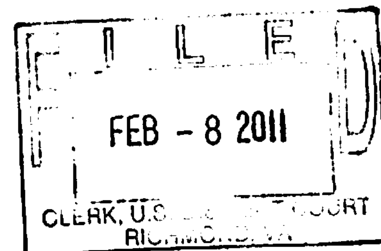
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
Richmond Division



PHILIP MORRIS USA INC.
6601 West Broad Street
Richmond, VA 23230,

Plaintiff,

v.

THOMAS VILSACK, Secretary of Agriculture, and the UNITED STATES DEPARTMENT OF AGRICULTURE
1400 Independence Avenue, S.W.
Washington, D.C. 20250-0506,

Defendants.

Civil Action No. 3:11CV087(HEH)

COMPLAINT

For Declaratory and Injunctive Relief

Introduction

1. This is a challenge to an amended regulation the Defendants issued to justify imposing unlawful assessments on the Plaintiff and others in its industry under the Fair and Equitable Tobacco Reform Act of 2004, 7 U.S.C. §§ 518-519a ("FETRA"). After implementing and administering the assessments under that statute from fiscal year 2006 through fiscal year 2010 using the then-current maximum federal excise tax rates, as Congress intended, the Defendants now refuse to use new federal excise tax rates Congress has established. As a result, the Plaintiff and others in its industry must pay significantly higher assessments than Congress intends them to pay.

Parties

2. Plaintiff Philip Morris USA Inc. ("PM USA") is a Virginia corporation with its principal place of business in Richmond, Virginia.

3. The Plaintiff, at all times relevant to this action, was and continues to be engaged in the manufacture and distribution of cigarettes. PM USA is a cigarette manufacturer or importer for purposes of FETRA, and is subject to Tobacco Transition Payment Program ("TTPP") assessments under that statute.

4. The Plaintiff has been and will continue to be directly affected and injured by the Defendants' unauthorized and unlawful amendment to regulations for allocating TTPP assessments under FETRA.

5. Defendant Vilsack is the Secretary of Agriculture. This action is maintained against him in his official capacity. Secretary Vilsack ("the Secretary") is responsible for ensuring that the United States Department of Agriculture ("USDA") complies with the terms of FETRA.

6. Defendant United States Department of Agriculture is an agency of the United States. The USDA administers the TTPP under FETRA through the Commodity Credit Corporation ("CCC"), an agency within the USDA subject to the supervision and direction of the Secretary.

Jurisdiction and Venue

7. This Court has jurisdiction over this action pursuant to 28 U.S.C. § 1331. The declaratory relief and other relief requested in this action are authorized by 5 U.S.C. §§ 701-706, 28 U.S.C. §§ 1361, 2201-2202, and Fed. R. Civ. P. 57. Judicial review is authorized by 5 U.S.C. §§ 701, *et seq.*

8. Venue in this Court is proper pursuant to 28 U.S.C. § 1391(e).

Facts

A. FETRA Background

9. FETRA, passed in 2004, eliminated longstanding Depression-era tobacco quota and price support programs. It also established the Tobacco Transition Payment Program to assist domestic tobacco quota holders and growers transition to a free-market system, by providing them with ten equal installment payments, paid during fiscal years 2005 through 2014. The total payments under the program over those ten years are expected to be approximately $9.5 billion.

10. Congress funded the TTPP through assessments imposed on tobacco manufacturers and importers, such as the Plaintiff. Congress divided the domestic tobacco market into six major classes – cigarettes, cigars, chewing tobacco, pipe tobacco, snuff, and roll-your-own tobacco.

11. Congress then allocated to each tobacco class a percentage share of the total TTPP obligation. Congress calculated the allocation shares for fiscal year 2005 for the six tobacco classes by multiplying each class's net tobacco product removed (*e.g.*, tobacco product taken from factories, internal revenue bond or customs custody) by the current maximum federal excise tax ("FET") rate for that class. Congress used the then-current maximum FET rates for all the tobacco classes in the TTPP because the excise tax on large cigars is imposed at an *ad valorem* rate, capped at a specified amount per cigar. *Ad valorem* taxes vary from brand to brand based on price. The use of the cap for large cigars provides a uniform rate for such products. For each of the other tobacco classes, the maximum FET rate is also the actual FET rate in place at the time.

12. For fiscal year 2005, Congress allocated cigarette manufacturers and importers a 96.331% share of the total TTPP and cigar manufacturers and importers a 2.783% share using

the above formula. Congress distributed the balance of the shares among the four remaining tobacco classes. 7 U.S.C. § 518d(c)(1).

13. For the 2006 through 2014 fiscal years, Congress required the Secretary to "periodically adjust the percentage of the total amount required . . . to be assessed against, and paid by, the manufacturers and importers of each class of tobacco product . . . to reflect changes in the *share* of gross domestic volume held by that class of tobacco product." 7 U.S.C. § 518d(c)(2) (emphasis added). Congress defined "gross domestic volume" to mean "the volume of tobacco products . . . removed [for FET purposes and] not exempt from [the FET]." 7 U.S.C. § 518d(a)(2).

B. The Defendants' Original TTPP Assessment Regulations Used the Maximum Current Federal Excise Tax Rates, i.e., the Tax Rates in Effect for the Assessment Year at Issue

14. On February 10, 2005, the Defendants issued regulations ("2005 Regulations") for implementing the TTPP, which included the methods to be used in making class share allocations of FETRA assessments as well as the methods to be used to allocate the class assessments among class members. USDA, *Tobacco Transition Assessments*, 70 Fed. Reg. 7007 (Feb. 10, 2005), *see* Attachment A. In drafting the 2005 Regulations, the Defendants analyzed the tobacco class shares for fiscal year 2005 established by Congress in FETRA (described in par. 12, above), and determined that Congress derived those class shares "by multiplying net tobacco products removed by the maximum excise tax rate for each class of tobacco." *Id.* at 7007.

15. The Defendants' 2005 Regulations implemented the statute by providing that "[f]or fiscal years 2006 through 2014, the . . . assessment will be adjusted annually." 7 C.F.R. § 1463.5(c) (2005). The Defendants stated that, in order to carry out Congress' intent, "it is CCC's intention to adjust the class percentages annually by using th[e] *same methodology* [that

Congress used to calculate the fiscal year 2005 allocations as set forth in the statute] to ascertain changes in the volume of sales of each class." 70 Fed. Reg. at 7008 (emphasis added). In other words, when making adjustments to the tobacco class shares allocated under the TTPP to reflect changes in shares of volume in the marketplace, the Defendants stated that they would multiply net tobacco products removed by the maximum FET rate for each class of tobacco. The 2005 Regulations further made clear that the FET rates to be used were those in effect from time to time, by expressly stating that the annual class allocations will be "based upon . . . each class's share of the excise taxes *paid*" with "[t]he value of the excise taxes paid for each class [to be] based upon the reports filed by domestic manufacturers and importers of tobacco products with the Department of Treasury and the Department of Homeland Security . . . ." 7 C.F.R. § 1463.5(a) (2005) (emphasis added).

16. The meaning of this language is clear. The excise taxes on which the class allocations are to be based are the "excise taxes paid," except that for large cigars the allocation will be based on the maximum FET cap, not the lower *ad valorem* tax paid. Moreover, the Defendants' 2005 Regulations required that the "excise taxes paid" for each class for allocation purposes were to be determined "based upon the reports filed" by the manufacturers and importers with the Department of Treasury ("TTB") and Department of Homeland Security ("Customs"). The preamble to the 2005 Regulations identified the reports to be used for these purposes as TTB Form 5220.6, TTB Form 5210.5, TTB Form 5200.14, TTB Form 5620.8, and Customs Form 7501. 70 Fed. Reg. at 7008. The only excise taxes that are reported on such forms are calculated by taxpayers based on the rates in effect for the relevant period.

17. The methodology used both by Congress in FETRA and by the Defendants in the 2005 Regulations for implementing the statute treats all tobacco product classes the same, *i.e.*, the maximum current FET rates for each class are used for allocation purposes.

18. The Defendants used this method for calculating TTPP class allocation shares for fiscal years 2006 through 2010.

C. **Congress Established New FET Rates for the Tobacco Classes**

19. In January 2009, President Obama signed into law the Children's Health Insurance Program Reauthorization Act ("CHIPRA"). P.L. 111-3 (2009). CHIPRA raised and adjusted the FET rates on all classes of tobacco products, effective on April 1, 2009. 26 U.S.C. § 5701. In enacting CHIPRA, Congress was aware that the relative FET rates were disproportionate across tobacco classes, specifically that the FET rate on cigarettes was proportionately much higher than the rates on non-cigarette tobacco products, such as small cigars and roll-your-own tobacco. Accordingly, Congress acted to correct this disproportion to bring the rates on the tobacco product classes more into line with each other.

20. CHIPRA increased the federal excise tax on cigarettes (from 39 cents to $1.01 per pack) and imposed the same tax on little cigars. With regard to large cigars, CHIPRA raised the *ad valorem* rate by an amount comparable to the increase in the cigarette rate but increased the maximum ("cap") rate per large cigar to an even greater extent, from five cents per cigar pre-CHIPRA to a little more than 40 cents per cigar post-CHIPRA. This reflected Congress's judgment that the old cap rate was too low and needed to be adjusted to achieve more comparable taxes across tobacco product classes. Joint Committee on Taxation, Technical Explanation of the Code Provisions of H.R. 2, the "Children's Health Insurance Program Reauthorization Act of 2009" as Passed by the House of Representatives on January 14, 2009, (JCX-3-09), January 14, 2009, at 3-4.

21. The CHIPRA rates came into effect beginning in the second quarter of 2009. The first year the CHIPRA rates affect the FETRA allocations is fiscal year 2011. For fiscal year 2011, the use of the new FET rates would allocate to cigarette manufacturers and importers a 78.5% share of the total TTPP under FETRA, rather than the 91.6% share that would be allocated to cigarettes under the 2005 FET rates. Similarly, the use of the new rates would allocate to cigar manufacturers and importers a 19.5% share, rather than 7.1% under the 2005 FET rates.

D. In 2010, the Defendants Posted Preliminary FETRA Class Allocations That Did Not Use the Current FET Rates

22. On October 5, 2010, the Defendants posted on their website their preliminary class share allocations for fiscal year 2011 (which were, in accordance with past practices, based on calendar year 2009 removals). At the time they were posted, the preliminary allocations violated the Defendants' 2005 Regulations, because the allocations did not use the FET rate increases that took effect on April 1, 2009 under CHIPRA. Instead, the allocations assumed that the prior 2005 FET rates were in effect for the entire 2009 calendar year rather than just the first quarter.

23. The methodology the Defendants used to calculate the preliminary class share allocations for fiscal year 2011 was contrary to FETRA, five years of the Defendants' practice, and their 2005 Regulations because it did not base the calculations on "[t]he value of the excise taxes paid for each class" and it did not determine the "value of the excise taxes paid for each class . . . based upon the reports filed by domestic manufacturers and importers" with Treasury and Customs. *See* 7 C.F.R. § 1463.5(a) (2005). Rather, the preliminary fiscal year 2011 allocations were based on the hypothetical FET rates that would have been paid, and the hypothetical reports that would have been filed, if CHIPRA had not been enacted.

E. The Defendants Amended Their Regulations to Support Their Preliminary 2011 Allocations, and the Amendment Disregards the Current Federal Excise Tax Rates When Calculating FETRA Allocations

24. Because the fiscal year 2011 preliminary tobacco class allocations violated the Defendants' 2005 Regulations, the Defendants issued a so-called "Technical Amendment" to the 2005 Regulations on December 10, 2010. *Tobacco Transition Payment Program; Tobacco Transition Assessments*, 75 Fed. Reg. 76921 (Dec. 10, 2010) (hereinafter "regulatory amendment"), *see* Attachment B. The regulatory amendment, which was issued by the Defendants without notice or opportunity for comment in reliance on section 519a(b) of FETRA, 7 U.S.C. § 519a(b), revised the first sentence of section 1463.5(a) of the 2005 Regulations to read as follows: ". . . [T]he national assessment will be divided by CCC among each class of tobacco based upon CCC's determination of each class's share of the excise taxes paid *using for all years the tax rates that applied in fiscal year 2005*." 7 C.F.R. § 1463.5(a) (2010) (emphasis on new language added by the regulatory amendment).

25. The Defendants claim that the regulatory amendment is simply a clarification of the 2005 Regulations, and that the term "excise taxes paid" always meant the excise taxes that would have been paid under the FET rates in effect in 2005 (*i.e.*, the rates in effect before the increases Congress enacted in 2009 with CHIPRA) – irrespective of the subsequent legislative changes to those rates. 75 Fed. Reg. at 76921. The Defendants' claim is wrong. The plain language of the 2005 Regulations contains nothing to support such an interpretation, nor does the language of the statute. The regulatory amendment is therefore not a "technical amendment" but rather a major, substantive amendment that, unlawfully and contrary to Congress's intent, changes the way tobacco class allocations are to be calculated each year under the TTPP.

F. The Defendants' Regulatory Amendment Ignores FETRA and Congressional Intent to Use the Current FET Rates for Post-2005 Fiscal Years

26. FETRA, 7 U.S.C. § 518d(c)(2), states: "For subsequent [post-2005] fiscal years, the Secretary shall periodically adjust the percentage of the total amount [of the assessment] . . . to be assessed against . . . each class of tobacco product . . . to reflect changes in the share of gross domestic volume held by that class of tobacco product." FETRA defines "gross domestic volume" as "the volume of tobacco products . . . removed [for FET purposes and] . . . not exempt from [the FET]." *Id.* § 518d(a)(2).

27. The statutory mandate is that the Defendants adjust the class percentages to reflect "changes in the *share* of gross domestic volume . . . of each tobacco product class." 7 U.S.C. § 518d(c)(2) (emphasis added). As recognized by the Defendants, 70 Fed. Reg. at 7007-7008, the legislative history of FETRA is clear that any calculation of shares of gross domestic volume requires the multiplication of two factors – namely, the number of units removed for FET purposes and the maximum FET rate. Otherwise, there would be no common unit of measurement (dollars) on which the tobacco product class shares could be calculated since cigarette and cigar removals are measured in sticks, and removals of all other classes are measured in pounds. It follows that the changes in the shares which the Defendants are required to adjust for can occur whenever there is a change in either factor – units removed or FET rates. Nothing in FETRA or the legislative history supports the regulatory amendment's conclusion that only changes in one of the factors (units removed) may be considered in calculating share changes, with changes in the other factor (FET rates) simply ignored.

28. The Defendants implemented and carried out the assessments program every fiscal year from 2006 through 2010 "by multiplying net tobacco products removed . . . by the maximum excise tax rate for each class of tobacco." 70 Fed. Reg. at 7007. In each of those

years, the Defendants used the FET rates then in effect. FETRA does not authorize the Defendants to now shift from that approach by using FET rates that are not in effect.

G. Until the Defendants Amended Their Regulations, the Defendants Consistently Defended Their Use of the Current Year's FET Rates, and Congress Has Confirmed Its Intent That Current Rates Should Be Used

29. After the Defendants published their 2005 Regulations in February 2005, a major large cigar manufacturer filed a lawsuit challenging those regulations. Among other things, the lawsuit sought to overturn the 2005 Regulations' use of the current maximum excise tax rate for large cigars under the FETRA program. *Swisher Int'l, Inc. v. Johanns*, No. 3:05-cv-871-J16-TEM, 2007 WL 4200816 (M.D. Fla. Nov. 27, 2007). Swisher argued that the 2005 Regulations were contrary to the statutory language of FETRA, and moreover violated the equal protection and due process clauses of the U.S. Constitution, because they based class shares on the actual excise taxes paid in the case of all tobacco classes, except that for large cigars the 2005 Regulations assumed that the current maximum excise tax rate was being paid – even though many such cigars were actually paying FET at less than the maximum rate on an *ad valorem* basis. The Defendants responded that the maximum FET rates were in fact being used for all classes and, therefore, large cigars were being treated the same as the other classes, consistent with the intent of Congress.

30. In the District Court and the Court of Appeals, the Defendants successfully defended their use of the maximum FET rate for all classes even though it was only in the case of large cigars that the actual and maximum rates differed. The courts recognized that using the maximum rates was consistent with congressional intent. *Swisher Int'l Inc. v. Schafer*, 550 F.3d 1046 (11th Cir. 2008), *cert. denied* 130 S. Ct. 71 (2009).

31. While the *Swisher* case was proceeding in the courts, Congress was presented with numerous proposals to overturn the class allocation provisions of those regulations. Congress consistently declined to amend those provisions of the 2005 Regulations. For example:

- In August 2005, the Cigar Association of America ("CAA") asked the Chairman of the House Ways and Means Committee to amend FETRA to overturn the class allocation provisions of the 2005 Regulations. Among other things, the CAA proposed that the cigar class allocation share be frozen at the 2005 FET level. *See* Attachment C. Congress did not adopt any of the proposed amendments urged by the CAA.
- Moreover, in January 2009, in connection with the congressional deliberations regarding the FET increases included in CHIPRA, Swisher proposed an amendment to the FETRA class allocation provisions to impose an across-the-board requirement that class allocations be based on the "actual federal excise taxes paid" by all tobacco products. The purpose of this amendment was to ensure that the allocation to the cigar class would – like all other classes already were – be based on excise taxes paid, thus eliminating the use of maximum per-cigar cap in the cigar class allocation. Congress rejected Swisher's proposed amendment.

32. Having acquired a clear understanding that the 2005 Regulations made class allocations based on current maximum FET rates from the *Swisher* litigation and multiple proposals to overturn this class allocation methodology, Congress then rejected proposed legislative changes to the 2005 Regulations. In fact, Congress specifically re-adopted the allocation methodologies set out in those regulations for purposes of the user fees imposed on the tobacco industry under the Family Smoking Prevention and Tobacco Control Act of 2009

("FSPTCA") (giving the Food and Drug Administration authority to regulate tobacco products). *See* 21 U.S.C. § 387s(b)(2)(B)(ii).

- Congress considered various other methods for allocating the user fees among and within classes, as well as several proposals by members of the industry to modify the class allocation provisions of the 2005 Regulations for purposes of the new FSPTCA user fees. One of those proposals would have required the class allocations to be made using the pre-CHIPRA tax rates. Congress rejected that proposal.
- All such proposals to modify the FETRA class allocation methodology were rejected, and Congress instead adopted the class allocation methods then being applied by USDA under the 2005 Regulations. *See* H.R. Rep. No. 111-58, at 47 ("The method of assessing fees shall be the same as that currently used by" the Defendants to assess payments under FETRA.).

33. These actions by Congress, especially when it was adjusting the maximum FET rates under CHIPRA and rejecting efforts to prevent the Defendants from continuing to use the current maximum FET rates to calculate tobacco class allocations under FETRA, demonstrate that Congress intended the Defendants to use the maximum FET rates in effect in the year the tobacco removals occur.

34. The class allocation provisions of the 2005 Regulations, having been ratified and re-adopted by Congress as originally promulgated, therefore are controlling and cannot legally be changed through subsequent regulatory amendment. As a result, the Defendants violated FETRA when they issued their regulatory amendment because the amendment is contrary to that congressional intent. The 2005 Regulations, as written and in effect at the time re-adopted by

Congress in connection with the FSPTCA, cannot be read to permit the use of FET rates other than those currently in effect.

H. **The Plaintiff Has Been Injured by the Defendants' Unlawful Actions**

35. After the Defendants issued their regulatory amendment, the Plaintiff's representatives met with the Defendants' representatives and asked them to withdraw the regulatory amendment and to reinstate the 2005 Regulations. The Defendants refused and advised that the preliminary class allocations they posted on their website before issuing the regulatory amendment reflect the methodology that will be used to make the final class allocations, payment for which will be due from the Plaintiff under FETRA on or before March 31, 2011, and in subsequent quarters through fourth quarter 2014. Using the post-CHIPRA FET rates now in effect, as was required under the 2005 Regulations, the Plaintiff would have had to pay a significantly lower share than it will have to pay under the regulatory amendment, which requires the Defendants to use the pre-CHIPRA FET rates that are no longer in effect. Unless the regulatory amendment is withdrawn or rejected, the Plaintiff will continue to have to pay unlawfully higher shares each year until the TTPP ends in 2014.

36. Likewise, because the annual user fees imposed under the FSPTCA are based on the class allocation shares calculated under FETRA, *see* 21 U.S.C. § 387s(b)(2)(B)(ii), the Plaintiff was assessed and paid before December 31, 2010, greater user fees to FDA than it would have paid under USDA's methodology in the 2005 Regulations. The amount of the Plaintiff's increased FSPTCA assessments resulting from the regulatory amendment was in excess of $500,000. Unless the methodology reflected in the regulatory amendment is withdrawn, rejected, or later changed, the Plaintiff will continue to have to pay each year substantially higher FSPTCA user fees. Unlike TTPP assessments under FETRA, which end in 2014, the assessment and payment of user fees under the FSPTCA have no end date.

Causes of Action

Count I

The Defendants' Regulatory Amendment Violates FETRA

37. The Plaintiff incorporates and realleges here the foregoing paragraphs.

38. Congress intended the tobacco class allocation shares under FETRA to be calculated using the FET rates in effect in the year in which the relevant tobacco removals occurred.

39. The regulatory amendment does not do that.

40. Therefore, the regulatory amendment violates FETRA.

Count II

The Defendants' Action in Promulgating the Regulatory Amendment is Ultra Vires

41. The Plaintiff incorporates and realleges here the foregoing paragraphs.

42. Congress required the Defendants to calculate the tobacco class allocation shares under FETRA using the FET rates in effect in the year in which the relevant tobacco removals occurred.

43. The regulatory amendment issued by the Defendants does not do that.

44. Therefore, the Defendants lacked the authority to issue the regulatory amendment, and the amendment is ultra vires and unenforceable.

Count III

The Defendants' Regulatory Amendment is Arbitrary and Capricious, an Abuse of Discretion, and Contrary to Law

45. The Plaintiff incorporates and realleges here the foregoing paragraphs.

46. Congress intended the tobacco class allocation shares under FETRA to be calculated using the FET rates in effect in the year in which the relevant tobacco removals occurred.

47. The Defendants' regulatory amendment does not do that.

48. Therefore, that regulatory amendment is arbitrary and capricious, an abuse of discretion, and contrary to law.

Prayer for Relief

WHEREFORE, for the foregoing reasons, the Plaintiff respectfully asks this Court for the following relief.

A. Declare that the Defendants' regulatory amendment to the 2005 Regulations is a substantive rulemaking, rather than a mere technical clarification.

B. Declare that the Defendants' regulatory amendment violates FETRA, was issued without congressional authority, and is otherwise arbitrary and capricious, an abuse of discretion, or contrary to law.

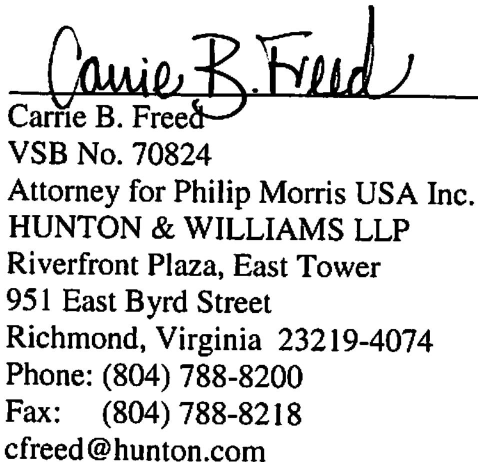
C. Vacate and remand the Defendants' regulatory amendment with instructions to the Defendants to apply their 2005 Regulations as originally written and to calculate changes in shares for class allocation purposes using the excise tax rates currently in effect and not the rates that were in effect in the past.

D. Order the Defendants to credit to PM USA (against payment of future FETRA assessments) any monies paid in excess of PM USA's rightful FETRA assessment.

E. Declare that the user fees the Plaintiff paid under the FSPTCA using the regulatory amendment's methodology for calculating those fees are in excess of PM USA's rightful obligation under the FSPTCA and that such excess amount should be credited against the Plaintiff's future user fee obligations.

F. Grant such other and further relief as this Court shall find just and proper.

Respectfully submitted this 8th day of February, 2011.



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