taxnotes® international
Volume 92, Number 5 ■ October 29, 2018

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Reprinted from *Tax Notes International*, October 29, 2018, p. 507

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In this article, the author discusses the taxation of heated tobacco products, explaining how the unique characteristics of these products present unique challenges and opportunities for tax authorities, with a focus on the European Union.

Several years have passed since companies first made heated tobacco products commercially available to consumers in Europe and Asia. Like electronic cigarettes — the first-generation vapor device — heated tobacco products generate nicotine-infused vapor using an instrument that controls the temperature electronically. This technology delivers nicotine without creating smoke. Unlike e-cigarettes, however, which use a liquid solution that contains nicotine, these products generate vapor by electronically heating a mixture of flavored tobacco. This distinction seems to appeal to smokers and attracts consumers from other vapor platforms who want a more authentic tobacco flavor. Because these products do not involve combustion and therefore lack harmful smoke constituents, they potentially carry a reduced risk profile.

Research by government bodies and independent sources into the risk profile of heated tobacco products began several years after similar studies about e-cigarettes. Initial results indicate a significant reduction in harmful chemicals in the aerosol generated by heated tobacco products compared with cigarette smoke, suggesting that heated tobacco products likely pose a lower health risk. For example:

- In the United Kingdom, the Committee on Toxicity assessed the health risks from two heat-not-burn tobacco products available on the U.K. market. The committee concluded that "while there is a likely reduction in risk for smokers switching to heat-not-burn tobacco products, there will be residual risk."[1]
- Public Health England reached a similar result in February, stating that "the available evidence suggests that heated tobacco products may be considerably less harmful than tobacco cigarettes and more harmful than e-cigarettes."[2]
- Researchers associated with Germany's Federal Institute for Risk Assessment held: "The strongly reduced Harmful and Potentially Harmful Constituents [HPHC] levels in the emissions of the heat-not-burn [HNB] device are likely to reduce toxicant exposure."[3]
- In January, the U.S. Tobacco Products Scientific Advisory Committee held a meeting to consider Philip Morris International's request to market heated tobacco as a modified risk tobacco product. According to briefing documents that the U.S. Food and Drug Administration (FDA) released for that meeting, the level of harmful and potentially harmful constituents in the new products were

[1] The Committee on Toxicity, "Statement on the Toxicological Evaluation of Novel Heat-Not-Burn Tobacco Products" (Dec. 2017).

[2] Public Health England, "Evidence Review of E-Cigarettes and Heated Tobacco Products" (Feb. 2018).

[3] Nadja Mallock et al., "Levels of Selected Analytes in the Emissions of 'Heat Not Burn' Tobacco Products That Are Relevant to Assess Human Health Risks," 92(7) *Archives of Toxicology* (May 2018).

> "significantly lower than those in mainstream smoke from combusted cigarettes."[4]

As consumers started scrutinizing these new product offerings, government regulators and fiscal policymakers began to consider them as a potential source of tax revenue.[5] Liquids containing nicotine for use in e-cigarettes have been widely available for nearly a decade, but have largely escaped taxation in all but a dozen or so countries. Although the liquid may contain nicotine derived from tobacco, there are no actual tobacco leaves present in the solution. Excise laws typically specify the categories of tobacco that are subject to taxation. Until recently, liquid nicotine for use in e-cigarettes did not appear in most tax codes. Thus, regulators did not feel immediate pressure to subject e-cigarettes to taxation when they were first launched. However, by mid-2018 nearly half of the EU member states had introduced taxes on e-cigarettes at relatively low rates.

A New Tax Category or a Best Fit?

The introduction of heated tobacco products, however, presents manufacturers and regulators with the challenge of complying with existing excise laws that require taxation of manufactured tobacco. Faced with the need to levy a tax on these new products, revenue authorities had two choices — create a completely new excise classification or find the best fit among existing categories.

At first glance, designing a new category seems the logical decision given the distinct and innovative nature of the heated tobacco products. After all, there is no combustion with these products and they are not smoked by the consumer. They require the use of an electronic device to heat the tobacco and generate a vapor that is inhaled. No existing excise category addresses these product characteristics.

Designing a new excise category, however, is not a cost-free exercise. Sound knowledge of the product's features and functionality is essential to identifying the taxable base. Instituting a new category also involves administrative costs — for both the taxpayer and the administration — such as staffing, developing reporting procedures, training, and ensuring compliance. If the volume or value of all underlying transactions that generate the tax is not substantial, the revenue collected may not be a worthwhile return on states' investment in people, systems, and enforcement.

In contrast, lumping heated tobacco into a broad basket of heterogeneous products, including pipe and other smoking tobacco, allows tax administrators and taxpayers to piggyback on existing procedures with little incremental expense. This is why — or at least one reason why — numerous countries classified heated tobacco as "other smoking tobacco" (Germany, the Netherlands) or "other manufactured tobacco" (Switzerland) when the product launched. This class of products generally carries the lowest tax rate of the existent combustible tobacco tax categories, which has led some tax authorities to deem them to be the best fit. As consumption volume grows, however, taxing authorities may decide that market conditions justify creating a new tax category.

Notwithstanding the low initial transaction volume and the administrative expenses, there are compelling reasons why creating a new category for heated tobacco is a good practice — and why it is the path that many European countries have taken. One way states can reduce the harm from tobacco is by enticing smokers to switch from cigarettes to safer alternatives. Differential taxation can encourage consumers to migrate from highly taxed cigarettes to less risky products that are heated rather than burned if they carry a lower tax rate. While countries often tax other smoking tobacco and pipe tobacco at lower rates than cigarettes, there is little justification for treating heated tobacco the same as combustible forms of tobacco when the risk is potentially so much less.

Recently, the U.K. House of Commons' Science and Technology Committee recommended the government take action on the

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[4]FDA Office of Science Center for Tobacco Products, "FDA Briefing Document: Meeting of the Tobacco Products Scientific Advisory Committee" (Jan. 24-25, 2018).

[5]Philip Gambaccini and Servane Claudel, "Are Evolving Regulations Laying the Groundwork for Taxing E-Cigarettes?" *Tax Notes Int'l*, Nov. 3, 2014, p. 441.

taxation of e-cigarettes and heated tobacco. The committee suggested that:

> the level of taxation on smoking-related products should directly correspond to the health risks that they present, to encourage less harmful consumption. Applying that logic, e-cigarettes should remain the least taxed and conventional cigarettes the most, with heat-not-burn products falling between the two.[6]

For price-sensitive consumers, higher prices induced by higher tax rates may prevent them from switching to less risky vapor products.

On the other side of the equation, manufacturers incur substantially higher costs researching, developing, and producing heated tobacco products than they do in the production of traditional cigarettes. Companies may find they cannot simply retrofit older factories to switch from making cigarettes to manufacturing the tobacco mixture used in rods, pods, or capsules. The change may require greenfield investment — that is, building new facilities from the ground up. Furthermore, companies often provide electronic heating devices, which they usually obtain through outsourced production, to consumers at low or no margin. These devices require after-sale service and customer care — services that are not required with traditional tobacco products. Moreover, regulatory bodies expect manufacturers of heated tobacco products to demonstrate their reduced risk potential. This stipulation means the manufacturer must conduct complicated and costly scientific studies, including clinical trials. Manufacturers of heated tobacco products need to recoup these expenses through higher margins.

Before they allocate hundreds of millions of euros to purchasing land, constructing new factories, and developing the supply chains needed to produce heated tobacco products, manufacturers want some degree of certainty regarding the market regulations and operating environment. Notably, this segment of the vapor products market is more highly concentrated than the electronic cigarette sphere, with a smaller number of players dominating a larger share of the market, given the high barriers to entry and significant supply chain requirements, which may include agronomy experts and tobacco purchasing programs.

Creating a new tax category for heated tobacco allows policymakers to address the special circumstances and cost profile of this novel product unencumbered by concerns about the best way to tax pipe or other smoking tobacco. It also signals to manufacturers and the trade that the authorities are more likely to address their unique commercial concerns and circumstances directly.

Trends in Europe

European markets have helped lead the way in creating new tax categories for heated tobacco, and the pace of these fiscal reforms is accelerating. The U.K. Treasury recently announced its intention to submit legislation to Parliament to amend the Tobacco Products Duty Act to include a new excise category for heated tobacco.[7] Likewise, recognizing the role of differential taxation in implementing a harm-reduction policy, the Czech Republic decided to create a new excise tax category for heated tobacco (pending parliamentary approval by November).

Effective July 1, Denmark withdrew heated tobacco from the "other smoking tobacco" basket and created a new excise tax category: "Tobacco intended to produce vapor without combustion." Similar action goes into effect in Lithuania as of March 1, 2019. By that time, 13 EU member states will have special tax categories for heated tobacco up and running — a number that may be even higher depending on parliamentary approval of the proposal in the Czech Republic and how quickly the U.K. Parliament is able to enact the Treasury's proposal. A few remaining markets, including France and the Netherlands, will tax heated tobacco products as other smoking tobacco as they (reportedly) await guidance from Brussels.

[6] U.K. House of Commons Science and Technology Committee, "E-Cigarettes: Seventh Report of Session 2017-19," HC 505 (Aug. 17, 2018).

[7] HM Revenue & Customs, "Policy Paper: Tobacco Duty on Heated Tobacco" (July 6, 2018). *See also* HMRC, "Tax Treatment of Heated Tobacco Products" (Mar. 20, 2017).

Direction From the European Commission

EU member states that are relying on existing categories to tax heated tobacco while they await direction from the commission may soon receive news.

On May 23, led by the Director-General for Taxation and Customs Union, the European Commission initiated a "public consultation on excise duties applied to manufactured tobacco and the possible taxation of novel products." According to the commission, the purpose of the consultation is:

> to gather the views of stakeholders on the current tobacco taxation in the EU, as well as on novel products (e-cigarettes and heated tobacco products) and appropriate options for a possible revision of Council Directive 2011/64/EU.

The consultation period ended on September 3, and the commission is expected to issue a report with its findings and recommendations soon.

Earlier this year, the commission concluded a similar review of Directive 2011/64/EU on the structure and rates of excise duty applied to manufactured tobacco. The project culminated in a January 12 report (COM(2018) 17 final) to the European Union's Council of Finance Ministers. According to the commission:

> The study found that the information available on e-cigarettes was limited and it was consequently difficult to draw conclusions on how the market will evolve in the future. Moreover, opinions on possible health effects of e-cigarettes and, consequently, the appropriate tax treatment largely diverge.

The commission decided not to propose a harmonized approach for taxing e-cigarettes. Instead, it endorsed a multi-phased approach to the taxation of e-cigarettes that would initially focus on gathering accurate data on the evolution of the market.

Under a separate subheading, the report examined heat-not-burn tobacco products. According to the report:

> Given the novelty and evolutionary nature of the market, it would be extremely difficult at this stage to develop a harmonized explicit definition which captures these products both as they appear now and their future developments.

The commission found that heated tobacco products are already covered by the directive indirectly because they contain tobacco. As an interim measure, the commission opined that heated tobacco products could be taxed at the same rate as smoking tobacco (that is, fine cut and pipe tobacco) under the directive. The commission decided to revisit the question of harmonized tax treatment by the member states during the next Regulatory Fitness and Performance Program evaluation — a program that regularly reviews EU legislation to identify issues and propose changes as needed — of the directive in 2019.

It appears that the commission's timetable for providing guidance to the member states on the taxation of heated tobacco products has accelerated. One reason: Cigarette sales have been declining across Europe. Despite rising tax rates, the principal source of tobacco excise revenue is trending downward in many member states. Considering the possibility that the rising sales volume of heated tobacco products may have played a role in reducing cigarette consumption, revenue authorities are increasingly scrutinizing the product category as a potential alternate source of tax revenue. However, authorities should restrain their expectations since consumption is still relatively low and price-sensitive consumers may not accept heavy tax rates.

Further, in the absence of guidance from Brussels, half of the EU member states have independently moved ahead with their own fiscal reforms and created new categories in their tax legislation for heated tobacco or similarly defined products. Nearly all these jurisdictions apply a specific tax based on the weight of the tobacco mixture and set the rate at or below the lowest tax on combustible tobacco. This tax differential reflects the general acceptance of the difference in physical product characteristics, cost profile, and a harm-reduction approach to tobacco taxation.

The table shows the status of new tax categories for heated tobacco created in European markets as of July 1. The similarity among the designs is apparent.

New Excise Categories for Heated Tobacco in Europe (as of July 1)

Country	Tax Category	Tax Rate & Base
Bulgaria	Heated tobacco	BGN 152 per kg
Croatia	Heated tobacco	HRK 600 per kg
Cyprus	Heated tobacco	€150 per kg
Denmark	Tobacco intended to produce vapor without combustion	DKK 738.50 per kg
Greece	Electrically heated tobacco product	€156.70 per kg
Hungary	Novel tobacco products	HUF 10 per unit
Italy	Inhalation product without combustion	Specific tax depending on SKU
Latvia	Heated tobacco	€66 per kg
Lithuania*	Heated tobacco	€60.24 per kg
Portugal	Heated tobacco	€80 per kg plus 15% of retail price subject to a minimum tax of €171 per kg
Romania	Heated tobacco	RON 383.78 per kg
Serbia	Tobacco that is heated but not combusted	RSD 2,946.80 per kg
Slovak Republic	Smokeless tobacco	€73.90 per kg
Slovenia	Manufactured tobacco intended for heating	€88 per kg
* Lithuania's tax was approved in July 2018 for implementation in March 2019.		

Summary and Conclusion

In all the EU countries cited above, in which the excise tax on heated tobacco products is applied on a per kilogram basis, the tax base is the weight of the tobacco mixture. As more countries adopt this template with each passing month, the commission may soon find that member states acting on their own initiative have preempted its opportunity for providing constructive counsel or a different approach. Now that a clear trend has emerged regarding product definition, excise structure, taxable base, and the application of a lower rate than that applied to cigarettes and other forms of smoking tobacco, it appears the commission's area to maneuver is somewhat circumscribed. ■