



STATE OPTIONS TO PREVENT AND REDUCE CIGARETTE SMUGGLING AND BLOCK OTHER ILLEGAL STATE TOBACCO TAX EVASION

To try to block or reduce state tobacco tax increases, the major U.S. cigarette companies regularly overstate the amount of cigarette smuggling and tax-avoidance prompted by differences among different states' cigarette tax rates. In fact, every state that has increased its cigarette tax rate significantly has enjoyed substantial revenue increases despite declining smoking levels and pack sales.¹ At the same time, recent research indicates that the highest-tax states could increase their tobacco tax revenues by five or ten percent if they implemented effective measures to reduce sharply both organized cigarette smuggling (which accounts for the majority of untaxed sales) and smoker tax avoidance.² New revenue aside, states should not tolerate illegal tobacco smuggling or any other tobacco-related crimes, especially if done by criminal organizations. Fortunately, there are a number of relatively simple and inexpensive measures that states could implement to minimize such smuggling and tobacco tax avoidance.

Measures to Make Smuggling & Tobacco Tax Avoidance More Difficult[†]

1. ***Improve state tobacco tax stamps.*** The few states that do not have tax stamps (NC, SC, and ND) should require them; and all states should take advantage of available new technologies to make their tax stamps larger, highly visible, easy to distinguish from other states' tax stamps, harder to counterfeit, and placed on two sides of the packages and under any cellophane wrapper – with the tax stamp coding providing information on each pack re what retailer or wholesaler originally purchased it from which distributor or manufacturer. California, for example, initiated new high-tech tax stamps and enjoyed a \$120 million boost to its cigarette tax revenues in the following 20 months.³ Tax stamps on non-cigarette tobacco products should also be established or improved. Tax stamps could also provide a phone number or email address for reporting suspected illegal sales, smuggling, or tax evasion, with rewards for tips that lead to arrests (and new stamps could also include a quitline phone number for smokers who want to quit).
2. ***Require State tax-exempt stamps on all cigarettes and other tobacco products sold in state that are not subject to the state's tobacco taxes.*** Require distributors selling cigarettes to Indian Tribes and others that make legal cigarette sales within the state's borders free from state tax to stamp those cigarettes with special state tax-exempt stamps – and to report all such sales, including amounts sold to whom, to state tax collection officials. The stamps could state “for legal tax-exempt sales only.” These stamps would make it more difficult to illegally divert tax-exempt cigarettes into non-tax-exempt sales and would provide state officials with important data on the extent of tax-exempt sales and illegal diversion within the state. Several states already have such tax-exempt stamping requirements.⁴
3. ***Forbid the sale, purchase, or possession in the state of any tobacco products that are not marked with state tobacco tax stamps or other state tax-payment indicia establishing that all applicable state tobacco taxes have already been paid – other than small personal-use amounts and those held by or transported between licensed cigarette manufacturers, distributor/wholesalers, retailers or other licensed tobacco product businesses.*** This catch-all

[†] U.S. interstate cigarette smuggling typically occurs when smugglers purchase cigarettes in a low-tax state or other low-tax or no-tax jurisdiction (such as Indian Tribal lands) and then illegally smuggle them into a high-tax state for illegal resale to otherwise-legal retailers. Otherwise legal retailers then purchase the cigarettes from the smugglers at prices that reflect the avoided state cigarette taxes, and the retailers subsequently sell the cigarettes to unknowing consumers. Through this process, the retailers and the smugglers, and not the smokers, enjoy the lion's share of the tax-avoidance “savings.” In some cases, the cigarettes smuggled from the low-tax jurisdiction are sold directly to final customers via black-market sales, but these black-market sales are quite small compared to the sales through otherwise legal retailers. Some smokers also avoid paying the cigarette tax in their state by purchasing their cigarettes in a nearby lower-tax state, from stores on nearby military bases or Indian Lands (which typically do not charge state taxes), or from the Internet (where sales of cigarettes from Tribal lands and low-tax states are common).

[†] Although many of these measures refer only to cigarettes, they could be applied to other tobacco products, as well.

requirement prohibits all sorts of cigarette smuggling and tax avoidance, mandates tax payments, and facilitates enforcement by establishing that any significant amount of tobacco products found in the state without the appropriate tax stamp or tax-payment indicia are illegal goods (unless in the possession of licensed tobacco product businesses or their delivery services).

4. **Require better record keeping by distributor/wholesalers.** Require distributors and wholesalers selling cigarettes to retailers (which, in turn, sell them to state residents) to keep and maintain records of amounts sold, to whom, tax-stamp status, etc., and to regularly provide this information to state officials.
5. **Require better record keeping by retailers.** Require all retailers that sell cigarettes in the state to keep and retain accurate records regarding: a) their receipt of cigarettes from others (including date, quantity, from whom received, etc.); b) their total cigarette sales in the state (with monthly totals); and c) their sale of any cigarettes in quantities exceeding 2,000 cigarettes, or 10 cartons (including date, quantity, description, to whom sold, etc.).
6. **Block retail sales clearly not for personal use.** Place a maximum sale amount of 2,000 cigarettes (10 cartons) for any single sale to a consumer in the state – with parallel limits for the sales of other tobacco products.
7. **Educate smokers about existing state laws restricting smuggling and tax avoidance.** Most states already have laws that prohibit state smokers from bringing more than two cartons of cigarettes (or some other maximum amount) into the state from any other jurisdiction (including nearby states, Tribal lands, military bases, and duty-free shops) – and states that do not have any such laws should pass them. While enforcing such laws is difficult, many smokers do not even know they exist – and some would stop going to other jurisdictions to buy cheaper cigarettes (or at least reduce the size of their purchases) if they did know about these laws. Similarly, many smokers do not know that it is against state law to avoid paying state cigarette taxes by purchasing them over the Internet from website sellers that do not collect or pay the tax owed to the state. To educate smokers about existing laws prohibiting tax avoidance the State could post the information on various state website pages, issue related press releases, run related public education announcements, and require retailers to post notices or include notices with each tobacco product sale they make. Making periodic highly publicized “stings” to catch some of the cross-border or Internet shoppers who are illegally evading the state cigarette tax might be an even more effective way to dampen many smokers’ enthusiasm for these tax avoidance strategies.
8. **Publicize toll-free hot lines to encourage reports of smuggling or tax-avoidance activities.** Require state-based wholesalers, distributors, importers, exporters, and retailers of tobacco products to post prominent signs that provide a toll-free number and email address for reporting anyone suspected of smuggling tobacco products or buying or selling smuggled tobacco products. These or other signs could also provide information on how to identify legal versus smuggled cigarettes, notify smokers and others of the existing laws and penalties re buying smuggled cigarettes, bringing cigarettes into the state from other jurisdictions, etc., and inform employees of existing whistleblower protections. The toll-free number could also be included on the state tax stamps placed on tobacco products.
9. **Protect “Whistleblowers.”** To encourage the reporting of smuggling activities and protect witnesses, states could pass laws to protect the employees of retailers, distributors, wholesalers, importers, exporters, manufacturers, and delivery services from being fired or otherwise penalized by their employers if the employee notifies authorities about their employers’ smuggling-related wrongdoing or testifies about it in court.
10. **Work with Neighboring States.** To increase each state’s cigarette tax revenues, groups of neighboring states can work together to make their cigarette tax rates equal or similar to each other’s (by the lower-tax states raising their rates) and can coordinate and expand their mutual efforts to minimize cigarette smuggling and other tax avoidance through new parallel state laws and coordinated enforcement efforts.

11. **Put pressure on the States with extremely low cigarette tax rates to raise them.** The average state cigarette tax is \$1.47 per pack, but Missouri has a tax rate of only 17 cents per pack, and low-tax states North Carolina, South Carolina, and North Dakota do not even put tax stamps on their cigarettes, making them even easier to smuggle and resell. Numerous other states also have rates way below the national average of over a dollar per pack. Cigarette tax increases in those states would help to dampen interstate cigarette smuggling by sharply reducing the available illegal profits. Similarly, very few Indian Tribes have their own Tribal tobacco taxes, and they should be encouraged to establish them (see the next item). States and Tribes with low or no taxes on other tobacco products should also be urged to establish or raise them.
12. **Enter into treaties with in-state Indian Tribes to eliminate tobacco product price disparities.** Some smokers and smugglers go onto Tribal lands to purchase cigarettes and other tobacco products free of any state taxes. To reduce this problem, some states have entered into special compacts or agreements with the Indian Tribes located within the states' borders whereby the Tribe agrees to collect the state's tax (or a similar Tribal tax) on all of cigarette or other tobacco product sales on the Tribe's lands (whether sold to Tribal members or nonmembers) – thereby making the Tribal prices comparable to the prices charged elsewhere in the state – and the state agrees that the Tribe can keep all of the revenues it raises from charging the state (or Tribal) tax. These kinds of state-Tribal agreements are necessary because, otherwise, when a Tribe establishes a Tribal cigarette tax it is legally required to collect that Tribal tax on top of any state cigarette tax in all sales to non-tribal members, which produces an odd double-taxation problem.⁵
13. **Support Federal Anti-Smuggling Legislation.** While each state can do a lot, the federal government can do more. Most notably, the federal government could require all states to put tax stamps on their cigarettes, thereby stopping the sale in some low-tax states of blank packs that can easily be used for smuggling – and could require special tax stamps or restricted-sale notices on all tobacco products sold free of state taxes on Indian reservations, military bases, and duty-free shops. The federal government can also create nationwide standards for tax stamps; cigarette labeling (e.g., requiring unique serial numbers or markings indicating where packs may be legally sold); record keeping by manufacturers, wholesalers, and retailers; maximum sales amounts; and the like.⁶ Federal legislation could also block tax-avoidance via Internet sales (see below).
14. **Coordinate enforcement with efforts to stop illegal sales to youth.** To qualify for federal grants to reduce substance abuse, each state must annually do compliance checks to confirm that less than 20 percent of all tobacco product retailers in the state are selling to youth. By also checking to make sure that the packs of cigarettes sold by the retailers in these youth-access compliance checks are legal cigarette packs on which all applicable state taxes have been paid, a state can greatly expand its efforts to identify those bad-apple retailers who are selling contraband cigarettes.

Special Measures to Stop Illegal Tax-Free Internet & Mail Order Sales of Cigarettes

The federal Jenkins Act requires all Internet sellers to provide each state with monthly reports listing state residents who have purchased cigarettes from the Internet sellers (including the quantities sold to each and the residents' mailing addresses), thereby enabling states to go after the in-state consumers to collect state taxes owed on the sales. The vast majority of Internet sellers, however, do not make the required Jenkins Act reports to the states, and federal officials rarely enforce the Act.⁷ Some states have marginally increased the Internet sellers' compliance rate simply by contacting them and demanding the reports, and a few states have initiated lawsuits against some Internet sellers to try to force compliance, but overall compliance rates remain low. While these state efforts could be expanded, they are ultimately of limited value given the large number of Internet sellers and the ability of customers to find non-complying vendors quickly and easily on the Internet. Even when Internet vendors comply with the Jenkins Act and provide the states with the customer information, going after each individual customer to

⁵ Retailers on Indian Lands are allowed to sell tobacco products to members of the same Tribe free of state tobacco taxes but are not allowed (unless expressly authorized by a state) to sell state-tax-free cigarettes to anyone who is not a Tribal member. However, a state's ability to take enforcement action against Indian Tribes that fail to collect and remit state taxes on sales to non-members of the Tribe are severely limited because of Indian Tribes' sovereign immunity (e.g., states cannot bring Tribes into state court to enforce state tax collection laws).

collect owed taxes is an inevitably time consuming and ineffective process. Accordingly, states that wish to minimize Internet-based tobacco tax evasion must go beyond trying to enforce the Jenkins Act and also establish more effective tax collection strategies.

- **Implement new State laws banning or restricting Internet tobacco product sales.** New York State has a law in place that prohibits Internet or mail order sales of cigarettes into the state – and the courts have upheld that law against cigarette company and Internet vendor attacks.⁸ To minimize Internet sales that avoid paying state taxes, a state could pass a ban similar to the New York law.⁹ Alternatively, a state could establish laws – such as those in Maine, California, Texas and other states – placing new requirements on all Internet and mail-order sales of any tobacco products to any state residents.¹⁰ To be effective, any such law must provide some way of interrupting illegal Internet sales without the state having to try to find and bring every one of the hundreds of active illegal internet sellers into court. The best way to do that is to block the illegal Internet sellers' deliveries to their customers in the state by instructing common carriers and other delivery services operating in the state not to make any deliveries for Internet sellers that are breaking state laws.¹¹
- **Support new federal laws to minimize Internet-based tobacco tax evasion.** As with smuggling in general, new federal laws can more effectively restrict Internet-based tobacco tax evasion than state laws because the federal government has nationwide authority, can restrict interstate commerce in ways that states cannot, and can restrict U.S. Postal Service deliveries of illegally sold or contraband tobacco products. One new effective federal law that will reduce tobacco tax evasion by restricting Internet tobacco product sales and strengthening other federal laws against contraband tobacco products is the Prevent All Cigarette Trafficking Act (PACT Act), which became effective in June 2010. The PACT Act creates a more level playing field and reduce the unfair cost and price advantage of Internet tobacco product sellers (which underlies Internet-based tax evasion), by making sure anti-smuggling provisions and other state laws that apply to in-state retail sellers of tobacco products also apply to Internet or mail-order companies that sell cigarettes to persons in the state, including all federal and state excise taxes collections with tax stamps applied, record-keeping requirements, and applicable penalties, among other provisions.¹²

Stronger Disincentives and Punishments for Smuggling

- **Expand definition of illegal smuggling subject to state prosecution and penalties.** To reach more illegal smuggling and tax avoidance through state law enforcement, reduce the minimum number of cartons/packs/cigarettes that trigger smuggling violations or major smuggling penalties. Establish or fortify penalties for the manufacture, possession, or sale of counterfeit tobacco tax stamps or counterfeit tobacco products.
- **Increase existing fines for cigarette or other tobacco product smuggling.** Increase the minimum dollar amounts of existing fines and have no maximum amount so that meaningful fines can be levied against large economic entities involved in smuggling.
- **Seize vehicles and properties used in cigarette or other tobacco product smuggling.** Establish new provisions to allow for the state's seizure of vehicles used in cigarette smuggling, putting liens on property for the value of smuggled goods, etc. (as with state laws pertaining to illegal drug trafficking).
- **Withdraw right to sell tobacco products from retailers involved in smuggling.** State anti-smuggling laws could ensure that retail outlets in the state that buy smuggled cigarettes or knowingly sell smuggled cigarettes will lose their right to sell any cigarettes in the state for some period of time (e.g., from one to ten years depending on the severity of the violation).
- **Include jail or prison time for guilty large-scale smugglers or repeat offenders.** Going beyond just fines and other economic disincentives, state laws could call for jail or prison sentences for persons participating in large smuggling efforts or who are guilty of repeatedly violating the states anti-smuggling or tax-avoidance laws.

¹ Farrelly, M, et al., *State Cigarette Excise Taxes: Implications for Revenue and Tax Evasion*, Research Triangle International, May 2003, http://www.rti.org/pubs/8742_Excise_Taxes_FR_5-03.pdf. See also, Campaign for Tobacco-Free Kids (TFK), *Raising State Tobacco Taxes Always Increases State Revenues & Always Reduces Tobacco Use*, <http://tobaccofreekids.org/research/factsheets/pdf/0098.pdf>.

² Yurekli, A & Zhang, P, "The Impact of Clean Indoor-Air Laws and Cigarette Smuggling on Demand for Cigarettes: An Empirical Model," *Health Economics* 9:159-170, 2000; Farrelly, M, et al., "Cigarette Smuggling Revisited," U.S. Centers for Disease Control & Prevention (CDC), in press. See, also, the references listed in endnote 1.

³ Halper, E, "States Tobacco Revenue Surges," *Los Angeles Times*, December 27, 2005. TFK factsheet, *The Case for High-Tech Cigarette Tax Stamps*, <http://tobaccofreekids.org/research/factsheets/pdf/0287.pdf>. California Revenue and Taxation Code Section 30162, <http://www.leginfo.ca.gov/cgi-bin/displaycode?section=rtc&group=30001-31000&file=30161-30165.2>. For the underlying legislation, see http://www.leginfo.ca.gov/pub/01-02/bill/sen/sb_1701-1750/sb_1701_bill_20020926_chaptered.pdf.

⁴ See, e.g., Arizona's separate tobacco tax, with tax stamps, on Tribal sales, with the revenues remitted to the Tribes. AZ Revised Statutes, 42-3301 to 42-3307, <http://www.azleg.gov/ArizonaRevisedStatutes.asp?Title=42>.

⁵ See above note re: AZ. For examples of State-Tribal tobacco tax compacts, National Congress of American Indians, <http://www.ncai.org/Tax-Agreements.97.0.html>.

⁶ For a list of effective federal anti-smuggling provisions, see American Cancer Society, et al., *Proposed Federal Measures to Reduce Cigarette Smuggling and Protect Federal and State Tobacco Tax Revenues*, January 2003, <http://tobaccofreekids.org/research/factsheets/pdf/0226.pdf>. See also, TFK Factsheet, *The Federal Smuggled Tobacco Prevention Act: Promoting Health and Protecting Revenues By Combating Tobacco Smuggling*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0364.pdf>.

⁷ See, e.g., U.S. General Accounting Office, *Internet Cigarette Sales: Giving ATF Investigative Authority May Improve Reporting and Enforcement*, August 9, 2002, <http://www.gao.gov/new.items/d02743.pdf>.

⁸ New York Public Health Article 13F, Section 1399-ll. *Brown & Williamson Tobacco Corp. v. Pataki*, U.S. Court of Appeals for the Second Circuit, Docket Nos. 01-7806, 01-7813, February 13, 2003.

⁹ For model legislation, see http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/internet/.

¹⁰ For model legislation, see <http://tobaccofreekids.org/research/factsheets/pdf/0230.pdf>.

¹¹ For more information on blocking Internet deliveries, see the provisions in the above cited model statutes and the TFK Factsheet, *The Critical Importance of a Delivery-List Enforcement Provision in State Internet Tobacco Sales Legislation*, <http://tobaccofreekids.org/research/factsheets/pdf/0259.pdf>. More on how to address Internet tobacco product sale is at http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/internet/.

¹² For more information on the PACT Act, see http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/internet/.