



## **PROPOSED FEDERAL MEASURES TO REDUCE CIGARETTE SMUGGLING AND PROTECT FEDERAL AND STATE TOBACCO TAX REVENUES**

The tobacco industry regularly uses smuggling, or the threat of it, as an argument against taxation and effective and meaningful regulation of tobacco products. Concerns about the threat of increased smuggling of tobacco products have grown domestically as more states look to tobacco taxes as a way to reduce tobacco use, particularly among children, and as a source of revenue, and as more websites sell tobacco over the Internet. Increasing concern has also been expressed about international smuggling of tobacco products. The most accurate evidence indicates that approximately one quarter of all legally exported cigarettes end up smuggled across international borders, a fact that is particularly disturbing because the evidence indicates a significant amount of international smuggling is condoned or abetted by the tobacco companies.

There are solutions that are technologically available at a reasonable cost to dramatically reduce smuggling without imposing undue burdens on manufacturers or law-abiding citizens. Reducing smuggling will also increase government revenues by minimizing tax avoidance. Criminals are able to engage in smuggling today largely because of weak penalties, products that are often poorly marked and inadequately labeled, the absence of tax stamps and a system to track sales across borders, and the lack of rules governing large block sales to individuals. Simple labeling and record-keeping requirements and restrictions on where tobacco products may be sold could vastly diminish the problem.

Illegal tobacco smuggling does not need to be tolerated. To permit the threat of smuggling to undermine the ability of government to take effective action to prevent and reduce smoking is to give in to the criminals. In response to crimes of this magnitude in any other field, Congress would demand that the loopholes allowing it be closed. This paper outlines a series of common sense policy changes to address the problem of tobacco smuggling.

### **Basic Measures to Reduce Both Interstate & International Cigarette Smuggling**

The following provisions would apply to all tobacco products made or sold in the United States, including all imported cigarettes.

**1. Labeling Requirements** (to help enforcement officials determine the source of smuggled cigarettes and otherwise track the paths smuggled cigarettes take from legal manufacture to final illegal sale):

- Require prominent under-the-cellophane text, in English, that identifies the country of manufacture.
- Require each pack to have a unique serial number, in standardized form, which identifies the tobacco product's manufacturer and the location and date of manufacture. To make counterfeiting difficult, serial number should be printed on the pack, itself, or at least be under the cellophane (not printed or stuck onto the cellophane). The required technology already exists, and some tobacco companies are already placing their own serial numbers on packs.

- Require standardized, under-the-cellophane markings that identify the importer of any tobacco product imported into the United States. Some cigarette manufacturers and importers, including relatively small ones, are already using under-the-cellophane markings to identify themselves on packs of cigarettes.

**2. Permits and Record Keeping Requirements** (to help enforcement officials determine the source of smuggled cigarettes, track the paths they take from legal manufacture to final illegal sale, and create a more closed system of legal sales and purchases):

- Make it illegal for manufacturers, distributors, importers, and exporters that have obtained tobacco-business permits to transact any tobacco-product business with any manufacturers, distributors, importers, or exporters that have not obtained such permits.
- Make it illegal for retailers to do any tobacco-product business with any manufacturers, distributors, importers, or exporters that have not obtained the required tobacco-business permits.
- Require retailers to retain records of both their *receipt* of tobacco products from any source for resale to final customers or others and their *sale or delivery* of any tobacco products to distributors, other retailers, or any other entity in quantities exceeding 5,000 cigarettes (25 cartons), including date, quantity, description, and identity of other parties.
- Require all distributors to retain records of sales and purchases of tobacco products in the same manner as already required of manufacturers, importers, and export warehouse proprietors.

**3. Penalties** (to create adequate disincentives to cigarette smuggling and tax avoidance):

- Increase existing civil and criminal penalties for violations of the federal tobacco-tax collection laws, and provide specific authority for fining, or otherwise penalizing, those convicted of smuggling tobacco products or tax-avoidance to obtain amounts equal to the taxes avoided and to the other tax-avoidance or smuggling-related revenues. (Currently, different sections of existing federal laws prohibiting smuggling and tax avoidance have penalty caps of only \$1,000, \$10,000 or 5% of the avoided federal tax).
- Provide for a graduated series of penalties for repeat violators including increasing fines and, after a second intentional violation, a prohibition from engaging in any tobacco-product business in the United States for one to ten years, or permanently – with the fines and other penalties adjusted for the severity and number of violations, the size of the smuggled shipments, and the violators ability to pay.

Some states have laws that call for revoking the tobacco-selling licenses of dealers that knowingly sell smuggled cigarettes (e.g., New York), and 24 states have laws that call for suspending or revoking a retailer's license to sell cigarettes after repeated illegal sales to minors. Numerous state and federal statutes have penalties calculated, in part, on the violator's "ability to pay" (e.g., 39 USC 3012 re illegal use of the mails).

**4. Protection for "Whistleblowers"** (to encourage the reporting of smuggling activities and protect witnesses). Protect the employees of retailers, distributors, importers, exporters, manufacturers, etc. who notify authorities or testify in court regarding their employers' smuggling-related wrongdoing from being fired or penalized by their employers.

## **Provisions to Reduce U.S. Interstate Smuggling & Related State-Tax Avoidance**

These provisions apply to tobacco products made or imported for final sale in the United States.

- 1. Reduce the number of smuggled cigarettes necessary to make interstate smuggling a federal crime.** Reduce the number of cigarettes that makes smuggling them a federal crime from 60,000 to 10,000 cigarettes (i.e., from 300 to 50 cartons) or less, with parallel changes in the jurisdictional amounts for other tobacco products. Reportedly, some smugglers break up their shipments into multiple loads of just under 60,000 cigarettes to avoid federal jurisdiction and the risk of related federal penalties.
- 2. Prohibit retail sales not for personal use.** Prohibit all retail sales of cigarettes to consumers in amounts greater than 25 cartons (5,000 cigarettes), and forbid multiple sales by any single retailer to the same buyer that total more than 5,000 cigarettes in any single week – with parallel limits for the sales of other tobacco products.
- 3. Require that all state-taxed cigarette packs be marked with tax stamps that meet minimum standards for visibility, tamper-resistance, and anti-counterfeiting.** All states except North and South Carolina, Alaska, and North Dakota already use tax stamps to mark packs on which state taxes have been paid and identify where the cigarettes may be sold legally. Tax-stamp technology has not advanced for several decades, but California has passed a law calling for the replacement of existing tax stamps by January 2005 with new stamps that can be read by a scanning device (like a bar code reader) and will provide encrypted information, including the identity of the distributor affixing the tax stamp and the tax stamp date and value. Broader anti-smuggling legislation could also specifically require that the new tax stamps be more visible, take advantage of new laser-stamping technology to make it more difficult to counterfeit or alter the tax stamps, and include other encrypted information to assist anti-smuggling efforts (such as the identity of the entity that purchased the cigarettes from the distributor that affixed the tax stamps and the identity of the entity that supplied the cigarettes to the distributor that affixed the tax stamps).
- 4. Establish or increase penalties for manufacturing, importing, exporting, shipping in interstate commerce, or possessing any counterfeit cigarettes or counterfeit tax stamps.** While still a relatively small problem in the USA, counterfeit premium brand cigarettes offer cigarette smugglers another way to increase their illegal profits. Counterfeit cigarettes can also reduce the final prices charged to retailers and consumers, thereby increasing overall sales and consumption. Counterfeit tax stamps are used on both counterfeit and genuine cigarettes to indicate that applicable taxes have already been paid in the final state of sale to consumers.
- 5. For packs sold in the United States but not subject to state tax, require prominent, under-the-cellophane text that identifies where in the United States the packs may be legally sold at retail to adult smokers.** Tobacco products sold on U.S. Indian reservations, military bases and duty-free stores are wholly or partially exempt from state sales taxes but often end up being sold in transactions that are subject to state taxes. To minimize such diversions to illegal untaxed sales, untaxed packs delivered to U.S. military installations, Indian reservations, or duty-free shops for subsequent resale should be labeled "For U.S. Military Sale Only," "For Indian Reservation Sale To Tribal Members Only," or "For Duty-Free Sale," respectively.

6. **Eliminate the sale of tobacco products at U.S. duty-free shops.** Duty-free shops, where tobacco products are sold free of certain taxes, are another source of cigarettes for informal and organized smuggling, especially those duty-free shops at or near the Mexican border.
7. **Collect state tobacco taxes at factory level or upon import.** Federal cigarette taxes are collected at the U.S. factory where the cigarettes are made or, for foreign-made cigarettes, at import. Collecting state taxes at the same time would make illegal diversion much harder.
8. **Require reports to state tax officials of all tobacco products shipped into the state.** Requiring all entities that sell or ship tobacco products into a state for resale or as final retail sales to register with the state's tobacco-tax administrator and provide monthly reports (with sharp penalties for violators) will create a closed system that will prevent diversion and facilitate enforcement against those operating outside of it.
9. **Authorize state attorneys general and other state and local government enforcement personnel to bring civil actions in an appropriate federal court to enjoin violations of federal anti-smuggling laws that occur within their jurisdictions and to seek related equitable and legal relief.** Because federal enforcement resources are limited and state and local governments have a direct interest in minimizing tobacco product smuggling and related tax avoidance, enforcement of all federal anti-smuggling laws could be expanded and improved by authorizing state and local government enforcement personnel to bring civil enforcement actions to the extent permitted by law.

#### **Additional Measures to Reduce Smuggling Across U.S. and Other International Borders**

The following provisions would apply to all tobacco products exported out of the United States.

1. **Identify the destination countries on exported packs.** Require under-the-cellophane text on each cigarette pack that identifies the country of manufacture and the destination country where it is to be sold to consumers. The text should be in English and the primary language of the country of final sale.
2. **Require exporters of tobacco products from the United States to post a bond that will be released upon proof that all applicable foreign taxes and duties were paid upon delivery to the destination country.** The McCain Bill, as passed by the Senate Commerce Committee in 1998, included this provision. Canada already has a similar provision in place.
3. **Record keeping for exported tobacco products.** Require exporters and sellers of cigarettes for export to keep records of the buyers, sale dates, total amounts sold, designated destination countries for final sale to consumers, and the amounts and serial numbers of the cigarettes destined for each specified country.
4. **Establish strict liability for suppliers of smuggled cigarettes.** Hold each U.S. cigarette manufacturer directly responsible (strictly liable) for any of its cigarettes exported out of the USA that do not legally enter the designated destination country or that are later seized as contraband goods. Set minimum fine at \$10,000 or the actual amount the manufacturer originally received for the cigarettes, whichever is greater. The Basel Convention on Transboundary Movement of Hazardous Waste applies a similar liability provision to toxic-waste producers regarding waste shipped out of a country and disposed of improperly.
5. **Permit foreign governments that have been victims of smuggling by U.S. companies to seek recovery in U.S. federal courts.** The European Union, Canada, 22 Colombian

states, Honduras, and Belize have brought lawsuits against U.S. cigarette companies alleging damages caused by cigarette smuggling. Some federal courts have dismissed these cases – prior to any judgment on the merits – based upon their interpretation of a federal statute that prohibits foreign governments from using the U.S. courts to collect revenue. Explicitly giving foreign governments the ability to recover damages from U.S. cigarette companies engaged in illegal cigarette smuggling would create a strong disincentive to illegal smuggling by U.S. cigarette companies. In many cases, enforcement actions in U.S. courts may be the most effective way, if not the only way, for foreign governments to force U.S. cigarette companies to take readily available steps to stop cigarette smuggling across their borders.

The cigarette companies tried to include language in the Financial Anti-Terrorism Act (the “Patriot Act”) to restrict the ability of foreign governments to bring lawsuits against them. Given the growing evidence of terrorist organizations using cigarette smuggling to finance their activities, Congress concluded that the special-protection language desired by the cigarette companies would actually contradict the anti-terrorism purposes of the act and removed it prior to the legislation's final passage.

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