



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

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To try to block or reduce state tobacco tax increases, tobacco companies and their allies regularly overstate the amount of smuggling and tax avoidance prompted by differences among different states' 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.<sup>1</sup> States can also increase their tobacco tax revenues by implementing effective measures that would reduce sharply both organized cigarette smuggling and smoker tax avoidance. 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**<sup>†</sup>

1. **Improve state tobacco tax stamps.** The two states that do not have tax stamps (NC and ND)<sup>‡</sup> 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. Years after implementation, California's most recent report shows that its high-tech tax stamps, along with increased enforcement, saved the state nearly \$90 million in revenue in 2016.<sup>2</sup> Tax stamps on non-cigarette tobacco products should also be established or improved. Tax stamps could also provide a way to report 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). Technology used in Michigan's high-tech tax stamps already enables some of this activity.<sup>3</sup>
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.** States should 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 and recipients, 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.<sup>4</sup>
3. **Increase enforcement and penalties for violations.** Additional enforcement agents looking for illegal sales, as well as steeper fines for violations can discourage illegal activity. If the consequences of getting caught are worse and the potential for getting caught higher, then potential violators might think twice. Some states have minimal fines for violations, so the “cost” of getting caught is not a deterrent.

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<sup>‡</sup> 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 can avoid paying the cigarette tax in their state by purchasing their cigarettes in a nearby lower-tax state, or from stores on nearby military bases or Indian Lands (which typically do not charge state taxes).

<sup>†</sup> Although many of these measures refer only to cigarettes, they could be applied to other tobacco products, as well.

<sup>‡</sup> In 2016, South Carolina passed a law to require cigarette tax stamps, which will be effective January 1, 2019.

4. **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 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).
5. **Require better record keeping by distributor/wholesalers.** Distributors and wholesalers selling cigarettes to retailers (which, in turn, sell them to state residents) should be required to keep and maintain records of amounts sold, to whom, tax-stamp status, etc., and to regularly provide this information to state officials.
6. **Require better record keeping by retailers.** All retailers that sell cigarettes in the state should 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.) so state agencies can review if needed. Retailers can play a significant role in tax evasion, so requiring better record-keeping and checking those records would help to reduce illegal sales. For instance, an investigation by the Office of the New York City Sheriff found that more than 46 percent of cigarette retailers that they inspected were found to be selling unstamped or untaxed product.<sup>5</sup> Similarly, a report on tax evasion by the California Board of Equalization stated, “California cigarette tax evasion by retailers is a far larger revenue problem compared to casual cigarette tax evasion by consumers. Evasion by retailers is organized or systematic evasion, primarily by retailers who knowingly purchase contraband cigarettes.”<sup>6</sup>
7. **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.
8. **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. 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.
9. **Publicize hot lines to encourage reports of smuggling or tax-avoidance activities.** State-based wholesalers, distributors, importers, exporters, and retailers of tobacco products should be required 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. For example, Chicago launched a campaign to encourage Chicago residents to report illegally stamped or unstamped cigarettes in return for a \$100 reward.<sup>7</sup>

10. **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.
11. **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.
12. **Put pressure on the states with extremely low cigarette tax rates to raise them.** The 2015 report from the National Research Council (NRC) and the Institute of Medicine (IOM), *Understanding the U.S. Illicit Tobacco Market: Characteristics, Policy Context, and Lessons from International Experiences*, stated, “tax harmonization agreements that set a high floor for excise taxes (i.e., requiring minimum levels of taxation while also allowing jurisdictions to levy higher taxes) could reduce the health harms of tobacco, increase revenues for governments, and mitigate illicit activities associated with tax avoidance and tax evasion.”<sup>8</sup> State cigarette tax rates vary greatly, from the highest in New York and Connecticut at \$4.35 per pack to Missouri at only 17 cents per pack. 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 a dollar per pack. Tobacco tax increases in those states would help to dampen interstate 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.
13. **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.<sup>†</sup> 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.<sup>9</sup>
14. **Support federal anti-smuggling policies.** While each state can do a lot, the federal government can do more. Most notably, the Family Smoking Prevention and Tobacco Control Act authorizes the U.S. Food and Drug Administration to implement a track and trace system, which would not only provide support for its regulatory standards, but also for federal and state tax collection efforts. A federal system would support states by enabling comprehensive tracing of products through the supply chain in different jurisdictions.<sup>10</sup> The federal government could also 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.,

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\* In 2016, South Carolina passed a law to require cigarette tax stamps, but until it goes into effect on January 1, 2019, the state does not have tax stamps.

† 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).

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.<sup>11</sup>

### **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.<sup>12</sup> 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.

The federal PACT Act, effective in June 2010, reinforces the Jenkins Act, by requiring Internet sellers to register with states and comply with the same state or local laws that apply to in-state retailers. Cigarettes and smokeless tobacco are designated "non-mailable matter" for the U.S. Postal Service. The passage of the PACT Act already had a significant impact on Internet sales – the large majority of Internet sellers closed down. However, the PACT Act only applies to cigarettes and smokeless tobacco, so other tobacco products are still available via Internet.

- ***Implement and enforce state laws banning or restricting Internet sales of all tobacco products.*** New York State 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.<sup>13</sup> To minimize Internet sales that avoid paying state taxes, a state could pass a ban similar to the New York law. 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. 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. This policy would also have the positive effect of protecting in-state businesses from the predatory pricing of Internet vendors.
- ***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. There have been several federal efforts to reduce tobacco smuggling, including the Smuggled Tobacco Prevention (STOP) Act, which would have implemented a federal track and trace system, increased penalties for violations, and required better information sharing between governmental agencies at different levels and internationally, among other provisions.

### **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.

**Campaign for Tobacco-Free Kids, January 18, 2018**

<sup>1</sup> 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](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>.

<sup>2</sup> California Board of Equalization (BOE), *Revenue Estimate: Cigarette and Tobacco Products Tax Evasion*, October 3, 2016, <https://www.boe.ca.gov/legdiv/pdf/Evasion-10-2016F.pdf>. See also, TFK factsheet, *The Case for High-Tech Cigarette Tax Stamps*, <http://tobaccofreekids.org/research/factsheets/pdf/0287.pdf>.

<sup>3</sup> U.S. Centers for Disease Control and Prevention (CDC), *Preventing and Reducing Illicit Tobacco Trade in the United States*, December 2015, <https://www.cdc.gov/tobacco/stateandcommunity/pdfs/illicit-trade-report-121815-508tagged.pdf>.

<sup>4</sup> 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 42-3308, <http://www.azleg.gov/arsDetail/?title=42>.

<sup>5</sup> Testimony of Commissioner David M. Frankel, New York City Department of Finance, Before the New York City Council, Committee on Finance, March 4, 2013

<sup>6</sup> California Board of Equalization (BOE), *Revenue Estimate: Cigarette and Tobacco Products Tax Evasion*, June 27, 2007, <https://www.boe.ca.gov/pdf/cig-evasion-07.pdf>.

<sup>7</sup> Mayor Rahm Emanuel Press Office, "Chicago Calls On Residents To Join Fight Against Illegal Tobacco Sales," Press Release, June 16, 2014, <https://www.cityofchicago.org/city/en/depts/cdph/provdrs/drug/news/2014/jun/chicago-calls-on-residents-to-join-fight-against-illegal-tobacco.html>.

<sup>8</sup> National Research Council (NRC) & Institute of Medicine (IOM), *Understanding the U.S. Illicit Tobacco Market: Characteristics, Policy Context, and Lessons from International Experiences*, Committee on the Illicit Tobacco Market: Collection and Analysis of the International Experience, P. Reuter and M. Majmundar, Eds. Committee on Law and Justice, Division of Behavioral and Social Sciences and Education. Board on Population Health and Public Health Practice, Institute of Medicine. Washington, DC: The National Academies Press, 2015, <https://www.nap.edu/catalog/19016/understanding-the-us-illicit-tobacco-market-characteristics-policy-context-and>.

<sup>9</sup> 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>.

<sup>10</sup> CDC, *Preventing and Reducing Illicit Tobacco Trade in the United States*, December 2015, <https://www.cdc.gov/tobacco/stateandcommunity/pdfs/illicit-trade-report-121815-508tagged.pdf>.

<sup>11</sup> 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>.

<sup>12</sup> 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>.

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