Post, an aide to the Senate Finance Committee commented that a change to the definition has been considered by both the deficit-reduction supercommittee, and negotiators involved in the extension of the payroll tax cut.

Congress is positioning the change to the definition as the closing of a "tax loophole," and not a new tax. According to Senator Baucus, the provision:

. . . partially closes a loophole regarding roll-your-own tobacco. Congress raised taxes on tobacco to pay for the reauthorization of the Children's Health Insurance Program in 2009. Tax rates on pipe tobacco were not increased as much as on roll-your-own tobacco; therefore, tobacco companies are selling bags of roll-your-own tobacco and labeling them as pipe tobacco. In other words, the pipe tobacco is masquerading as tobacco to be rolled into cigarettes to avoid the additional tax.

Senator Baucus noted that “[t]he abuse is so prevalent that gas station owners now have cigarette rolling machines to facilitate the loophole. A customer purchases a bag of pipe tobacco and then uses the machine to roll cigarettes.”

Despite the intent of Congress to close a perceived tax loophole created by the misuse of pipe tobacco, the provision (in its MAP-21 form) would also impact taxation of roll-your-own tobacco. As the provision only changes the definition of a “manufacturer of tobacco products,” it would draw no distinction between cigarettes rolled using pipe tobacco or roll-your-own tobacco. This could lead to the double taxation of roll-your-own tobacco.

Further, the language is vague enough to include retailers and companies that sell personal roll-your-own machines to consumers as “manufacturers of tobacco products.” Although section 5702(d) of the Internal Revenue Code currently includes an exemption for individuals that make tobacco products for their own personal consumption, this exemption would not apply to retailers and other companies that only sell supplies and equipment to individuals that make their own tobacco products.

Another issue not directly addressed in the language of the provision was how affected retailers would be treated under the Family Smoking Prevention and Tobacco Control Act (Tobacco Control Act). An expansion to the definition in the Internal Revenue Code would not have a direct bearing on the definition of a “tobacco product manufacturer” in the Tobacco Control Act. Despite this, the change to the Internal Revenue Code may prompt FDA to consider broadening its application of the current Tobacco Control Act definition to include rolling machine operations by retailers. If FDA decided to follow the lead of Congress (when and if such a provision is ultimately enacted), affected retailers would be subject to regulatory requirements equivalent to those imposed on cigarette manufacturers. Such regulatory requirements currently include payment of user fees, submitting premarket applications for new tobacco products, and compliance with labeling, good manufacturing practice (GMP), registration and reporting provisions.

If FDA chose to adopt a broader interpretation of “tobacco product manufacturer,” along the lines of the Internal Revenue Code proposal, it is not currently known how FDA would implement such a change. For example, FDA may determine such a change requires notice and comment through the traditional administrative rulemaking process. Alternatively, FDA may consider the current definition of “tobacco product manufacturer” in the Tobacco Control Act sufficiently broad enough to include retailers affected by the proposed Internal Revenue Code.

The Senate’s action last month leaves a number of unanswered questions that have a direct impact on the business of many retailers and other companies. Most immediate among these questions is the potential impact such a change would have on the taxation of retailers, and how the government might assess those taxes. Such a change would also undoubtedly have an impact on the taxes paid to states for the manufacture of cigarettes.

Sheppard Mullin is actively monitoring this provision, as it is an important issue for many retailers. Updates will be posted on our blog as they develop. Retailers and other companies seeking further clarity on this provision may contact the author directly.

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## **STATE LOOKING TO TAX ROLL-YOUR-OWN CIGARETTE MACHINES**

By Eric Stidman

KCRG ABC-9 (Cedar Rapids, IA)

April 3, 2012

State lawmakers are looking at legislation designed to tax roll-your-own cigarette machines that allow Iowans to produce their own tobacco products at about half the price of buying their smokes retail.

Sen. Pam Jochum, D-Dubuque, said owners of roll-your-machines that cost about \$35,000 have set up store fronts where customers can purchase loose tobacco and tubes with or without filters and then temporarily rent the machine to produce up to 200 rolled cigarettes in about 10 minutes. She said the products are assessed state sales tax but not cigarette or excise taxes like similar manufactured cigarettes.

“We are closing a technical tax loophole that has allowed these roll your owns to escape or evade taxation,” said Jochum, floor manager of Senate File 2328 – a wide-ranging bill offered by the state Department of Revenue that seeks a number of changes that includes treating cigarette rollers as vending machines and increasing the tax on store-rolled smokes. The tax change sought by the state revenue department would not apply to hand-rolled cigarettes that consumers who purchase loose tobacco might make at work or home.

Jochum said she views the issue as one of tax equity in requiring owners of roll-your-own machines to pay the same tax that cigarette makers pay.

However, Jeffrey Burd, an Ohio attorney representing a company with roll-your-own machines in Iowa, said the situation in Iowa is a “very unholy alliance” of anti-smoking advocates and big tobacco manufacturers, distributors and retailers working together to snuff out a budding business.

“They don’t want to level the playing field, they want to demolish the playing field,” said Burd, who contended that people who roll their own cigarettes pay tobacco tax at a rate of 50 percent of the wholesale price of the tobacco and the idea that a loophole exists in Iowa’s law “is a myth.” He said the provisions in S.F. 2328, which could be debated as soon as Wednesday, would put small businesspeople who purchased roll-your-own machines out of business.

“This bill would treat some people who roll their own cigarettes differently than others,” Burd said. He noted that similar efforts have been tried in at least 26 states, with a few succeeding but most have failed.

Jochum said proponents try to portray the roll-your-own operations as mom and pop shops but generally the businesses are operated by out-of-state owners who have placed machines in Dubuque, Marion, Davenport and Burlington. With five machines currently known in Iowa and at least six more on order, the Dubuque Democrat said she hopes lawmakers get in front on the taxation issue to avoid a repeat of the TouchPlay fiasco where businesses who purchased state lottery devices were hurt when the Legislature pulled the plug on the program.

"Our concern is a lot of innocent people will purchase (roll-your-own machines) only to have the state say you can't do it," she said. "We're trying to address it early on before this blossoms into something very large."

Originally published here: <http://www.kcrg.com/news/local/State-Looking-To-Tax-Roll-Your-Own-Cigarette-Machines-146014985.html>

## **IOWA LEGISLATURE CONSIDERING TAX HIKE ON LOOSE TOBACCO**

By Kera Mashek

KWWL NBC-7 (Waterloo, IA)

April 4, 2012

A bill being considered in the statehouse would hike taxes on loose tobacco, the kind to roll your own, to the same rate of a pack of regular cigarettes. Lawmakers supporting the measure say it's only fair, that all tobacco products should be equally taxed. But smoke shops are concerned more taxes could be bad for business.

Eric Maybon's been buying loose tobacco to roll and smoke his own cigarettes for more than two years. He made the switch mostly because it's much cheaper.

"You get cost savings and you get better tobacco, a lot less additives and they're better for you," Maybon said.

Traditional loose tobacco has become very costly, after a recent spike in its federal taxes. So now dual purpose pipe tobacco, that can also be used to roll cigarettes, is becoming a popular, cost-friendly alternative. Sales have been boosted further as new electronic machines make rolling your own easier than ever.

"We don't sell near the cigarettes we used to sell. With the pipe tobacco and dual purpose tobacco, it has really increased. You can smoke for around \$1.25 a package versus \$6-7 on a cigarette like a Marlboro or a Camel," said John Eveland, owner of National Cigar Store in Waterloo.

So taxing loose tobacco to the rate of regular cigarettes, which might make a \$22 package cost \$100, could be very bad for businesses like the National Cigar Store, which has also seen a boom in online sales of the product.

"I'm concerned they're going to tax us out of the market. And what are they going to tax after they don't tax cigarettes?" Eveland said.

But groups like the American Cancer Society say there are ample benefits to increasing tobacco taxes.

"Lung cancer's the most preventable form of cancer and death that we have currently with us right now. And increasing the tax could easily help us prevent that, and make it a little harder, especially for youth and younger adults, to begin smoking if it's a little bit higher price for them," said Kelly Warren, American Cancer Society spokesperson in Waterloo.

But ultimately, the decision on whether loose tobacco taxes are hiked lies with the Iowa legislature.

If the hike is approved, it could generate thousands in new revenue for the state. And in Iowa, that money goes into the Health Care Trust and state general fund for various projects.

Original story and video here: <http://www.kwwl.com/story/17336384/iowa-legislature-considering-tax-hike-on-loose-tobacco>

## **IOWA CONSIDERS TAXING RYO**

CSP Daily News

April 4, 2012

*Bill would treat cigarette rollers as vending machines*

State lawmakers in Iowa are looking at legislation designed to tax roll-your-own (RYO) cigarette machines that allow users to produce their own tobacco products at about half the price of buying cigarettes at retail, reported The Gazette.

State Senator Pam Jochum (D) said owners of RYO machines that cost about \$35,000 have set up storefronts where customers can purchase loose tobacco and tubes with or without filters and then rent the machine to produce up to 200 rolled cigarettes in about 10 minutes.

She said the products are assessed state sales tax but not cigarette or excise taxes like similar manufactured cigarettes.

Pam Jochum "We are closing a technical tax loophole that has allowed these roll your owns to escape or evade taxation," said Jochum, floor manager of Senate File 2328--a wide-ranging bill offered by the state Department of Revenue that seeks a number of changes that includes treating cigarette rollers as vending machines and increasing the tax on store-rolled cigarettes.

The tax change sought by the state revenue department would not apply to hand-rolled cigarettes that consumers who purchase loose tobacco might make at work or home, said the report.

Jochum said she views the issue as one of tax equity in requiring owners of RYO machines to pay the same tax that cigarette makers pay.

However, Jeffrey Burd, an Ohio attorney representing a company with RYO machines in Iowa, said the situation in Iowa is a "very unholy alliance" of anti-smoking advocates and big tobacco manufacturers, distributors and retailers working together to snuff out a budding business.

"They don't want to level the playing field, they want to demolish the playing field," he told the newspaper. Burd contended that people who roll their own cigarettes pay tobacco tax at a rate of 50% of the wholesale price of the tobacco and the idea that a loophole exists in Iowa's law "is a myth."

He said the provisions in S.F. 2328 would put small businesspeople who purchased RYO machines out of business.

"This bill would treat some people who roll their own cigarettes differently than others," Burd said. He noted that similar efforts have been tried in at least 26 states, with a few succeeding but most failing.

Jochum said proponents try to portray the RYO operations as mom-and-pop shops, but generally the businesses are operated by out-of-state owners who have placed machines in Dubuque, Marion, Davenport and Burlington. With five machines currently known in Iowa and at least six more on order, the Dubuque Democrat said she hopes lawmakers get in front on the taxation issue to avoid a repeat of the TouchPlay situation where businesses who purchased state lottery devices were hurt when the legislature pulled the plug on the program.

"Our concern is a lot of innocent people will purchase [RYO machines] only to have the state say you can't do it," she said. "We're trying to address it early on before this blossoms into something very large."

*Originally published here: <http://www.cspnet.com/news/tobacco/articles/iowa-considers-taxing-ryo>*

## **IOWA SENATE VOTES TO CLOSE CIGARETTE MACHINE TAX LOOPHOLE**

By Jason Clayworth  
Des Moines Register (IA)  
April 5, 2012

Vending machines that roll loose tobacco into cigarettes would no longer be able to avoid many of Iowa's taxes under a bill approved tonight by the Senate.

Senate File 2328 would amend the state's definition of a cigarette vending machine to include the so-called "roll your own" machines that have recently started popping up in Iowa and other states.

Sen. Pam Jochum, D-Dubuque, noted an example of one machine in Iowa that sold a carton of cigarettes for \$27, which she said would have retailed for around \$58 if sold in a regular store, partly because of the roll your own machine's ability to skip many tobacco taxes.

"What we are attempting to do is create tax equity. That's it," Jochum said.

The bill passed in a 44 to 1 vote. Sen. Mark Chelgren, R-Ottumwa, was the no vote. It now heads to the House for further consideration.

Originally published here: <http://blogs.desmoinesregister.com/dmr/index.php/2012/04/04/iowa-senate-votes-to-close-cigarette-machine-tax-loophole/>

## **LOOPHOLE SHOWS IOWA NEEDS A MODERN TAX SYSTEM**

Daily Iowan Editorial (University of Iowa)

April 5, 2012

With tax season upon us, Iowans are rummaging through months worth of receipts and returns to figure out exactly what they owe. But some may not know their Iowa use tax — the ones paid for online purchases — could may be taken advantage of by out-of-state corporations.

Iowa legislators are currently concerned with a loophole that allows businesses who sell their products online to establish their distribution centers out-of-state in order to avoid charging online customers sales tax. Now, legislators are attempting to close that loophole, which essentially allows for the establishment of subsidiaries as a means for legal tax evasion.

But Iowa legislators should not only pass the bill closing the sales-tax loophole, they should update the commerce-tax code for the technological age.

Taking their cues from Texas, which in 2010 billed Amazon \$269 million in wrongfully avoided taxes through the use of a subsidiary, Iowa plans to keep in front of the insidious tax loophole.

According to Iowa's current tax code, retailers must maintain a place of business in Iowa to legally be required to collect sales tax from customers and pay it on their taxable merchandise. An unfortunate loophole in Iowa law, similar to Texas law, would allow businesses to set up a subsidiary to distribute goods bought online under a different name or organizational structure.

Senate File 2330 seeks to retool the Iowa definition of a business to close the loophole and fortify the tax system.

But the Iowa Legislature should not stop there. With the globalization and the spreading of Internet commerce, dubbed by some as "e-tailers," Iowa's current sales and use tax system is outdated.

Right now, if a company or individual buys from a business that is not registered with the state, then the individual is subject to an Iowa use tax. The out-of-state company is not subject to the state tax, because it is not registered, and therefore the burden is placed directly on the resident's shoulders.

The online businesses should not get away with this. All online, transient, or out-of-state vendors should be subject to collecting their own use taxes and reporting them to each respective state — the burden should not fall to the residents or businesses of Iowa.

Sen. Pam Jochum, D-Dubuque, who voted to close the loophole in a Senate ways and means subcommittee, said the vote was for crucial Iowa residents.

"It does put Iowa retailers at a disadvantage when people are buying online and escaping our taxes," she told to the Des Moines Register.

The lack of a sales tax online means less business for Iowa retailers. Tax-free shopping is just another reason to browse a big-name webpage as opposed to the aisles of a local shop or boutique. The reality is that the loophole feeds the fire of an undeniably preferential model.

"That's not to mention that the sales tax is something that helps support all of our services, including schools at the local level and cities," Jochum said.

The Legislative Services Agency, a nonpartisan organization, estimates that the loophole results in a statewide loss of \$6.8 million in tax money each year. Like any tax, sale tax finances a variety of projects, including infrastructure development and security, and it fuels the public-school system. The services afforded to community members statewide, every day, are thanks to taxation. The loophole not only hinders local business growth, but by its nature, works to slow the state's ability to function smoothly and securely.

Customers need to be aware of the effects of tax-free shopping — the relationship between taxation and public well-being is a reciprocal one. While a sale tax-free purchase is appealing, customers are ultimately robbing themselves. The loophole not only ends up hurting state and local businesses but also the very people shopping online.

The bill passed the Senate in an overwhelming 48 to 0 vote, and the House should consider sales and use tax further as Iowa heads into a dominant technological age.

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## **LOCAL MACHINE ROLLS 200 CIGARETTES IN 8 MINUTES**

By Kris Turner  
Toledo Blade (OH)  
April 5, 2012

*Low-cost 'smokes' avoid tax*

Sales and marketing director Chris Markho, left, shows customer Justin Lusher how to prepare a machine to make cigarettes at the RYO Filling Station at Tobacco Haven on Spring Valley Drive in Holland.

The empty cigarette casings loaded into the front of the RYO Filling Station at Tobacco Haven moved through the machine like a tiny assembly line on Wednesday.



Mild tobacco was siphoned from a bin on top of the ATM-like machine and stuffed into the white tubes, which rotated on a cylinder resembling a miniature Gatling gun.

In a matter of eight minutes, 200 cigarettes were produced and packed into a see-through plastic bag.

The roll-your-own machine -- a cause of concern for federal and state legislators because it falls into a tax loophole -- is a boon for Sam Markho, who owns Tobacco Haven on Spring Valley Drive in Holland. Mr. Markho said the technology is so promising that he plans to operate up to eight shops in the Toledo area. "It produces the same product as a name brand but saves the customer money," said Mr. Markho, who also has stores in Maumee and Oregon.

A box of "smokes" at the store retails for \$21.99, which is as much as \$40 less than a carton of cigarettes at a retail store. The business calls the cigarettes "smokes" to comply with the law, Mr. Markho said. Smoking is not allowed inside the store, and employees check IDs to make sure customers are old enough to buy tobacco.

The store offers a choice of tobacco brands and flavors, as well as a variety of cigarette tubes. Although customers can leave the store with as many "smokes" as they want, they're essentially buying tax-free cigarettes. The loose tobacco leaf used for roll-your-own cigarettes is considered produce and thus not subject to federal taxes. They also do not incur Ohio's cigarette tax.

Two pieces of legislation working their way through Congress aim to add these machine-made cigarettes to a list of federal taxable tobacco products and capture the revenues associated with them.

The rolling machine emits a complete cigarette. A box of "smokes" from the store sells for \$21.99 -- as much as \$40 less than a carton of cigarettes at a retail shop. The loose tobacco leaf used for the roll-your-own cigarettes is considered produce and thus not subject to federal tax. But Legislation now working its way through Congress could change that.

Rep. Diane Black (R., Tenn.) is sponsoring an amendment to the federal tax code that would expand it to include "any person who for commercial purposes makes available for consumer use a machine capable of producing tobacco products." The bill was referred to the House Committee on Ways and Means on March 5.

The other piece of legislation would amend the Secure Rural Schools and Community Self-Determination Act with similar language. It is sponsored by Sen. Max Baucus (D., Mont.) and was passed by the Senate on March 8.

At least some of the country's biggest tobacco companies are lobbying for the legislation, including Altria Group Inc., which is the parent company of Philip Morris USA, the country's largest cigarette manufacturer.

The American Cancer Society opposes all tobacco use because of the serious health risks associated with it, and supports a federal tax on roll-your-own products, said Wendy Simpkins, a spokesman for the group's east-central division.

Lucas County Chief of Staff Bridgette Kabat said she was unaware of the machines and said the county most likely would not possess the authority to regulate them.

Although Mr. Markho is not opposed to a slight tax on the "smokes," he fears he would lose business if they are taxed at the same rate as name-brand cigarettes.

Chris Markho, director of sales and marketing for Tobacco Haven, wants legislators to look at alternative ways of taxing the product instead of lumping roll-your-own cigarettes in with ready-made ones. "What we are hoping is they create a new tax and put it in a whole new tax bracket," he said.

Originally published here: <http://www.toledoblade.com/business/2012/04/05/Local-machine-rolls-200-cigarettes-in-8-minutes-1.html>