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ROBERT J. LEWIS
Senior Vice President for
Federal Relations

April 18, 1986

Delivered By Hand

The Honorable
Bob Packwood, U.S.S.
259 Russell Senate Office Building
Washington, D. C. 20510

Re: Tax Reform

Dear Mr. Chairman:

During the ongoing debate on the excise tax provisions of the Finance Committee tax reform proposal, considerable misunderstandings have arisen with respect to the payment of the tobacco excise tax. The attached explanatory statement makes it clear that:

-- the cigarette excise tax is imposed upon manufacturers when their products leave the factory premises;

-- on average the manufacturers pay this tax before they are reimbursed by their distributors so that they lose substantial sums of interest on the transaction; and

-- because all major companies are required to remit this tax to the Treasury through electronic funds transfer (EFT), the manufacturers gain no interest whatsoever through check lag "float."

In short, existing law imposes substantial net company losses through the excise tax payment system.

The Finance Committee draft would impose additional very substantial losses by eliminating the deduction for the excise tax payments and indexing the tax to inflation. Elimination of the deduction in effect imposes an income tax on excise tax payments -- clearly unfair, certainly contradictory to the basic principle that an income tax is supposed to tax income, and perhaps unconstitutional for that reason. The Tobacco Institute statement on the excise tax provisions of the Committee draft, a copy of which I have enclosed, elaborates on these points.

Finally, I have enclosed for your information a copy of a report by agriculture specialists Schnittker Associates that explains the adverse impact of these excise provisions on grain, grape and tobacco growers.

Please ask your staff to call me if you have any questions.

Sincerely,

RJL

Robert J. Lewis

Enclosures (3)

RJL/msr

PROCEDURES FOR COLLECTION AND PAYMENT
OF CIGARETTE EXCISE TAXES

Under current law excise tax returns must be filed every 15 days. Payment of the tax reported in such return must be paid on the 25th day following the last day of the return period. [Or the tenth day following the last day of the next succeeding return period].

The original procedure for collecting excise taxes on tobacco products involved prepayment by purchase of tax stamps, even before manufacture of the product. As part of the Internal Revenue Code of 1954, Congress, recognizing the inherent unfairness of prepayment before income, mandated that the prepayment by stamps procedure be replaced by a deferred system of payment and return. The function of implementing these new collection procedures was delegated to the Secretary of the Treasury.

In further recognition of the unfairness of the collection procedure, the deferral period was subsequently increased form 15 days to the current 25 days, immediately following the return period.

Even so, the additional 10 day deferral has not resolved the prepayment problem. Because we have a 34 day lag time between the removal of a product from the factory premises (or from "bond" in Treasury lexicon), when the excise tax attaches and receipt of payment, the industry is forced to borrow a substantial sum, which averages almost $50 million a day in outstanding debt.

The 1984 Tax Act provided that payment of the excise tax, for those payers whose total annual tax is $5 million or more, must be made by Electronic Fund Transfer [EFT]. Thus, that the excise tax payment must be deposited in a bank which has the capability to transfer that deposit, electronically, to the credit of the Treasury account in the Federal Reserve System. That means that the Treasury must actually receive the payment on or before the 25th day of the deferral period. Clearly, because of the EFT requirement, major cigarette companies do not issue checks in payment of excise taxes and thus, there is no "float" enabling them to earn interest thereon.

It is especially significant that when Congress took this action, it refused to adopt proposals to shorten the 25 day deferral period, thus confirming its resolve to defer the prepayment of this tax.

It should be noted that the tobacco industry is probably the most efficient tax collector for the federal government. The government does not pay one "red cent" for that collection service.

Statement of The Tobacco Institute
Before the U.S. Senate Committee on Finance
on The Excise Tax Provisions
of The Draft Tax Reform Bill

April 21, 1986

A distinguished member of the Finance Committee, Senator Durenberger, has said that the excise tax and tariff proposals which are under consideration demonstrate "how far we have strayed from true tax reform." His judgement has been echoed by many experts in the field of tax policy.

Let us recall that the tax reform movement was launched in order to achieve a tax system that would be more fair, more neutral, less discriminatory, and less burdensome on low income groups. These admirable objectives led many leaders in the business world, including several in the tobacco industry, to active and enthusiastic participation in the movement. I think it is clear that the proposals before the Senate Finance Committee have dampened enthusiasm and weakened support for tax reform.

These proposals relating to excise taxes and tariffs are neither fair nor neutral. They violate every canon of tax reform laid down by Secretary of the Treasury Baker when he told the House Ways and Means Committee on February 27, 1985,

> "...the tax system must not be used to favor one taxpayer over another, to favor one industry over another, to favor one form of consumption over another, or to favor one investment over another."

The existing Federal excise tax system is a hodgepodge of selective levies imposed on producers and consumers of relatively few products and services as an addition to the normal and general sales and income tax burden. By its very structure it favors some taxpayers, some industries, some consumers over others. It adds to the tax burden of those who drink beer rather than milk or orange juice. It adds to the burden of those who ship by truck rather than by rail. It increases the taxes of those whose favorite pastime is hunting or fishing rather than softball. It raises taxes for those who rely on coal rather than some other energy sources. It bears more heavily on those who travel by air rather than by bus.

To raise these taxes as the proposals before this Committee would do -- either directly or indirectly by ending the deduction for excise tax payments -- compounds the discriminatory effect of the excise tax system. As the Institute for Research in the Economics of Taxation has observed, "Instead of contributing to attainment of a level playing field, ostensibly a major objective of the current tax reform effort, this change would riddle the playing field with potholes."

If there is any common characteristic of the various Federal excise taxes, it is regressivity. This is clearly true of excises that hit almost everybody, such as those on telephone service and gasoline, which, with splendid impartiality, take from the poor and the rich on the same basis.

That it is also true of other excise taxes has been demonstrated in two recent studies by deSeve Associates, a major firm of economic consultants. One of these studies analyzed the proposals before the Finance Committee. It found that the excise tax and tariff proposals would

-- take, as a percentage of income, five times as much from households with income below $20,000 as would be taken from households above $100,000.

-- take away from households under $10,000 more than 60 percent of the income tax reduction promised by the Finance Committee draft plan while depriving households over $200,000 of only 6 percent of their income tax reduction.

For many millions of Americans, particularly at lower income levels, the excise tax proposals would wipe out completely any income tax reduction granted by the plan which your Committee is considering. These proposals thus actually undermine a major objective of tax reform -- tax relief for low-income families.

The staff proposal seeks to make the tax reform package revenue-neutral by increasing the burden of excise taxes and tariffs to provide an estimated $75 billion of additional revenue over the next five years. Most of this revenue gain would come from a radical reversal of basic income tax policy -- termination of the deductibility of excise tax and tariff payments as a business cost. Stated simply, this proposal unfairly imposes a tax on a tax. No longer would the income tax be imposed on net income. If the Congress denies a deduction for a particular type of tax, which is an inescapable cost of doing business, how can it continue to allow business to deduct other forms of taxation? And how can it permit deductions for other business costs, many of which are not required by law but are discretionary? And how long will it be before the income tax is transformed into a tax on gross income?

Other witnesses have discussed this anti-business and anti-consumer proposal relating to deductibility of excise taxes. I would like to focus on the proposal to raise the excise tax on three types of products -- tobacco, alcohol, and motor vehicle fuels -- and to index them to price changes.

These three products provide more than 60 percent of the revenue currently received through the excise tax system. I ask this Committee to consider the magnitude of the tax burden already imposed on most of these products -- not only by the Federal Government but by State and local governments as well. Is it equitable to add to the burden of those who are already overtaxed? In the case of tobacco, a recent study by Chase Econometrics demonstrates that almost 50 perent of the price paid by the consumer for cigarettes goes to tax collectors of one level of government or another.

I ask this Committee to consider what this proposal does to the revenue systems of the states you represent -- a subject on which the National Governors Association has expressed its deep concern.

Above all we urge that Congress be even-handed and consistent in the tax policy it adopts.

Five years ago the Congress established an important principle of taxation by indexing the individual income tax to make certain that tax rates did not rise with inflation. At that time Congress decided that the tax burden should not increase with price changes; that the taxpayer should be protected against paying a double penalty for inflation by moving into a higher tax bracket when he realized a purely nominal increase in income; that government should not reap a tax windfall as a result of inflation, and that the tax system should not operate to magnify inflation. Most of the members of this Committee, including the Chairman, voted for these principles.

Now you are faced with a proposal that reverses these sound principles. The proposal would declare that the consumers of certain products should be treated differently, and should be subjected to steady, relentless tax increases without any further Congressional determination of the appropriate tax rate for them. This proposal, in short, would transform these excises into ad valorem - or sales - taxes - but only on certain products.

A close examination of the effects of this proposal to raise three types of excise taxes indicates that those who would be most hurt by it, are consumers in the lowest income groups.

The consumer would not be the only victim of the excise tax proposals before this Committee. The tobacco farmer would be harshly affected. For him this would be the crowning blow after having been buffeted in recent years by bad weather, high assessments, a doubling of the Federal cigarette excise tax and a tidal wave of tax increases by state governments, which have resulted in a steep reduction in the number of farms producing tobacco.

Indeed, all whose livelihood depends on tobacco would be hurt by the reduced demand for tobacco products that would follow from the proposal for built-in annual increases in the excise tax and the loss of deductibility.

Mr. Chairman, we ask your Committee to reject the proposals before you relating to excise taxes. We have heard the argument that "revenue must be found somewhere to offset tax reductions" which in some cases may be of general benefit, but, in too many cases, amount to preferential treatment for a few. This argument is no justification for tax increases so arbitrary, capricious, inequitable, and regressive.