

# Tax Law as a Competitive Weapon

by Stanley R. Arnold

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## Introduction

Recently in several states, legislation has been introduced to change the method of taxing moist smokeless tobacco (MST) products from an ad valorem (price-based) method to a weight-based method. Until that recent legislative activity, states overwhelmingly have imposed an ad valorem excise tax on MST, generally basing the tax on a percentage of the wholesale price or the manufacturer's price.<sup>1</sup>

When similar legislation surfaced this spring in New Hampshire, the law firm I work for was retained by Conwood Co. LP (Conwood), a manufacturer of smokeless tobacco, to oppose the switch to weight-based taxation. In connection with that effort, I provided some history of the policy reasons in favor of the existing ad valorem system based on my previous service for 14 years as the commissioner of the New Hampshire Department of Revenue Administration. Ultimately, the New Hampshire legislature did not adopt the weight-based proposal.

What I discovered from that legislative effort was that the source of the proposal was not any attempt to enact "good" tax policy. Rather, the weight-based initiative is the result of an unbridled attempt by the

leading MST manufacturer to use tax law as a weapon to improve the competitiveness of its products.

Following the successful defense of ad valorem taxation in New Hampshire, I have been retained by Conwood to help shed some light on the true competitive forces driving the debate and to help explain to state legislators and state tax officials why the proposed switch from ad valorem taxation to a weight-based method is bad tax policy.

## The Rise of Weight-Based Taxation of Smokeless Tobacco

Typically, tax legislation is designed to address some tangible policy goal, such as economic development, revenue to finance government spending, fairness and equity, or administrative efficiencies. However, regarding the recent spate of legislation to substitute a weight-based method of taxing smokeless tobacco products, that is not the case. A careful review of the circumstances surrounding that initiative reveals one principal objective: to use the tax law to prevent erosion of market share for the leading manufacturer of smokeless tobacco products.

***The weight-based initiative is the result of an unbridled attempt by the leading MST manufacturer to use tax law as a weapon to improve the competitiveness of its products.***

For years, UST Inc. has been the leading player in the smokeless tobacco market. UST, which once held nearly 100 percent of the MST market, primarily sells premium-priced products. Recently, UST has been losing market share to so-called price-value brands, such as those sold by Conwood. In its most recent annual report filed with the U.S. Securities and Exchange Commission, UST explained:

The smokeless tobacco category is highly competitive and the Company's volumes and profitability may be adversely affected by continued consumer down-trading from premium

<sup>1</sup>As of January 1, 2006, 43 states imposed an excise tax on sales of smokeless tobacco products based on the price or value of the product sold.

brands to price-value brands or by potential new entrants into the marketplace.<sup>2</sup>

Although state tax issues are rarely important enough to be prominent in a public company's SEC filings, review of UST's 2005 annual report reveals a stunning exception to that general rule. In that report, UST makes the following disclosure:

Furthermore, the current *ad valorem* method of taxation, which is utilized by most states, bases the amount of taxes payable on a fixed percentage of the wholesale price, as opposed to some states which tax premium and price value brands equitably based on weight. Therefore, the *ad valorem* method of taxation has the effect of increasing the taxes payable on premium brands to a greater degree than the taxes payable on price-value brands, which further exacerbates the price gap between premium and price-value brands.<sup>3</sup>

With that clear disclosure, UST has publicly announced its reason for lobbying for elimination of the *ad valorem* method: It seeks to use the tax system to improve the price competitiveness of its products compared with other products in the market.

The math behind that approach is simple: When the tax is based on price (*ad valorem*), the higher the product price, the greater the tax paid. Attempts to switch to weight-based methods would significantly increase taxes on value-priced products and reduce taxes on premium-priced products. Thus, on an after-tax basis, UST's premium-priced products would become more competitive with price-value products (like Conwood's).

### The Weight-Based Proposal Is Bad Tax Policy

Clearly, my client opposes the weight-based tactics on economic competitiveness grounds — it does not want to see the tax system used in a manner that unfairly harms the competitiveness of its products. But even a summary review of the proposal reveals that state legislatures and state tax officials should reject the weight-based proposal because it is bad tax policy for three reasons.

**1. The Weight-Based Approach Is Difficult to Administer.** First, the weight-based approach should be rejected because it would undermine the administration of the excise tax on smokeless tobacco products. Under the current *ad valorem* system, wholesalers can comply with their tax collection and remittance obligations by using their business records and equipment based on sales (which reflects price, not weight). Those systems would require substantial and expensive revision to incorporate

product weight data. Similarly, the “unlinking” of the excise tax from the clear price and sales data would undermine the ability of state tax departments to audit wholesaler compliance. Indeed, during the debate before the New Hampshire legislature, one wholesaler testified in opposition to the weight-based proposal on the grounds that compliance would be costly to his small business. That wholesaler also pointed out that some of the fastest growing products in the category (for example, premium pouches) are not even sold by weight. For those products, state tax auditors would be required to either trust the manufacturer's statement regarding weight or perform a random series of tests by weighing samples of each product to properly determine compliance.

**2. The Weight-Based Approach Is Unfair and Inequitable.** Tax policy experts have long held that one of the most important goals of a tax system is economic neutrality — the tax system should not alter economic choices that would otherwise be made in the economy. The weight-based approach violates that standard tax policy objective. Price or value is the common denominator for competing in economic markets. So, if the tax is charged based on a percentage of price, all products bear the tax costs on a proportional basis, and customers are not driven by the tax system to purchase one product over another. The traditional retail sales tax is based on price, and not weight, and therefore meets the neutrality standard.

The proponents of the weight-based tactic attempt to turn that fundamental point on its head by arguing that it is the *ad valorem* system that artificially distorts market behavior. That argument does not hold water. It is the same as arguing that retail sales taxes on automobiles should be changed because the tax on a premium-priced sports car is higher than the tax on a low-priced commuter car. If the sports car manufacturer adopted that twisted logic, it might advocate a weight-based or per-car tax to replace the *ad valorem* sales tax. Using that logic, even owners of pricey real estate might start to argue for transformation of the *ad valorem* property tax on the grounds that basing the tax on property value unfairly creates a market preference for less expensive real estate.

**3. The Weight-Based Approach Will Reduce State Revenue.** The third argument against the weight-based approach is that it will ultimately result in a less stable state revenue system. Under a weight-based approach, aggregate revenue will not grow as product prices increase. To keep pace with regular inflation in state government expenditures, state tax officials would be required to

<sup>2</sup>UST Inc. Annual Form 10-K Report for 2005, p. 9.

<sup>3</sup>*Id.*

press for frequent increases in the tax rate, a task that no state tax official (or legislator) enjoys.

Again, the proponents of the weight-based approach have tried to turn that argument on its head by suggesting that the change will actually raise revenue because they would set the weight-based rate high enough at the beginning to allegedly raise more revenue than the current system. That argument is suspect on several fronts. First, because state tax officials lack any reliable data on the weight or volume of MST products, they are unable to provide any independent check on the revenue estimates provided by the proponents. Also, as noted above, a tax based on weight will be less likely to grow over time than a tax based on value.

### Conclusion

#### **State Legislatures and State Tax Officials Should Scrutinize Any Attempt to Adopt a Weight-Based Excise Tax for Smokeless Tobacco Products**

With three tax policy “strikes” against the weight-based method, how is it possible that several states switched to it in 2006? And how is it possible that other states are certain to see similar legislation appear in 2007?

A cursory review of the legislative process in the states that switched suggests a possible answer: In most cases, the proposals appeared only late in the legislative process, and the tax policy scrutiny typically provided by the taxwriting committees was avoided. For example, in Rhode Island, New Jersey, and Vermont, the proposal to adopt weight-based taxes arose only in the late stages of their legislative sessions.<sup>4</sup>

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<sup>4</sup>In New Jersey the amendment appeared only after the governor shut down state government because he and lawmakers could not agree on a budget. In Vermont the change was added to a late-breaking healthcare bill. In Rhode Island the change was added as part of the final budget proposal.

In New Hampshire, the result was different. The state’s open legislative process required a public hearing on the weight-based proposal. Even though our efforts to shed light on the adverse tax policy commenced only after the weight-based proposal had already passed the New Hampshire Senate as an amendment to a larger bill, the House Ways and Means Committee held a full public hearing, heard all testimony, and ultimately voted to kill the proposal and retain the ad valorem method. Efforts to change to a weight-based system were also attempted in Idaho, Texas, and New Mexico, but failed once they received legislative scrutiny.

***State legislatures and state tax officials should reject the weight-based proposal because it is bad tax policy.***

We have identified a number of states in which proponents of a change to a weight-based system have been active, and we expect legislation to be introduced in the upcoming legislative session. Legislators and state tax officials should scrutinize any weight-based proposal carefully and demand complete information on the following important policy questions:

- What is the real reason for the proposed change?
- What are the real consequences for administration of the tax both for businesses and for state tax administrators?
- What are the real long-term effects on state tax revenue?

I believe that if those questions are examined openly, in the full light of a public hearing, state legislators and state tax officials will conclude that it should be “three strikes and you’re out” for the weight-based excise tax on smokeless tobacco products. ☆