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REPORT FROM THE COMMISSION TO THE COUNCIL
**on Directive 2011/64/EU on the structure and rates of excise duty applied to
manufactured tobacco**

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1) Introduction

On 8 March 2016, the Council (ECOFIN) requested the European Commission to undertake the necessary studies to submit a legislative proposal for revision of Directive 2011/64/EU of 21 July 2011 on the structure and rates of excise duty applied to manufactured tobacco.^{1, 2} In the event that the Commission decided not to submit a proposal, the Council requested to be informed of the reasons for this decision. This report presents the results and conclusions of an external study on this subject and sets out the reasons why the Commission has decided to not submit a proposal for revision of Directive 2011/64/EU at this moment in time.³

2) Background

Directive 2011/64/EU sets out harmonised rules at EU level on the structure and rates of excise duty applied to manufactured tobacco. In particular, it defines and classifies various manufactured tobacco products covered by the Directive according to their characteristics. The structure of the excise duties for the different types of products is also established in this Directive. The Directive was identified for evaluation under the Commission's Regulatory Fitness and Performance Programme (REFIT).⁴ An external evaluation of this Directive was finalized in 2014 and was followed by a Commission Report presenting the results and conclusions of the evaluation in 2015.⁵ This report was discussed by Member States in the Council (ECOFIN) and a set of conclusions on future action in this area was adopted on 8 March 2016. In order to comply with the request of the Council contained in these conclusions, the Commission started the preparation of an impact assessment and contracted an external consultant to carry out a study for this purpose. The object of the study was to contribute to the impact assessment for a possible revision of Directive 2011/64/EU. The issues analysed were among those identified in the evaluation carried out in 2014.

3) Issues and findings

¹ Council conclusions on the structure and rates of excise duty applied to manufactured tobacco, 8 March 2016 <http://www.consilium.europa.eu/en/press/press-releases/2016/03/08-ecofin-conclusions-structure-rates-manufactured-tobacco/>

² Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco

³ The external study is published on the website of the Directorate-General for Taxation and Customs Union: https://ec.europa.eu/taxation_customs/publications/studies-made-commission_en.

⁴ REFIT is a programme to review the entire stock of EU legislation – to identify burdens, inconsistencies, gaps or ineffective measures and to make the necessary proposals to follow up on the findings of the review.

⁵ TAXUD/2012/DE/341, Specific contract No4 under FWC TAXUD/2012/CC116, "Study on the measuring and reducing of administrative costs for economic operators and tax authorities and obtaining in parallel a higher level of compliance and security in imposing excise duties on tobacco products"

COM(2015) 621 final "REPORT FROM THE COMMISSION TO THE COUNCIL on the REFIT evaluation of Directive 2011/64/EU and on the structure and rates of excise duty applied to manufactured tobacco"

The external study on the possible revision of Directive 2011/64/EU focussed on six areas. The main issues analysed and the findings of the external study are summarized below.

a) Harmonisation of the tax treatment of novel products such as electronic cigarettes at EU level

E-cigarettes

E-cigarettes are currently not covered by the tobacco excise duty directive. Member States may apply a national tax to e-cigarettes as they find fit under their own rules. At present nine Member States tax e-cigarettes under national rules and a few more are reported to be considering it.⁶ These different tax treatments might distort the functioning of the internal market.

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. Therefore, from a health perspective a cautious approach should be adopted towards a potential harmonized taxation of e-cigarettes. The hypothetical excise duty loss caused by substitution between traditional cigarettes and novel products including e-cigarettes is estimated to be less than 2.5 % (EUR 2 billion) of the total revenue of excise duty on cigarettes. A positive tax rate might contribute approximately to EUR 0.3 – 0.5 billion to the budgets of Member States, although enforcement difficulties are expected. These figures have to be taken with great caution because the full effects of the rules of the Tobacco Products Directive, which entered into force on 20 May 2016, particularly on smaller producers, are still unknown.⁷ The Tobacco Products Directive covers a broader range of products than Directive 2011/64/EU, including smokeless tobacco, herbal products for smoking, and in particular e- cigarettes and their refill containers. The Tobacco Products Directive introduced, among others, specific requirements for the packaging, labelling, safety, monitoring and reporting of e-cigarettes.

The Commission supports the recommendation of the external study to adopt a multi-phased approach, starting with collecting accurate data to fill the information gap. Compiling a robust information or evidence base is an essential component of better policy making. The data currently available does not provide sufficient evidence to support a proposal for a harmonized approach for taxation of e-cigarettes. The Commission expects that more data will become available as a result of the obligations under article 20 of the Tobacco Products Directive and has decided therefore to revisit the issue in the context of a REFIT evaluation and the next regular report on tobacco taxation due in 2019 pursuant to the obligation laid down in article 19 of Directive 2011/64/EU. By that time, it is expected that the effects of the requirements of the Tobacco Products Directive on the e-cigarette market will also be known better.

Heat-Not-Burn tobacco products

⁶ Italy, Portugal, Romania, Slovenia, Latvia, Hungary, Finland, Greece and Croatia

⁷ DIRECTIVE 2014/40/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 3 April 2014 on the approximation of the laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco and related products and repealing Directive 2001/37/EC

The study has revealed that by 2016, the Heat-Not-Burn tobacco products have been subject to large-scale commercialisation in a limited number of Member States only. At present, Member States have different approaches towards the tax treatment of these products, varying from taxation at the same rate as smoking tobacco under the current directive (Croatia, Germany, Greece, Latvia, the Netherlands, Slovakia, Slovenia, Romania and United Kingdom) to taxation at a different level on a national basis (Italy, Portugal, Hungary). These different tax treatments have the potential to distort the functioning of the internal market.

Moreover, many Member States have not decided on a fiscal regime, simply because the products are not sold on their market. Heat-Not-Burn tobacco products are currently used by less than half a million people across the EU and substitution with traditional tobacco products has been found to be negligible.

The Commission is of the opinion that, 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. Some of these products are already, albeit indirectly, covered by the directive because they contain tobacco. In the Commission's view, a possible treatment of these products would be to tax them at the same rate as smoking tobacco under the directive. Again, the Commission has decided to revisit this issue with the next REFIT evaluation and report on tobacco taxation due under article 19 of Directive [2011/64/EU](#).

b) Illicit trade in raw tobacco

Raw tobacco currently does not come within the scope of excisable goods as defined in Directive [2011/64/EU](#). During the evaluation in 2014, it was reported that raw tobacco was being diverted to the illicit circuit. This is because diverting raw tobacco to the illicit circuit could be an easier option compared to manufactured tobacco products because monitoring tools such as the Excise Movement and Control System (EMCS) are not used to monitor movements of raw tobacco. Illicit trade in raw tobacco is estimated at approximately 10 000 tonnes per year, about 1 % of the EU raw tobacco market. If cigarettes were produced from this amount of raw tobacco, this could cause a tax evasion between EUR 1 and 2 billion, amounting to 1.6 to 2.7 % of the current revenues from cigarettes.

Including raw tobacco in the scope of excisable goods would enhance control but would also impose administrative and compliance costs on all legitimate operators. These costs are high compared to the value of production; about 35 % of the market price of EU raw tobacco. Compared to the overall EU raw tobacco market, these costs would represent about 8 % of its value. This would lead to loss of competitiveness of EU-grown tobacco compared to imported tobacco. The regulatory costs consist of setting up and receiving authorisation to operate a tax warehouse and setting up and moving goods under the EMCS system. This would give an advantage to growers and first processors outside the EU which would not have to bear these costs but could still export (raw) tobacco to the EU. Moreover, the amount of tax evaded that might possibly be recovered as a result of EMCS monitoring is unlikely to outweigh the administrative and compliance costs incurred by economic operators and, to a lesser extent, public authorities.

The Commission would therefore support the recommendation of the external study which concludes that including raw tobacco in the scope of excisable goods would be disproportionate and that similar

benefits might be achievable at lower costs by a common regulatory framework for growers and first processors in the EU. Some Member States have already introduced a national regulatory framework which requires economic operators to register and keep records of stocks and the flows of raw tobacco.

c) Tax-induced substitution of cigarettes by low-price cigarillos

The minimum excise duty rate applicable to the category of "cigars and cigarillos" is lower than for cigarettes. Borderline cigarillos have characteristics similar to cigarettes but can be sold for a lower price because they are classified as cigarillos and benefit from a more favourable tax treatment. Such borderline products might cause a reduction of revenue, distortion of competition and undermine tobacco-control policies.

The study found, however, that tax-induced substitution of cigarettes by borderline cigarillos had significantly declined due to the entry into force on 1 January 2015 of a revised definition of the category "cigars and cigarillos" in the directive and the consequential adoption of appropriate tax structures by Member States.⁸

Therefore the Commission supports the recommendation of the external study that there is little rationale for further action on this matter at EU level. Moreover, the directive allows Member States to develop a tax structure reducing the incentive for low-price cigarillos which are competing with cigarettes. Member States could for example introduce or increase specific taxes or a minimum excise duty for this product category.

d) Tax-induced substitution of cigarettes by fine-cut tobacco

The minimum excise duty rate applicable to fine-cut smoking tobacco is lower than for cigarettes. The difference in the tax level could act as an incentive for substitution of cigarettes by fine-cut tobacco, leading to revenue losses and undermining tobacco-control policies. As expressed in the recitals of Directive 2011/64/EU, it was found desirable to bring the minimum levels for fine-cut tobacco closer to the minimum levels applicable to cigarettes, taking into account competition and the equally harmful character of both products. Fine-cut tobacco is largely a substitute for cigarettes and currently counts for almost 20 % of total tobacco consumption. In the directive, gradual increases are still foreseen for fine-cut tobacco in 2018 and 2020 to bring the overall minimum rates closer to the rates for cigarettes. The fine-cut tobacco market had been growing between 2006 and 2012 and then stabilized between 2013 and 2016 in the EU due to adjustment of tax policies and market saturation. Various scenarios have been considered in the study which could mitigate the incentive for substitution. Effects largely diverge, depending on the scenario and also between Member States. Given the large share of SMEs in the fine-cut tobacco market, any decline would have proportionally a larger impact on SMEs compared to big tobacco companies.

⁸ See also the derogation for DE and HU until 31 December 2014 in article 4 (2) of Directive 2011/64/EU

Most Member States already tax fine-cut tobacco well above the overall minimum rate. A change to the minimum rate would therefore have little effect in this regard, particularly as in a few cases, the tax rates applicable to fine-cut tobacco and cigarettes have already been aligned. A greater impact might be expected if Member States were to 'peg' the tax treatment of fine-cut tobacco to cigarettes. To this end, it should be noted that the directive neither prevents Member States from aligning the rates of fine-cut tobacco and cigarettes nor from 'pegging' the rates of these product categories. The directive is silent on these points thereby allowing Member States to decide on appropriate measure to address substitution of cigarettes by fine-cut tobacco. In view of the freedom the directive leaves Member and the visible stabilization of the market, the Commission is of the opinion that, in line with the external study, further action at EU level would have no obvious added value.

e) Illicit trade in water-pipe tobacco

Water-pipe tobacco is currently classified as 'other smoking tobacco' in Directive [2011/64/EU](#). It appears that water-pipe tobacco has experienced a high level of illicit trade. Data on water-pipe tobacco is scarce, but it would seem that most of these products are imported. Overall consumption in the EU is estimated to be at 5 000 tonnes per year, of which two-third is estimated to be non-duty paid. Although significant in proportional terms, water-pipe tobacco remains a niche product in absolute terms as compared to other products. A separate product category would allow Member States to tax water-pipe tobacco at a different level from 'other smoking tobacco'. However, while a separate category for water-pipe tobacco and an adjusted lower rate could be beneficial in eliminating the incentive for illicit trade, more favourable rates could act as an incentive for the development of further borderline products. In line with the external study, the Commission is of the opinion that the available data is too limited and unreliable to support a major tax reform such as the introduction of a separate category for water-pipe tobacco at the present time.

f) Minimum Excise Duty on cigarettes

The directive allows Member States to set a "tax floor", also known as a Minimum Excise Duty, provided that the overall mixed structure is respected. No specific method of calculation of this Minimum Excise Duty is provided in the directive. However, both economic operators liable to pay the excise duty and tax administrations indicated in the study that the Minimum Excise Duty works well. The room for application of the rules given by the directive is appreciated by Member States because it enhances the flexibility they have in achieving the objectives of the Minimum Excise Duty. At the same time, in light of the various technical terms used in the directive which could lead to confusion concerning the calculation of Minimum Excise Duty, a clarification may become necessary to allow Member States to make use of this provision against low price cigarettes in a more efficient manner.

4) Conclusion and way forward

In this report the Commission has explained the reasons why no proposal to revise or amend Directive 2011/64/EU will be tabled in 2017. The main reasons are the lack of data necessary to underpin a proposal for harmonized taxation of e-cigarettes and the fact that some issues identified in the evaluation of 2014 have since been solved at national level or have been settled. The question whether there is a need to propose a harmonized explicit category for e-cigarettes and Heat-not-Burn tobacco products will be re-considered in the context of the next REFIT evaluation and report on the directive due in 2019.

The REFIT evaluation will cover the outstanding issues which the external study could not conclude on including e-cigarettes and Heat-Not-Burn tobacco products. It is expected that more information will become available from, among other sources, the reporting obligation under article 20 of the Tobacco Products Directive. The Commission will therefore continue to monitor the developments related to e-cigarettes and Heat-Not-Burn tobacco products.

Finally, the Commission considers that a review of the minimum rates applicable under the Directive should also take place in parallel with the REFIT evaluation. According to Article 19, paragraph 1 of Directive 2011/64/EU the Commission is required to submit a report on the rates and structure of excise duty laid down in this Directive every four years. The last report was submitted in 2015 and the next report will be due in 2019. In the last evaluation finalized in 2014, minimum rates were not examined because some of the current transitional periods had not yet ended and not all increases had entered into force. Currently almost all Member States, except Bulgaria, Hungary and Romania, have reached the overall minimum rates. By 2019, when the next report and possible revision are due, it will have been almost 10 years since the current minimum rates were approved and no correction for the effects of inflation has been applied. In an annex to the Council Conclusions of 8 March 2016, five Member States supported the conclusion that the work on a future revision of the minimum rates should be started without delay.⁹ Moreover, bearing in mind the serious harm to health of tobacco products, it should be taken into account that article 168 of the Treaty on the functioning of the EU requires a high protection of public health and that the EU is a party to the Framework Convention on Tobacco Control (FCTC). For these reasons, the Commission now believes that the examination of the need to increase minimum rates should also take place in parallel with the REFIT evaluation. Therefore, the Commission will start the evaluation of the minimum rates in 2018.

⁹ Austria, Ireland, Finland, France and Sweden