



HM Treasury

# Tax treatment of heated tobacco products: response to the consultation

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# Chapter 1

## Introduction

- 1.1 At Budget 2016, the government announced it would consult on the tax treatment of heated tobacco products. These are a new type of tobacco product and do not include e-cigarettes. E-cigarettes do not contain tobacco and are therefore not liable for tobacco duty.
- 1.2 A consultation setting out the case for change, the current rules and the rationale for potential changes to the tobacco duty regime in response to the development of heated tobacco products was published on 20 March 2017. The consultation closed on 12 June 2017.
- 1.3 A total of 31 responses were received. The largest group of respondents were tobacco companies and retailers (52%). Other respondents comprised public health bodies (35%) and trade bodies (13%).
- 1.4 Over 60% of all respondents were in favour of changes to the duty regime on heated tobacco products. Public health bodies who responded were all supportive of the proposals. Manufacturers and trade bodies were split with 50% in favour and 50% against.
- 1.5 The responses to the consultation and the government's conclusions are set out in the following chapter.

## Background

- 1.6 Heated tobacco (also known as heat-not-burn) products are a recent innovation in the tobacco market. In these products, processed tobacco is heated, but not burned as it is in conventional tobacco products.
- 1.7 There are a few different ways that this can be achieved, however, all products use tobacco to either produce or flavour vapour which is then inhaled by the consumer. Unlike e-cigarettes, heated tobacco products contain tobacco. E-cigarettes were not in the scope of the consultation.
- 1.8 The rules for calculating the amount of excise duty due on tobacco products are laid out in the Tobacco Products Duty Act 1979. Definitions of the products liable to pay duty are detailed in the Tobacco Products (Descriptions of Products) Order 2003.
- 1.9 Under current rules, there are five classifications of products which attract differing levels of tobacco duty:
  - cigarettes
  - cigars

- hand-rolling tobacco (HRT)
- other smoking tobacco (OST)
- chewing tobacco

1.10 While these classifications capture tobacco designed for smoking, they do not specifically capture smokeless products (apart from chewing tobacco). At present, there are only a very small number of heated tobacco products on the market and HMRC assess these on a case-by-case basis to determine the appropriate liability for tobacco products duty.

1.11 Assessing products on a case-by-case basis will not be efficient in the long term, particularly if the number of products on the market increases. Introducing a new category would give certainty to consumers and producers about the duty heated tobacco products are liable for, reduce complexity in the duty system and ensure that products are captured efficiently. Having a clear definition that captures the full range of heated tobacco will also mean that there is less incentive for manufacturers to attempt to reduce their duty liability by producing products which do not clearly fall within an existing category.

# Chapter 2

## Summary of responses

**Q1: Is introducing a new category in the Tobacco Products Duty Act 1979 the best way to capture heated tobacco products for duty purposes? If not, how should heated tobacco products be captured?**

- 2.1 Two thirds of respondents said that introducing a new category is the best way to capture heated tobacco products for duty purposes.
- 2.2 The majority of respondents who responded commented that heated tobacco products are new and novel and that a new category would distinguish them from traditional tobacco products and avoid confusion with existing categories in the future.
- 2.3 One third of respondents disagreed about the need for a new category on the basis that heated tobacco products are a substitute for cigarettes and should be treated as cigarettes for duty purposes.

### Government response

- 2.4 The government agrees with the majority of respondents that a new category is the best way to capture heated tobacco products for duty purposes. This will ensure the efficiency and effectiveness of the duty regime will be maintained and give certainty to manufacturers and consumers about the duty treatment of heated tobacco products.

### Definition

- 2.5 The government is aware of three broad types of heated tobacco products:
  - processed tobacco heated directly to produce vapour
  - processed tobacco designed to be heated in a vapouriser
  - devices that produce vapour from non-tobacco sources, where the vapour is then passed over processed tobacco to flavour the vapour

**Q2: Are you aware of any current, or planned, heated tobacco products which would not fit into these categories?**

- 2.6 The respondents that support the creation of a new category were not aware of any current or planned heated tobacco products that would not fit into these categories.
- 2.7 Several respondents said that it is difficult to predict how heated tobacco products will evolve and that the proposed new category should have a degree of flexibility. In addition, any definition should include a clear

reference to the delivery of vapour by heating tobacco without the combustion of the tobacco mixture.

2.8 Based on these product types, the government sought views on whether a definition of heated tobacco for duty purposes should be based around the following criteria:

- is not cigarettes, cigars, hand-rolling tobacco, or chewing tobacco
- consists of or includes tobacco
- has been prepared to produce or flavour vapour
- has not been prepared for use in a water pipe

**Q3: Do these criteria accurately define and capture both current and planned heated tobacco products? Are there any criteria which should not be included in a definition?**

**Q4: Are there any products other than heated tobacco products that could be captured by this definition?**

2.9 There was consensus among two thirds of respondents that the proposed criteria are appropriate and capture current and planned heated tobacco products.

2.10 The majority of respondents were not aware of any other products that could be captured by this definition but a number suggested the definition is kept under review as products continue to evolve.

2.11 The one third of respondents who disagreed about the need for a new category said that the criteria saying it is not a cigarette is incorrect as in their view it is a substitute for cigarettes and should be treated the same for duty purposes.

## **Government response**

2.12 The government notes the view of the majority of respondents that the proposed criteria are appropriate and will capture current and planned heated tobacco products. Since e-cigarettes do not contain tobacco and are outside the duty regime the government does not see the need to include a provision on non-nicotine and nicotine-containing e-cigarettes.

2.13 The government is aware that, depending on the duty rates, there could be an advantage to designing products that are defined as heated tobacco products but could be smoked. The government restates the point that if a product is capable of being smoked without further industrial processing it would likely fall within the existing duty categories.

**Q5: What would be an appropriate maximum size for a heated tobacco capsule? Would it be appropriate for the maximum size to be based on the weight of the tobacco?**

2.14 A number of respondents said that it would not be appropriate to have any size restrictions for a heated tobacco capsule as it may restrict innovation and create entry barriers in a new market.

- 2.15 Those respondents who saw heated tobacco products as direct competitors to cigarettes generally thought that the weight of tobacco in an individual capsule should not exceed that in a cigarette.
- 2.16 Manufacturers generally disagreed with the requirement for a heated tobacco product to be encapsulated, as encapsulation does not affect their essential nature as a heated tobacco product.

**Q6: Alternatively, are there any objective, technical or scientific criteria that differentiate heated tobacco from conventional tobacco for smoking?**

- 2.17 There was consensus among those who responded that the only differences were those identified within the consultation document: that the tobacco is intended to be heated, not combusted.

**Q7: Are there any other criteria that the government should consider including in the definition?**

- 2.18 Eight respondents of those that responded said that they do not think there are any other criteria beyond those set out in the consultation.
- 2.19 Six respondents of those who responded said that it is the absence of combustion which differentiates heated tobacco products from conventional products. A number of respondents said that standards should be established to verify the absence of combustion.
- 2.20 A number of respondents said that the intended use of the tobacco should be captured in the definition, while some noted that as it is a new and innovative product it would be unwise to include technical or scientific criteria to differentiate heated tobacco products from conventional products.

**Q8: Are there any consumer or product-based incentives for manufacturers to develop products outside of these categories?**

- 2.21 One respondent said that future evolution will be driven by advances in technology and scientific research and development, while another said that there will be an ongoing incentive for manufacturers to develop further products due to increasing competition in developing non-combustible alternatives.
- 2.22 Six respondents who responded said that there is a strong incentive for manufacturers to develop reduced harm products due to the continuing decline of the traditional tobacco market.

**Government response**

- 2.23 The government is grateful for the views expressed in response to these questions and has decided to amend the criteria in the consultation document for what must be met for tobacco to be heated tobacco. The amended criteria are:
- is not cigarettes, cigars, hand-rolling tobacco, other smoking tobacco, or chewing tobacco
  - consists of or includes tobacco

- has been manufactured as an insert for exclusive use in a device designed to produce vapour without combustion

2.24 The government has decided to remove the requirement for the tobacco to be encapsulated but will consider how the use of such products should be restricted to heated tobacco devices.

2.25 The government has removed the separate carve-out for water pipes as it is understood from further information that when prepared for use in a water pipe the tobacco product would be capable of being smoked and so would not meet the other criteria.

**Q9: Would a smokeless tobacco category be a better way to capture heated tobacco products? If so, how should smokeless be defined?**

2.26 The majority of respondents who responded said that a smokeless category would not be a better way to capture heated tobacco products. Some noted that smokeless tobacco products are chewed, sucked or sniffed to achieve nicotine absorption, while heated tobacco products are designed to produce a vapour.

2.27 Two respondents said that a smokeless category would risk capturing non-novel smokeless products and e-cigarettes.

2.28 Six respondents said that it is not possible to define smokeless as heated tobacco products still produce a vapour in the same way as cigarettes when heated.

**Q10: Are there any wider implications of introducing a smokeless tobacco category which the government should consider, for instance on other types of tobacco?**

2.29 There was consensus among the majority of respondents against a smokeless category being introduced.

2.30 Six respondents noted the UK treats different types of smokeless tobacco very differently, with some such as nasal snuff not subject to duty, and would like these distinctions to be maintained.

2.31 Two respondents said that the government would need to consider the risk of capturing other tobacco products that are not heated tobacco products but are also consumed without combustion.

2.32 One respondent said that creating this category, particularly if it attracted a substantially lower duty than other categories, would create an implicit incentive for tobacco companies to introduce new smokeless products.

**Government response**

2.33 The government agrees that a smokeless category would not be a better way to capture heated tobacco products. Since this type of category would be too broadly defined to capture heated tobacco products specifically, the government will therefore not introduce a smokeless category but will keep it under review in the context of future product innovation.

**Q11: Do you agree that a heated tobacco duty category should only capture the tobacco capsule used in devices, rather than devices themselves?**

- 2.34 All respondents agreed that for duty purposes the category should capture the tobacco used in the devices, rather than the devices themselves with a number noting this would be consistent with pipe tobacco.

## **Duty calculation**

**Q12: Do you agree that weight is the best way to calculate the duty on heated tobacco?**

- 2.35 The majority of respondents agreed that weight is the best way to calculate duty on heated tobacco products.
- 2.36 Seven respondents said that heated tobacco products are a substitute for cigarettes, and should be treated in the same way as cigarettes for duty purposes.

**Q13: If the duty on heated tobacco is levied based on weight, how should the duty be calculated: the weight of the total capsule, the weight of the capsule contents, or the weight of the tobacco?**

- 2.37 The majority of respondents said it should be the weight of the tobacco in use. Some commented that it is not difficult, in practical terms, to measure the amount of tobacco in use in any heated tobacco product as the base for the duty.
- 2.38 A number of respondents said that the duty should be based on the total capsule so it is the same as cigarettes, which include the weight of the filter and paper.

**Q14: Are there any other factors that the government should consider in deciding the regime for calculating the duty on heated tobacco products?**

- 2.39 The majority of respondents who responded were not aware of any other factors that the government should consider.
- 2.40 It was noted by a respondent that the regime for calculating duty should be sufficiently robust to cover both present and future product designs, to minimise the risk of 'loophole' products appearing. Another respondent noted the risk of revenue loss if the category grows and the duty regime is not effective, commenting that a precautionary approach should be taken until more independent evidence is available.

## **Government response**

- 2.41 The government notes the consensus among respondents that weight is the best way to calculate the duty on heated tobacco products.
- 2.42 The government has therefore decided that the duty on heated tobacco should be calculated based on weight as this will provide flexibility and ensure that the duty will be based on the amount of tobacco in the product.

## **Administration**

**Q15: Would there be any difficulties administering the regime in this way?**

- 2.43 The majority of respondents who responded said that the current system for collecting duty is tried and tested and works well for other tobacco products. None of the respondents were aware of any difficulties in collecting the duty through the same form as the existing duty return.

**Q16: Are there any other administrative issues which the government should consider?**

- 2.44 The majority of respondents who responded were not aware of any other administrative issues.
- 2.45 One respondent commented that the revenue would be low from this category as a limited number of manufacturers have introduced heated tobacco products but acknowledged it is an evolving category.
- 2.46 Eight respondents said that heated tobacco products should be subject to the track and trace regime required under Articles 15 and 16 of the revised EU Tobacco Products Directive.
- 2.47 Respondents who disagreed about the need for a new category on the basis that heated tobacco products are a substitute for cigarettes said it would create an extra administrative burden.

**Government response**

- 2.48 The government is grateful to the answers to these questions confirming there will be no difficulties administering the regime in the same way as other tobacco duties.

**Duty Rate**

**Q17: Are there any other factors the government should consider when setting the duty rate?**

- 2.49 One respondent of those who responded said there is a risk of setting a duty rate that encourages the illicit trade and suggested rates are set at an equivalent level to neighbouring countries. Another said that the rate should be set pragmatically and lower than cigarettes due to uncertainties around the growth potential and to support innovation.
- 2.50 Nine respondents said that the duty rate should be set at a level that reflects evidence of relative harm informed by independent evidence, which should allow flexibility for the future level when evidence becomes more robust.
- 2.51 One respondent said that while it is likely that heated tobacco products will be less harmful to health than smoked tobacco, it would not be appropriate to create a strong incentive to use these products by charging them a much lower rate of duty than other forms of tobacco.

**Government response**

- 2.52 The government notes the answers to this question and will consider them when determining the duty rate. The duty rate will be announced at Budget on the same basis as other tobacco products. The government will also consider products already on the market paying duty under the current rules.

## Future evolution

**Q18: Thinking about the UK in particular, what is the current size of the market for heated tobacco products (in terms of units sold and amount of tobacco per unit)? How do you expect this will develop over time?**

- 2.53 A number of respondents said they do not know the current size of the UK market, and it is too early to assess it, as it is a new and innovative sector, however they expect there will be a large increase in the size of the market over time as a large amount of money is being invested in these products.
- 2.54 It was noted by some respondents the UK market is evolving and research is needed to monitor the progression of the market.

**Q19: For products not currently on sale in the UK, do you have any data on sales or market shares for international sales? How has this changed over time, and how do you expect it to change in the future?**

- 2.55 Six respondents said that they do not have any data on sales or market shares for international sales, but expect the worldwide market for heated tobacco products to increase considerably because manufacturers are investing a large amount of money into their development.
- 2.56 A number of respondents noted that one heated tobacco product already has substantial, and rapidly growing, sales in Japan. These were estimated most recently at 5.5% of the cigarette market, but Japan has a very different market environment from the UK. It was expected that the number of such products and the number of users in the UK market will grow, but that market growth in the early years is likely to be slow (as was the case with e-cigarettes).
- 2.57 One respondent said that they launched a heated tobacco product in key cities in 25 countries worldwide. They estimate that more than 2 million adult smokers globally have quit cigarettes and converted to the product. For example, in Italy, Switzerland and Portugal, their national share reached 0.5%, 0.9% and 0.4%, respectively, in the first quarter of 2017.

## Q20

**: Do you have any information on the users of heated tobacco products compared to conventional tobacco users?**

- 2.58 The majority of respondents who responded said that as these products are very new no worthwhile data is currently available.
- 2.59 One respondent noted that a very high percentage of adult smokers who purchased their product either fully (more than 95% of their tobacco consumption) or predominantly (more than 70% of their tobacco consumption) convert. Their evidence suggested that a clear majority of consumers are those who have been, or still are, consumers of traditional tobacco products.
- 2.60 Seven respondents said that researchers recently began asking respondents to a smoking study about usage of heated tobacco products and found use to be low at less than 1% of past year smokers. However, the small number of respondents who report using heated tobacco products means it is not

possible to draw any conclusions on who the users are. It was noted that given the cost of devices users are likely to be more affluent.

### **Government response**

- 2.61 The government notes the information provided in answer to these questions and recognises that the market for heated tobacco products is relatively new and will evolve over time.

# Chapter 3

## Next steps

- 3.1 The government notes that the majority of respondents were in favour of introducing a new category and agrees that it is the best way to capture heated tobacco products for duty purposes.
- 3.2 The government has therefore decided to introduce a new category for heated tobacco products. This will maintain the efficiency and effectiveness of the duty regime and give certainty to manufacturers and consumers about the duty treatment of heated tobacco products.
- 3.3 The government is aware that, depending on the duty rates, there could be an advantage to designing products that were defined as heated tobacco products but could be smoked. It wishes to restate that if a product is capable of being smoked without further industrial processing it would likely fall within the existing duty categories.
- 3.4 The government is grateful for the views expressed in response to these questions and has decided to amend the criteria in the consultation document for what must be met for tobacco to be heated tobacco. The amended criteria are:
  - is not cigarettes, cigars, hand-rolling tobacco, other smoking tobacco, or chewing tobacco
  - consists of or includes tobacco
  - has been manufactured as an insert for exclusive use in a device designed to produce vapour without combustion
- 3.5 The government has decided to remove the requirement for the tobacco to be encapsulated but will consider how the use of such products should be restricted to heated tobacco devices.
- 3.6 The government has removed the separate carve-out for water pipes, based on further information that when prepared for use in a water pipe the tobacco product would be capable of being smoked and so would not meet the other criteria.
- 3.7 The duty on heated tobacco will be calculated based on the weight of the tobacco as this will provide flexibility and ensure that the duty will be based on the amount of tobacco in the product rather than the weight of the total capsule.
- 3.8 The government plans to publish draft legislation in summer 2018 for technical consultation and to legislate the change in Finance Bill 2018-19. The change will come into effect on Royal Assent.

# Annex A

## List of stakeholders consulted

Al Fakher Tobacco Factory

ASH and the UKCTAS

ASH Scotland

ASH Wales

Association of Convenience Stores

Association of Independent Tobacco Specialists

British American Tobacco

Cancer Research UK

Doncaster Council

Eaglecloud II Ltd

F Duckworth and Sons

Fontem Ventures

Fresh

Gawith Hoggarth

Havana House Bath

Havana House Hove

Havana House Windsor

Imperial Tobacco

Institute of Economic Affairs

Japan Tobacco International

North Yorkshire County Council

Philip Morris Limited

Royal College of Physicians of Edinburgh

Royal College of Physicians

Scottish Grocers' Federation

Smokefree Barnsley Tobacco Alliance

Tabac World Ltd

The Bear Shop Cardiff

The Black Swan Shoppe LTD

Tor Imports LTD

UK Health Forum

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