Public Health and Tobacco Policy Center

Tax Evasion in New York State

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Introduction

Two and a half million New Yorkers use tobacco products,[1] generating medical costs of more than $10 billion every year.[2] From smoking bans to advertising restrictions, the state of New York and its localities have adopted numerous public health measures to combat the harms associated with tobacco use. Tobacco taxes are a critical component of the state's overall tobacco control strategy. Research has demonstrated that high tobacco taxes greatly reduce smoking rates,[3] and New York has the highest tobacco tax rates in the United States.[4] However, New York faces a serious problem with tobacco tax evasion. The Surgeon General warns that "implementation of effective strategies to limit … the availability of untaxed tobacco products is essential to maximizing the effectiveness of higher taxes in reducing tobacco use."[5] Tobacco tax evasion can seriously undermine public health by removing incentives not to start using tobacco products or to quit or reduce use.

This report provides an overview of tobacco tax evasion in New York State. **Part I** outlines the connection between tobacco taxes and public health; **Part II** documents the financial impact of tobacco tax evasion on New York; **Part III** explains how cigarettes are taxed in New York; **Part IV** illustrates how tax evasion works and why it is attractive to lawbreakers; **Part V** summarizes the federal agencies and laws related to tobacco tax evasion; and **Part VI** suggests ways to improve current laws and/or their enforcement.

Part I: Tobacco Tax Evasion Undermines Public Health

Direct Effects on Public Health

Although taxes may not be an obvious public health strategy, they are in fact a very useful and effective method of influencing tobacco use. A "large and growing literature" definitively shows that raising the price of tobacco products through taxation decreases tobacco use.[6] One primary reason is that high prices encourage established users to quit.[7] Increasing the price of a pack of cigarettes adds a financial burden to smoking. While low socioeconomic status populations have higher smoking rates than higher-income groups,[8] studies have drawn different conclusions about whether low-income smokers are more sensitive to price than higher-income smokers[9] or whether the tax is regressive, causing low-income smokers to spend higher proportions of their already limited budgets on cigarettes.[10] In any case, there is a general consensus that raising tobacco taxes leads to fewer smokers overall. A second benefit of high prices is that those who continue to use tobacco products reduce the frequency and amount of consumption in response to tax increases.[11] The retail price of cigarettes will increase at least as much as the tax rate and

Benefits of high tobacco taxes:

- Increase cessation
- Reduce consumption among smokers who don't quit
- Deter youth experimenters from becoming regular users

often more; a 1996 study found that a state tax increase of one cent raised retail prices by 1.11 cents.[12] Research data indicate that a 10% increase in the price of cigarettes is followed by about a 4% decrease in adult consumption (about half due to quitting and half from decreased use),[13] and about a 5% decrease in youth consumption.[14] A third and critical benefit is the particularly strong effect high tobacco taxes have on teenagers and young adults, "keeping young people from moving beyond experimentation with tobacco, and preventing them from becoming regular and, eventually, addicted users."[15]

The evasion of tobacco taxes undermines all of these public health effects, causing a decrease in quitting rates, producing no decrease in consumption among regular smokers, and encouraging youth experimenters to transition to regular use. Significantly, real progress has been made in tobacco control: the prevalence of smoking is now less than one-half what it was in 1964 among both youth and adults.[16] These results can be threatened (or further progress impeded), however, by large-scale tax evasion. When untaxed – and thus less expensive – cigarettes are available, the public health impacts of tobacco tax increases are greatly diminished as smokers can "avoid pressures that might lead to cessation in the absence of cheaper cigarettes."[17] This problem is particularly critical in New York State. In the year following the June 2008 tax increase, more than half of cigarette buyers in New York avoided paying at least some taxes.[18] A survey of western New York smokers conducted around 2004 found that almost 67% bought cigarettes from local Native American reservations where they could easily purchase cigarettes for significantly less than from non-Native sellers or vending machines.[19] A study of low-income smokers in New York City reported that "pervasive illegal sales facilitated smoking by creating a visible trigger to smoke."[20] Experts estimate that eliminating cigarette tax evasion would result in anywhere from 50,000[21] to100,000[22] fewer smokers in New York.

Tobacco tax enforcement is particularly important in reducing youth access. The Surgeon General recently warned, "If smoking persists at the current rate among young adults in this country, 5.6 million of today's Americans younger than 18 years of age are projected to die prematurely from a smoking-related illness."[23] Targeting youth smokers is essential because the vast majority of new smokers are ensnared during their teenage years. The Synar Amendment is a 1992 federal law that requires states to ban the sale of tobacco products to anyone under age 18 as a condition of receiving federal grant money to support substance abuse and treatment programs.[24] The Amendment mandates states to enforce the law by conducting yearly random inspections of retailers, establishing timetables for reaching specific reduction goals, and submitting yearly reports summarizing their efforts.[25] The Synar Amendment has had success in

reducing youth smoking rates.[26] Most smokers start before they reach legal age (88%), and almost all smokers' first time smoking occurred before they turned 26 (98%).[27] Therefore, enforcing the ban on sales to young buyers is a critical measure to decrease the number of future smokers. Tobacco tax evasion severely undermines this goal. Sellers of tax-free tobacco, who are already breaking the law and typically operating outside the legally regulated supply chain, have little incentive to comply with laws banning underage sales. Teenagers and young adults with limited incomes are particularly affected by price;[28] in fact, some studies have shown that children and teens are three times more sensitive to price than adults,[29] a public health advantage that is lost when taxes are evaded.

Indirect Health Consequences of Tax Evasion

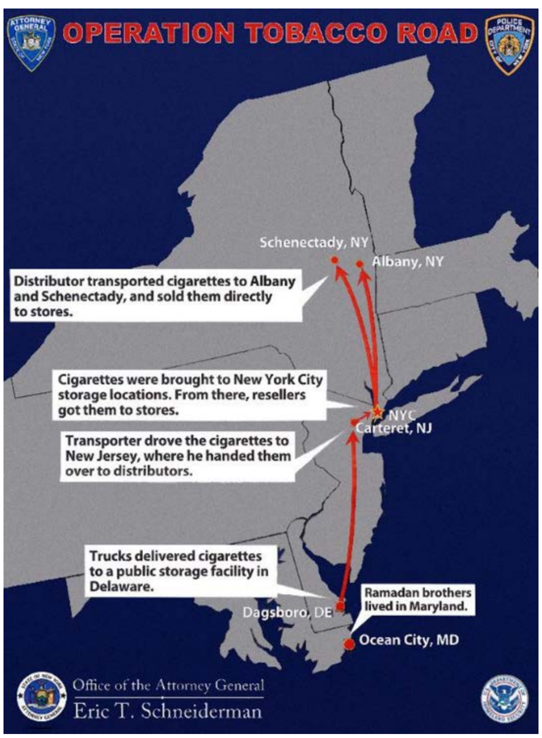
Suppliers, distributors, and retailers who follow the law are put at a disadvantage when illegal tax-free sales undercut their prices. Lost revenue can create a disincentive to comply with legal requirements, undermining respect for the law and enforcement efforts. Further, evasion of tobacco tax laws can lead to evasion of other tobacco-related laws and regulations. For example, manufacturers and importers must submit an annual list of ingredients to the Department of Health and Human Services,[30] health warnings are required on cigarette packages,[31] and the Synar Amendment bans sales to underage buyers and requires compliance checks and reports.[32] Compliance with these types of legal requirements is typically monitored at specific points in the legal supply chain.

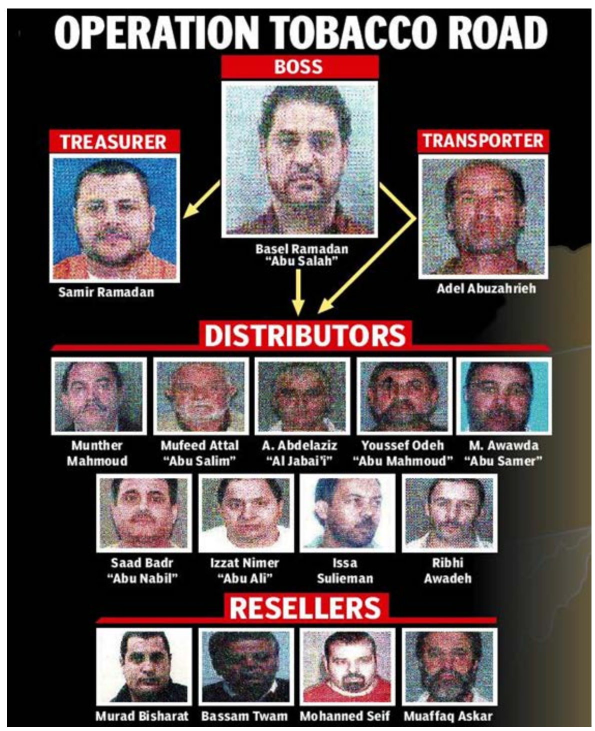
When products are illegally moved out of the regular distribution channels in order to avoid taxes, the public health benefit of other non-tax-related requirements can be lost as well.

Counterfeit pack on left hard to distinguish from real pack on right Source: Richmond Times-Dispatch

Counterfeit cigarettes, taxed or untaxed, pose a unique threat to public health. Illegally manufactured cigarettes can be entered into the chain of commerce at a later point, evading taxes and increasing profit. Counterfeiting has been increasing in recent years largely due to underground factories in foreign countries that can produce billions of illicit cigarettes from cheap, low-quality ingredients.[33] Because counterfeit products are by definition not regulated, it is impossible to know their ingredients, but given counterfeiters' lack of incentive to follow manufacturing standards and the fact that legally manufactured cigarettes are themselves extremely toxic, evidence that counterfeit cigarettes are even more dangerous than those produced by licensed manufacturers is unsurprising. One study found that "counterfeit cigarettes potentially result in a markedly greater exposure to toxic heavy metals [cadmium, thallium, and lead] than authentic brands,"[34] and estimated the danger increases "in some cases by an order of magnitude."[35] An investigative report also found "pesticides, arsenic, rat poison, and human feces" in counterfeit cigarettes.[36] Counterfeiting is a rare instance of tobacco tax evasion in which the interests of the tobacco industry align with those of public health advocates. The industry has a strong motivation to help identify and stop counterfeiting operations and has brought its own lawsuits against sellers of counterfeit brands[37] (*see* discussion at end of Part IV *infra*).

Finally, there is evidence that tobacco smuggling often supports criminal and even terrorist organizations.[38] Although the full extent of the problem is unknown, in 2008 the U.S. House Committee on Homeland Security estimated that foreign terrorist groups received millions of dollars from illegal tobacco trade.[39] There is mounting evidence that terrorist groups all over the world are financed by cigarette smuggling,[40] including the Taliban, the Irish Republican Army, and a militant Colombian rebel group, FARC.[41] Cigarette smuggling has also been linked to violence in Africa.[42] Organized smuggling in New York has been connected to groups like Hezbollah and Hamas.[43] The connection between cigarette smuggling and terrorism has made combating tobacco tax evasion an increasing priority for the US government.[44]





Source: "Tobacco and Terror: How Cigarette Smuggling is Funding our Enemies Abroad," a report by U.S. House Committee on Homeland Security, 2008.

PART II: Tobacco Tax Evasion Has a Devastating Financial Impact on New York

Tobacco tax enforcement has financial as well as health benefits.[45] Although tax evasion likely will increase along with tax rates, tobacco taxes are only one of many factors that influence illegal trade; after a tax increase there will still be a net increase in revenue and net decrease in tobacco use despite losses from tax evasion.[46] Tobacco taxes are an important source of state revenue, and tax avoidance costs states billions of dollars every year.[47] Taxes and fees make up an average of 53% of the price of a pack of cigarettes.[48] New York State's tobacco tax rate skyrocketed from $1.11 at the beginning of 2002 to $4.35 by the end of 2010.[49] The state consistently has one of the highest tax rates in the nation,[50] and tobacco products in New York City are among the most expensive in the United States,[51] costing up to $13 per pack.[52] However, in general about one-third of cigarettes sold in New York are estimated to be sold without charging state and local taxes.[53] New York State's annual losses from tobacco tax evasion are difficult to pin down, so estimates vary, but all sources estimate a loss on the scale of hundreds of millions of dollars and the problem is growing. A 2011 New York Department of Health Report found that cigarette tax evasion cost the state $465 to $610 million in 2010, while figures extrapolated from a 2015 report from the National Research Council and the Institute of Medicine estimate show New York State revenue losses amount to about $1.5 billion.[54] The American Cancer Society lists New York's annual losses at about $800 million and New York City losses at another $100 million each year.[55] Most of these sales involve Native American sellers;[56] estimates of New York's annual losses from tax-free sales on Native American territory range from a low of $200 million to a high of $1 billion.[57]

PART III: The Tobacco Supply Chain and Taxation

There are multiple kinds of tobacco taxes, including those imposed on tobacco leaves (tobacco crop taxes and import/export taxes on leaf shipments), the value-added tax,[58] import/export duties, general sales taxes, etc. Many of these taxes are applicable to many consumer items: for example, the state sales tax applies to all personal goods, not just tobacco products.[59] This report will focus specifically on tobacco excise taxes, which affect the prices of cigarettes relative to other commonly bought items and thus are key to achieving the goal of reducing tobacco consumption.

Cigarettes are typically sold in packs of 20 cigarettes, cartons of 10 packs (200 cigarettes), and cases of 60 cartons (12,000 cigarettes), although the number of cartons in a domestic case can vary and international cases usually have 50 cartons (10,000 cigarettes).[60] Cigarettes are taxed by the federal government, the states, and sometimes localities as well. As of December 2015, the federal excise tax is $1.01 per pack.[61] New York State charges a state excise tax of $4.35 per pack[62] and also imposes a "use tax" of the same amount "on all cigarettes used in the state by any person" if more than 400 cigarettes are brought into the state and the excise tax is required but not paid (for example, if the cigarettes were purchased online).[63] New

York City charges an additional city tax of $1.50 per pack.[64]

Current Cigarette Tax Rates Per Pack, December 2015

Federal	$1.01
New York State	$4.35
New York City	$1.50

Cigarette manufacturers are required to have a permit issued by the Department of the Treasury's Alcohol and Tobacco Tax and Trade Bureau ("TTB") in order to operate in the United States, and they are required to file monthly reports on the volume produced to the TTB before any products can leave the factory. They pay federal taxes at the point when the cigarettes are removed from the manufacturing facility and enter the chain of commerce. Manufacturers usually do not pay federal taxes on exports. Imports are taxed upon entry into the country (direct) or on upon release from a Customs-bonded warehouse or foreign trade zone for sale in the United States (indirect).[65] Importers must also have a TTB permit and file regular reports with the agency.

Cigarettes for the domestic market are typically shipped from the manufacturer to federally-bonded warehouses or distributors.

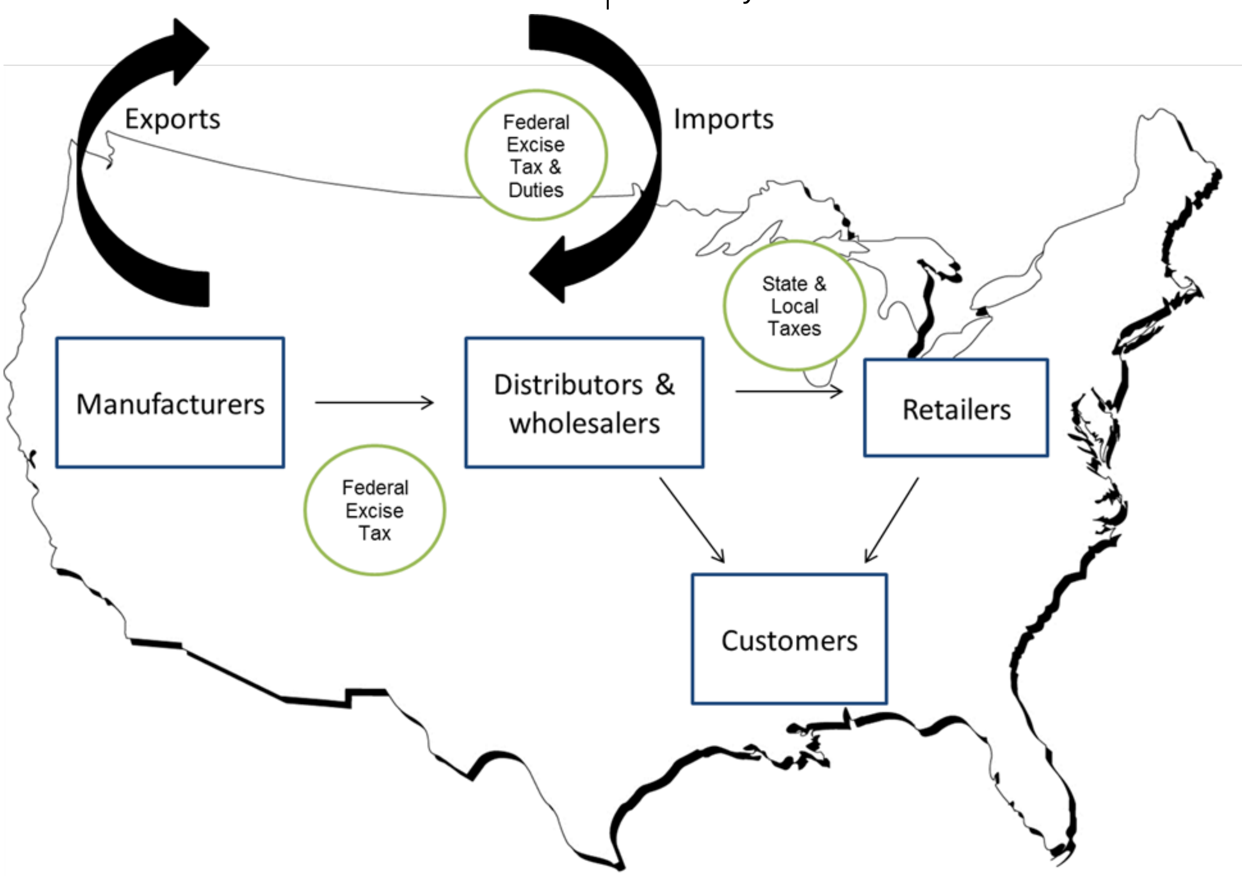


Figure 1. *Legal U.S. cigarette supply chain. Source: U.S. Gov. Accountability Office, Report to Congressional Committees,* Illicit Tobacco: Various Schemes Are Used to Evade Taxes and Fees *(2011)*

"Stamping agents" are wholesalers authorized by the state to indicate that state tax has been paid, usually by affixing a tax stamp to each pack. The stamping agent then sells the cigarettes to non-stamping agent wholesalers, distributors, and retailers. It is illegal to sell cigarettes in New York without the required tax stamp.66 New York City also issues its own tax stamps to indicate that the city tax has been paid. Wholesalers must be licensed by New York State to be distributors, to re-sell tobacco products, or to sell tobacco through vending machines. Both wholesalers and retailers sell products directly to consumers. In New York, it is legal to ship cigarettes only to licensed cigarette tax agents or wholesale dealers; direct-to-consumer shipments are forbidden.

Figure 1 shows the legal supply chain for cigarettes in the United States and indicates the points at which taxes are paid.

PART IV: Tobacco Tax Evasion

There are myriad ways to avoid paying tobacco taxes, and the illicit market changes over time depending on factors such as tax rates, laws and regulations, and patterns of law enforcement.[67] Illegal tobacco sales can range from small individual purchases to organized criminal groups with sophisticated operations.[68] Small-scale tax evasion tends to increase sharply after a tax increase and then fade over time as customers gradually choose convenience over price,[69] while large-scale smuggling is influenced more by factors such a political corruption and the existence of organized crime networks in a particular area.[70] Methods of tobacco tax evasion include unlicensed manufacturing; manufacturer underreporting of sales or manufacturing to the state; smuggling product into the country; illegal re-sale of products in a high-tax state that were purchased in another, lower-tax state; selling product marked "export-only" in the United States; illegal sale or re-sale of product purchased on Native American territory to non-members of the tribe; and purchasing from websites that do not charge taxes.[71]

The constantly changing nature of tobacco tax evasion patterns and methods has caused the United States Government Accountability Office to refer to enforcement as a "whack-a-mole" problem.[72] Further compounding the problem, law enforcement may not have community support in curbing tobacco tax evasion. Citizens on limited budgets may be supportive of smugglers who can offer them cheaper cigarettes, particularly if they are addicted to nicotine and tempted to forego necessities in order to afford cigarettes.[73]

Unfortunately, high potential profits and low legal risk combine to make tobacco tax evasion an enticing criminal venture.[74] First, smuggling tobacco is a very profitable business. A truckload (48,000 cartons) of Virginia-purchased cigarettes resold in NYC can yield $2 million in profit,[75] and even small-scale operations can net as much as $7,000 a day.[76] Tobacco smuggling can be more profitable than drug dealing in some cases,[77] with criminals offering undercover agents drugs and weapons for cigarettes.[78] A Maryland anti-smuggling officer observed "[T]he amount of money is phenomenal. It's tens of thousands of dollars in any particular run."[79] Second, the legal penalties for illegal tobacco sales are significantly lower than for other kinds of illegal trade, providing a further incentive for tax evasion.[80] Confiscation is commonly the only real penalty smugglers face,[81] and in cases resulting in jail time the sentence is often only a few years (higher sentences usually occur only when drugs or weapons are involved).[82] These light penalties make tobacco smuggling a low-risk criminal venture[83] that is particularly attractive to organized criminal groups that already have contacts and resources for smuggling drugs or arms.[84] The 2009 Prevent All Cigarette Trafficking ("PACT") Act, a federal law addressing tobacco smuggling, has begun to address this problem by increasing penalties (*see* discussion in Part V *infra*). Unfortunately, federal efforts to combat tobacco smuggling have been lacking. A 2009 Department of Justice report stated that from 2004-2009, only about 2% of the budget of the Bureau of Alcohol, Tobacco, Firearms, and Explosives ("ATF") was dedicated to tobacco and alcohol diversion combined,[85] reflecting that tobacco diversion was a low priority.[86] ATF requested additional manpower and funding for diversion in 2010, but this request was not approved by the Office of Management and Budget.[87] The report found numerous problems with ATF's diversion program, including primarily *ad hoc* efforts, a lack of communication across field divisions, inadequate support from the agency, and no way to share intelligence nationally.[88] Remarkably, although tobacco and alcohol diversion cases made up only 1% of ATF's caseload from 2004-2008, they comprised 46% of the value of seizures from all investigations,[89] suggesting that large financial losses to both federal and state governments often go unaddressed.

Methods of Tobacco Tax Evasion

One of the easiest and most common ways of avoiding tobacco taxes is to exploit the tax differences among states. For example, a pack of cigarettes in Richmond, Virginia might cost about $5, while the same pack would sell for about $13 in New York City. These dramatically different tax rates mean that the price of a case of cigarettes in the two states would vary by about $3000, creating an incentive for easy and illegal profit by selling Virginia-purchased cigarettes in New York.[90] This illegal interstate re-selling is known as "bootlegging."[91] Interstate smuggling can be appealing to smaller-scale

Methods of Cigarette Tax Evasion

- Unlicensed manufacturing
- Manufacturer underreporting sales or manufacturing to the state
- Smuggling products into the country without paying taxes and duties
- Illegal re-sale of products in a high-tax state that were purchased in a lower-tax state
- Selling products designated "export only" in the U.S.
- Illegal sale or re-sale of products purchased on Native American reservations to non-members of the tribe
- Purchasing from websites that do not charge taxes

Retail hiding space for contraband cigarettes. Source: New York City Department of Health and Mental Hygiene

operations that are not prepared to assume the risks of smuggling across international borders.[92] Larger-scale schemes might involve buying products from a wholesaler in a state that does not use tax stamps (e.g., the Carolinas and North Dakota) and then affixing counterfeit stamps from another, higher-tax state.[93]

Not all tax evasion is based on differences in tax rates. Large-scale smuggling operations tend to avoid paying taxes altogether by completely removing products from the legal supply chain.[94] Cigarettes that are exported to other countries are exempt from the federal excise tax, and some criminals seek to exploit this exemption by re-directing products made for export into the United States market,[95] particularly to high-tax states like New York. The three largest American manufacturers have decreased their exports in recent years, but there is evidence that illicit traders are diverting larger numbers of cigarettes made by small manufacturers still producing cigarettes for export.[96]

Cigarettes may also be illegally imported into the country in order to avoid taxes. These products typically are hidden, disguised, and/or not reported to United States Customs. They also may be falsely reported as other commodities or as a tobacco product with a lower tax rate.[97] Additionally, orders of cigarettes from foreign websites rarely include the payment of required federal taxes,[98] although the PACT Act has reduced this problem (*see* discussion in Part V *infra*).[99]

Illegal sales such as the ones described above may take place in retail stores or be sold in private venues by individuals. Manufacturers and distributors can also be involved in tax evasion. Illegal domestic manufacturers might produce cigarettes that are not reported to the TTB or taxed, while legal manufacturers may underreport the volume of cigarettes produced in order to reduce their federal tax burden.[100] Wholesalers and distributors might do the opposite to avoid state taxes, over-reporting out-of-state sales that would be exempt from their own state's tax.[101]

Figure 2 illustrates some of the ways illegal trade diverts cigarettes from the legal supply chain.

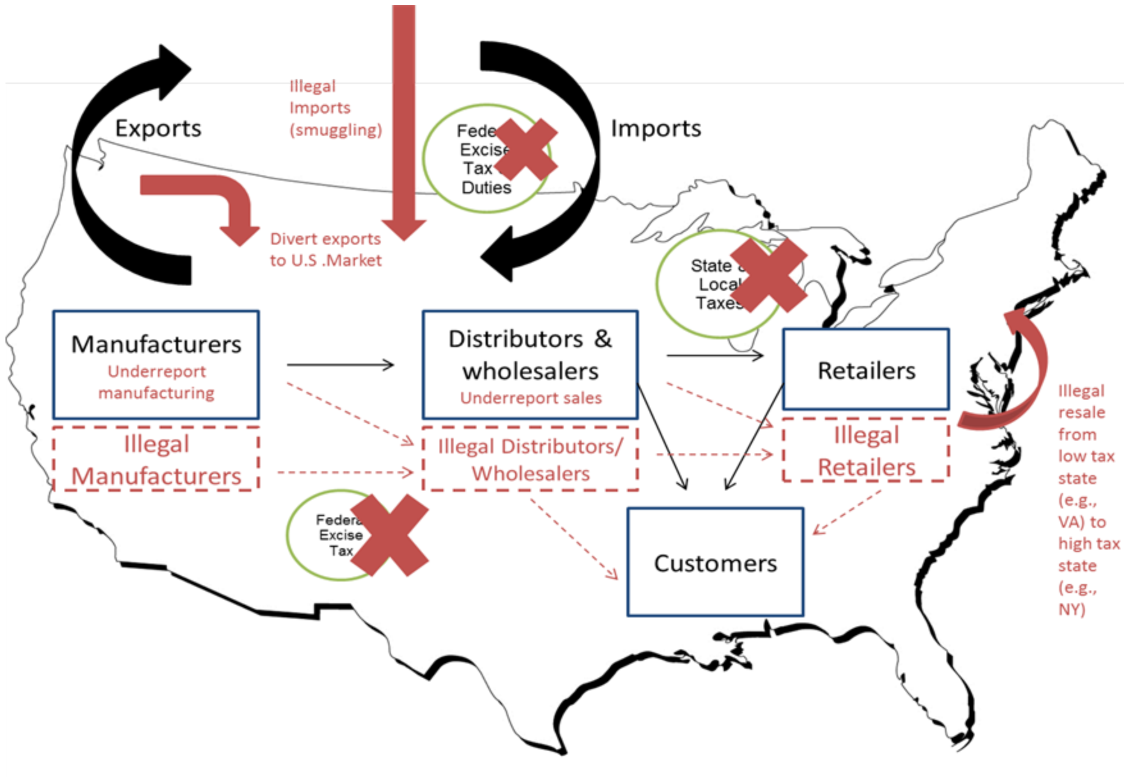


Figure 2. *Illegal cigarette diversion. Source: U.S. Gov. Accountability Office, Report to Congressional Committees*, Illicit Tobacco: Various Schemes Are Used to Evade Taxes and Fees *(2011)*

Native American Nations and Tobacco Tax Evasion

Native American nations play a key role in tobacco tax evasion in New York. Native American tribes are sovereign, which means that they possess nationhood status and retain the power of self-government, free to regulate their internal affairs without foreign interference. Nonetheless, through agreement tribes are subject to the United States Congress, and recent litigation has established that Native American manufacturers must pay federal taxes even on tribally-manufactured cigarettes.[102] Tribes have not generally entered into jurisdictional agreements with the states in which they are located, and thus, as sovereign nations, they retain taxation and other governmental authority.[103] Therefore, unless Congress acts, New York is largely powerless to regulate activity on Native American territories. Retailers on Native American lands may sell cigarettes tax-free to members of their own tribe, but it is illegal to sell to non-members of the tribe without charging the state tobacco tax.[104] Nonetheless, many Native American retailers routinely sell state-tax-free tobacco products to all customers. The large number of cigarettes previously imported by some Native American tribes in New York – more than their entire population could have possibly smoked – made it obvious that they were selling regularly to non-members of the tribe.[105] New Yorkers who are not members of a tribe often travel to Native American reservations specifically to purchase cheap, untaxed cigarettes. Some of these buyers are seeking the products for personal use and others intend to resell them illegally in high-tax areas like New York City.[106] Prior to

Tobacco outlet in western New York. Source: Unknown; on file with author

2010, when most tribes stopped selling name-brand cigarettes (*see* discussion *infra*), about a third of all brand-name sales in New York were estimated to be tax-free sales on reservations,[107] and western New York's Seneca Nation tribe is a major seller of tax-free cigarettes across the country.[108]

Despite a 1976 court ruling recognizing its right to collect taxes on cigarettes sales to non-members of a tribe that occur on Native American lands,[109] New York did not attempt to collect any taxes until 1988, when it passed a law that set a quota for Native American retailers' tax-free sales based on the "probable demand" of tribal members. The resulting litigation culminated in a 1994 Supreme Court ruling again affirming New York's right to collect the tax and approving the "probable demand" framework (though also allowing Native Americans to challenge its implementation if it proved problematic in the future).[110] The state did not attempt to enforce this law, however, in the wake of political battles and strong resistance from Native American tribes.[111] A group of non-Native retailers sued, claiming that state enforcement of tax collection against some retailers but not others violated their rights to equal protection, but a state court held that the state is not required to exercise its right to collect taxes from Native American retailers if the legislature chooses not to enforce the law for practical reasons.[112]

In 2005, New York passed another tax collection law that again involved estimating the amount of cigarette sales on reservations to tribal members versus non-members. Based on the "probable demand" standard from the earlier law, the new law provided that tribes would receive tax-exempt coupons for the expected number of tribal member purchases. Tribes could then give these coupons to wholesalers instead of paying taxes. Wholesalers, which distribute products made off-reservation to retailers, were required to pre-pay state taxes on all cigarettes, including those sold to Native American retailers, but they could exchange the coupons for a refund of taxes paid on cigarettes sold tax-free on reservations to tribal members.[113] Because New York lacks direct jurisdiction over Native American retailers, this law was designed to place the burden on wholesalers, over which the state retains jurisdiction, to ensure that state taxes were paid. The state failed to issue any regulations specifying the details of this system and attempted to negotiate an agreement directly with several tribes. Meanwhile, several county District Attorneys attempted enforce the law anyway; litigation followed, and the state appellate court ultimately held that, although New York could collect tobacco taxes on Native American sales to non-members of the tribe, reasonable collection mechanisms had to be in place before enforcement.[114]

In 2010, the cash-strapped state revised the 2005 law in yet another attempt to collect tobacco taxes. The new version of the law required wholesalers to affix pre-paid tax stamps to every pack of cigarettes sold, and, like the 2005 version, it allowed wholesalers to receive reimbursement for coupons used in lieu of tax payment by Native American retailers.[115] Native American tribes could choose not to participate in the coupon system, so the law also provided for an alternative “prior approval” system in which wholesalers got prior approval from the state Department of Taxation to sell tax-free to Native American retailers an amount of cigarettes that would not exceed the “probable demand” threshold.[116] The state calculated “probable demand” based on census and per capita cigarette consumption data.[117] Calling this law an “act of war” and “a deliberate effort to sabotage our federal treaty rights,” Native Americans retailers challenged it in court.[118] A federal appellate court held that the Native American tribes were unlikely to win on the merits and denied their requests for preliminary injunctions to enforcing the law,[119] and shortly afterwards a state appellate court denied all remaining preliminary injunctions and temporary restraining orders.[120]

In the wake of these decisions, many tribes stopped selling name-brand cigarettes and began to make their own Native American brands on reservations to bypass wholesalers and avoid the prospect of paying state tax on name-brand products.[121]

Although Native American manufacturers are usually federally licensed and pay federal taxes, it is difficult for the state to hold Native manufacturers responsible for ensuring that retailers pay state taxes. In 2013, New York entered into an agreement with the Oneida Nation that resolved several long-standing disputes, including the litigation mentioned above. Among other provisions, the agreement required the Nation to impose its own tax on cigarettes at a rate equal to or greater than the state and county sales, use, and occupancy tax rates; the Nation would keep the tax revenue, which it had to spend on programs similar to those funded by New York through state taxes. This agreement applied to both name brand and Native-produced cigarettes sold to non-members of the tribe.[122]

Though mostly resolved from a legal standpoint, tobacco tax collection remains politically complicated by longstanding and highly contentious property disputes between New York and the Native American tribes within its borders. Many Native Americans view state attempts to collect tobacco taxes as an extension of a long history of oppressive property confiscation.[123] The state, meanwhile, maintains that the tremendous volume of tobacco sales on Native American reservations to non-members of tribes has little to do with Native American sovereignty,

Source: Associated Press

a concept used merely as a cover for large-scale evasion of New York law by New York residents. Clashes between police and Native Americans when the state has attempted to collect the tax have resulted in violence and physical injury,[124] and in 2009 the Governor of New York even requested a "violence assessment" when considering increasing tax collection enforcement efforts.[125] Regardless of the governor's political party affiliation,[126] the executive branch appears to have concluded that the political consequences of collecting the tax are not worth the revenue gained.[127] Public health costs and benefits do not seem to have been a major consideration in these private deliberations. Fortunately, after recent court decisions removed the remaining legal barriers, it appears that New York finally intends to begin implementation and enforcement of a tax collection system.[128]

Internet Sales

Tax-free sales of tobacco products over the internet are a large problem. In 2000, only 88 sites were selling tax-free cigarettes to US residents, but by 2006 there were 772.[129] These sales are usually tax-free, providing a major pathway for tax evasion and increasing youth access because it is challenging to verify age online.[130] New York was a leader in addressing this problem, banning direct-to-consumer cigarette shipments[131] and successfully defending this law in court.[132] New York also helped organize an agreement among multiple states and credit card companies to prevent processing of payments for mailing untaxed cigarettes[133] and made agreements with private common carriers like UPS and FedEx that they would stop delivering cigarette shipments.[134] New York also pursued online

purchasers to collect unpaid tobacco taxes.[135] In one 4-year period, the state collected $3 million in "use taxes."[136]

Nevertheless, the state was unable to prevent the U.S. Postal Service from handling tobacco mailings. The PACT Act (*see* Part V *infra*) sought to remedy states' lack of power by making it illegal to deliver tobacco products through the mail.

Online sales have been a problem with Native American sellers in particular. New York has no jurisdiction over Native American shippers on Native American reservations, creating an enforcement gap. The PACT Act requires online sellers to report sales, verify age of purchasers, and follow local laws at the shipping location.[137] Even after the PACT Act went into effect, however, websites based in the Seneca Nation were still shipping as much as 1.7 tons of untaxed cigarettes per week around the country. According to a story on New York City's civil racketeering lawsuit aimed at preventing shipments of untaxed internet sales to the Seneca Nation:

> *[A]fter the new law barred anyone from shipping cigarettes through the Postal*

> *Service, and major delivery companies like FedEx and UPS separately agreed to end deliveries, some reservation-based distributors simply turned to new networks of logistics and shipping companies to reach their customers. Buyers still weren't required to pay taxes. Some sites never asked buyers to prove their age, or even provide a real name. A few retailers proudly advertised that they would help protect tax scofflaws.*[138]

Multiple cities and localities have initiated still-pending lawsuits against the shipping companies involved in these deliveries.

Military Commissaries

Another source of cheap, untaxed cigarettes is military bases. Although smoking has been shown to "significantly harm the combat readiness of military personnel," prices on military bases tend to be so cheap that "the military is the only retailer which consistently loses money on tobacco."[139] Experts have lamented that these low prices have long been "promoting a culture of tobacco use in the U.S. Military."[140] One study compared cigarette prices at every military retail store in the country to prices at the nearest WalMart and found a military discount of up to 73%.[141] Because generally only veterans, military personnel, and their families are permitted to shop at a commissary, the military is a less significant a source of untaxed cigarettes in New York than Native American reservations.

Suspect from Staten Island, NY, loads cartons of cigarettes purchased at PX at Ft. Belvoir, VA into his car. He was arrested by police shortly after leaving the base. Source: Richmond Times-Dispatch

Tobacco Industry Involvement in Tax Evasion

The tobacco industry has "a long history of involvement in smuggling operations,"[142] and "[e]vidence of the direct and indirect involvement of the tobacco industry in this large scale fraud is well documented."[143] The industry has been a willing participant in tax evasion around the world,[144] in some cases knowingly providing smugglers with cigarettes.[145] The industry has little incentive to combat tobacco tax evasion[146] because it largely benefits from illicit trade.[147] Tax evasion makes products more affordable, which discourages quitting, maintains demand, and increases the likelihood that youthful experimenters will become adult smokers.[148] Smuggling can also increase demand for specific brands that were not as widely available through legal importation.[149] Industry complicity in smuggling has been a particular problem in Canada[150] and Europe,[151] especially the United Kingdom.[152]

The notable exception to the industry's lack of incentive to deter smuggling is counterfeiting. The industry loses money and brand integrity from counterfeiting and is thus highly motivated to prevent it. For example, Altria, the parent company of Philip Morris USA, has a policy of supporting federal, state and local law enforcement and regulatory agencies, supporting federal and state legislation to protect against illegal cigarette trafficking, and pursuing litigation, to protect its trademarks.[153]

Any apparent tobacco industry support for efforts to combat illicit trade outside the realm of counterfeiting should be viewed with healthy skepticism. For example, in 2011, just before the long-negotiated adoption of the Framework for Tobacco Control's Illicit Trade Protocol urging high-tech solutions to smuggling (*see infra* Part VI), Philip Morris International ("PMI") made a sizable donation to the international police organization INTERPOL and then, along with three other major tobacco companies, formed an agreement with INTERPOL to use the industry-designed track-and-trace system, "Codentify."[154] Codentify is a system designed primarily to combat counterfeiting and has limitations compared to high-tech track-and-trace systems, such as an ability to identify where a product left the legal supply chain.[155] Further, "[r]eplacing tax stamps with Codentify would require delegating the power and technology for tax collection from government to an industry that could and has obviously benefitted from non-payment of tobacco excise."[156] Despite its limitations compared to other available systems, leaked company documents show that in 2010 four international tobacco companies agreed to "use the PMI Codentify marking system on their cigarette products

How Does the State Know?

How does New York know which individuals did not pay taxes on their online cigarette purchases? The Jenkins Act (*see* Part V) requires sellers to report the names and addresses of cigarette buyers to the state, and New York has the authority to collect the tax from buyers within the state. When the state does not have jurisdiction, it can seek to make voluntary agreements with involved third parties like credit card companies and parcel delivery services.

and work collectively to promote this system to governments on a global basis."[157]

PART V: Federal Agencies and Laws

Federal Agencies

Any real effort to combat tobacco tax evasion in New York must involve coordination between the state and the federal agencies involved in tobacco taxation. These include the Bureau of Alcohol, Tobacco, Firearms, and Explosives ("ATF"), now a division of the Department of Justice, which is in charge of law enforcement related to "illegal diversion" of tobacco. The Department of the Treasury's Alcohol and Tobacco Tax and Trade Bureau ("TTB") collects tobacco taxes for the United States government. Several other federal agencies also are involved in regulating illicit tobacco trade. The Federal Trade Commission enforces the Fair Packaging and Labeling Act, which sets forth accuracy and warnings requirements for labels and regulates tobacco advertising. United States Customs and Border Protection is in charge of taxes, fees, record-keeping, and other import requirements.

Federal Laws

The Jenkins Act of 1949 attempted to address interstate tobacco sales. It requires sellers to report the names and shipping addresses of recipients as well as the brand and quantity of cigarettes to the state to which they were sent. Rarely enforced due to jurisdiction, Native American sovereignty, and seller identification problems,[158] this law has been largely ineffective.[159]

The Contraband Cigarette Trafficking Act defines and penalizes illegal tobacco trade and establishes record-keeping requirements for all transactions over a set threshold. The USA PATRIOT Improvement and Reauthorization ACT of 2005 lowered these thresholds (to greater than 10,000 cigarettes and/or 500 single-unit package of smokeless tobacco),[160] and the PACT Act (*see infra*) increased enforcement authority.

The Prevent All Cigarette Trafficking Act (PACT) is the key federal law in addressing illicit tobacco sales. Passed in 2009 and enforced mostly by the ATF, it requires reporting tobacco taxes on sales, sales advertising, and shipping/transport of cigarettes and smokeless tobacco, including shipments to states, localities, and Native American reservations that impose their own taxes on the product.[161] It designates cigarettes and smokeless tobacco as "non-mailable" materials and prohibits common carriers from delivering packages mailed by noncompliant sellers.[162]

The PACT Act requires tobacco sellers who deliver by mail to pay taxes, register with and report to the state, verify age of purchasers at both sale and delivery, follow local laws at the shipping location, and mail only products weighing 10 pounds or less. Significantly, it gives states, localities, and Native American tribes the right to sue violators (and also extends this right to manufacturers, importers, and export warehouses). PACT does not, however, allow states to sue Native American tribes for non-enforcement, though they can make voluntary agreements for collection. The act imposes criminal fines and up to 3 years in prison as well as civil penalties.[163]

The constitutionality of the PACT Act is currently being challenged in court. In order for a state to tax a product or transaction, there must be some "minimum contacts" between the taxed activity or entity and the state.[164] Several online retailers have argued that the PACT Act is unconstitutionally broad, violating the due process rights of retailers who do not meet the legal standard for minimum connections in a state. So far, two federal courts have agreed, issuing temporary injunctions (both later upheld on appeal) against enforcement of the PACT Act until the litigation is resolved.[165] These two cases are currently being appealed. In contrast, another federal court found that the minimum contacts test did not apply to a federal law, and in any case, making sales online would meet the standard; based on these conclusions, the court dismissed the retailer's case.[166] The legal resolution of this issue is likely to remain uncertain until all of these lawsuits are resolved.

The Family Smoking Prevention and Tobacco Control Act of 2009 gave the Food and Drug Administration the authority to regulate tobacco products. In a section of the law addressing smuggling, it established new labeling, inspection, and record-keeping requirements and also made manufacturers and distributors responsible for reporting known or "reasonably suspected" smuggling and/or tax evasion.[167]

PART VI: Proposed Solutions

Tobacco smuggling should be easier to trace than other kinds of smuggling because there are legal channels of distribution.[168] Some already-established points of contact with state and local government, such as annual Synar Amendment compliance inspections, could be expanded to serve as checkpoints for evidence of other illegal activity. Many of the players in the supply chain have the power to decrease illegal sales and should be required to follow procedures to reduce smuggling,[169] as eliminating the source of contraband tobacco is an important part of the solution.[170]

Collect Taxes from Native American Sales

The single most important action New York could take to combat the illicit tobacco trade is to enforce the law after years of forbearance and collect taxes on Native American retailers' sales of tobacco to non-members of the tribe. This would have a direct impact on public health in New York and also regain at least hundreds of millions of dollars per year in lost revenue. With most legal barriers now removed, the state's historical reluctance to confront the controversy and potential resistance is the largest remaining obstacle. While it is understandable that the state wishes to avoid angry and potentially violent confrontations with Native American retailers, its longtime refusal to enforce the law has seriously undermined its public health authority. Although tobacco tax laws and court judgments have attempted to respect the right of Native American tribes to conduct their own business free of state interference, this right does not extend to the flagrant evasion of state law in business transactions with non-members of the tribe. In any case, while the public health implications are the same regardless of who benefits from the scheme, only a few members of a tribe - the smokeshop owners

- actually reap the financial rewards of tobacco tax evasion.[171]

Putting the burden on wholesalers through the state's "probable demand" standard, implemented through either a tax-exempt coupon or prior approval system, seems likely to withstand legal challenges as long as it is implemented in a reasonable manner. The recent agreement between New York and the Oneida Nation could also serve as a useful model for moving forward. Native American merchants agreeing to charge the equivalent of state and local taxes on reservation purchases in exchange for being allowed to keep the resulting revenue as long as it is spent on health programs is a win-win solution that would benefit the health of both New Yorkers generally and Native Americans specifically. In any case, the public health – and thus human - cost of allowing massive volumes of tax-free tobacco sales in the state with the highest tobacco taxes in the country is simply too high to ignore any longer.

Use Full Enforcement Powers under the PACT Act, Including Right to Sue Violators

While the PACT Act does not allow states to sue Native American tribes, it does permit them to bring enforcement suits against other tobacco tax violators. New York should use this authority to crack down on tax evaders, especially repeat or large-scale offenders, by imposing penalties likely to deter others. Some states have begun to exercise this right by suing the distribution networks for tax-free online sales from Native American sellers. New York and other states are suing a Native American wholesaler, Native Wholesale Supply, for receiving untaxed shipments of cigarettes

898 cartons of untaxed cigarettes (Brooklyn, NY). Source: New York Daily News from a Canadian tribal manufacturer. Localities with taxing authority can also bring lawsuits; New York City is currently pursuing legal action against two companies that allegedly helped deliver cigarettes from Native American reservations into the city tax-free.[172]

Coordinate Efforts with Other States, Localities and the Federal Government

Statewide efforts work best when localities are in communication with each other and can coordinate their efforts. For example, coordinating stings and crackdowns can prevent tax evasion schemes from simply moving to another part of the state, and most smuggling operations typically have a broad reach. Further, because New York is frequently the target location for interstate bootlegging or international smuggling, cooperation with other states and the federal government is necessary.

Design and Require High-Tech Tax Stamps that Are Difficult to Counterfeit

New technologies should be a key part of a strategy to reduce tobacco tax evasion. First, tax stamps can be made more high-tech and difficult to counterfeit,[173] similar to New York's enhanced driver's licenses. Advances in packaging can lead to "track and trace" systems that monitor products all the way down the supply chain.[174] The Framework Convention on Tobacco Control ("FCTC") recommends "developing a practical tracking and tracing regime that would further secure the distribution system and assist in the investigation of illicit trade," including bar codes, radio-frequency identification ("RFID") systems, invisible ink, product laser "fingerprinting," and code verification systems.[175] California has already designed high-tech stamps with changing colors that are hard to counterfeit and encrypted information that can track the product along the chain of commerce,[176] and New York should follow its lead. Ultimately, a high-tech digital tracking system would require coordination between the state and federal levels, but state improvements in technology are an important first step. The 2014 Surgeon General's Report asserted "There is no question that these proven interventions need to be fully implemented and sustained at recommended levels."[177] The added expense of these systems can be covered by additional tobacco taxes, although it is likely that they would pay for themselves in recovered tax revenue.[178] For example, an FCTC report found that California's introduction of new licensing requirements, high-tech tax stamps and greater authority for investigations cost $9 million a year while reducing tax evasion losses by $110 million between 2003-2006 and increasing tax revenue by $75 million between January 2004 and March 2006.[179]

Pressure Indirectly Involved Third Parties

New York has been a leader among states in working with third parties like credit card companies to combat illicit tobacco trade. The state should continue its outreach to legitimate businesses that may be unintentionally involved in tax evasion schemes. Agreements between New York and such businesses could benefit both parties. Businesses could receive positive publicity for taking proactive steps to ensure that they are in compliance with the law, and the state would enhance its ability to affect channels where it lacks direct jurisdiction.

Make It Easy to Report Tax Evasion and Protect Whistleblowers from Retaliation

New York should emulate federal law in encouraging whistleblowers to report their knowledge of tax evasion by establishing a hotline, website, or another easy way to report suspected tobacco tax evasion and widely publicize it.[180] In addition, the law should explicitly protect whistleblowers,[181] especially those who are not employees of entities involved in smuggling. Current New York law protects whistleblowers in certain situations, but there are many gaps in the law.[182] For example, no protection is offered for refusing to participate in illegal activities unless they pose a danger to the public, no protection is offered to an employee who reports a violation in good faith but was mistaken, and in many cases an employee must report the problem to a supervisor before filing a claim. In addition, protection is offered only to employees of the lawbreaking entities.[183]

Make Political Corruption and Organized Crime a Law Enforcement Priority

It is critical to aggressively combat political corruption and organized crime, which not only facilitate tobacco smuggling but also a host of other illicit activities. Successful operations would involve serious political will, investment, and manpower.

Work Directly with Local Communities to Design Programs

Many communities may resent law enforcement efforts to stamp out illicit cigarette trade, viewing smugglers as allies in helping them to afford the cigarettes to which they are addicted. No matter how well-intentioned, public health initiatives may be considered intrusive or controlling if they seek to change long-established behaviors. As one study in Harlem concluded:

> Community-based participatory research and action models that include community residents and organizations in the process of social change show promise in reducing tobacco-related health disparities. Community members may be more effective than local government agencies in creating local educational campaigns that reframe illegal sales as exploitive of poor neighborhoods and deleterious to the health of the community. It is also crucial to collaborate with community members to develop interventions that address pro-smoking norms.[184]

It might also be useful to educate communities about the effects of lost tax revenue on their own members. For example, a wide range of programs funded by the Tobacco Control and Initiatives Pool[185] are impacted negatively by illicit tobacco trade, and local businesses that comply with tobacco tax laws are disadvantaged by illicit tax-free sales.

Conclusion

Tobacco tax evasion has been extremely costly for New York from both a financial and public health standpoint. New York has the highest tobacco taxes in the country, which could be a tremendous public health asset, but it must do more to address its significant level of tobacco tax evasion. The state can take affirmative steps to combat this problem by committing to implement a plan to collect taxes on sales by Native American retailers to non-members of the tribe, perhaps though individual agreements with tribal leaders; taking advantage of enforcement powers under the PACT Act by filing lawsuits against tax evaders and facilitators; designing high-tech, hard-to-counterfeit tax stamps and a statewide track-and-trace system; making agreements with third parties who may be unwittingly involved in tax evasion schemes; establishing an easy way to report tobacco tax evasion and expanding its whistleblower laws to protect those who report it; cracking down on political corruption and organized crime generally; and working directly with local communities to design educational campaigns and interventions. Because tobacco tax evasion often involves interstate smuggling, internet purchases, and other issues that extend beyond state borders, however, New York's own efforts to stop illicit cigarette trade would be greatly enhanced by better effort and support from the federal government. A partnership between New York and the many federal agencies charged with combating tobacco tax evasion would be the ideal model for eliminating widespread tobacco tax evasion and improving the health of all New Yorkers.

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Appendix A

Other Tobacco Products ("OTP")

Though cigarettes are the most commonly used tobacco product,[1] it is also important to consider other tobacco products ("OTP") from a public health perspective. OTP include cigars and cigarillos, smokeless tobacco like snus, chew, and snuff, loose pipe and cigarette tobacco, and certain disssolvables, gels and waterpipe tobacco.[2]

In a 2009 effort to set taxes on similar tobacco products at similar rates and reduce the prevalence of cheaper products, the federal Children's Health Insurance Program Reauthorization Act (SCHIP) greatly increased the excise tax on OTP.[3] The changes included taxing small cigars the same as cigarettes and bringing RYO tobacco rates more in line with machine-rolled cigarette taxes.[4]

Every state but Pennsylvania imposes a state tax on OTP. Sometimes the tax is a specific amount and other times it is a percentage of the product price (known as *ad valorem*).[5] As of November 2014, New York taxes little cigars and snuff at specific rates ($4.35 per 20 little cigars and $2 per ounce of snuff) and all other products *ad valorem* at 75% of the wholesale price.[6]

Evasion of taxes on OTP is currently not as large a problem as cigarettes tax evasion because it is not as profitable; there is not as much variation in state tax rates of OTP as there is with cigarette tax rates. Nonetheless, interstate smuggling of OTP does occur. First, the Commonwealth of Pennsylvania does not tax any OTP except little cigars,[7] making it an exception among states and the primary source for OTP bootlegging.[8] Second, the tax payment system for OTP typically does not involve tax stamps,[9] making tax avoidance easier.

The tobacco industry typically tries to steer tax-sensitive consumers to lower-tax products. For example, when the federal tax on roll-your-own tobacco rose much higher than the tax on pipe tobacco, the industry began to package and promote pipe tobacco similarly to roll-your-own, leading consumers to switch to the cheaper product as an alternative ingredient in self-rolled cigarettes.[10] Similarly, when in 2009 the federal tax rate on small cigars rose dramatically, the industry sought to redesign its products to qualify as large cigars by TTB standards because the tax rate increase on large cigars was not as high.[11] Its efforts appear to have been successful; there were significant market shifts from roll-your-own to pipe tobacco and from small cigars to large after the tax rates were changed.[12]

OTP tax evasion may become a larger problem in the future if cigarette taxes continue to rise faster than OTP taxes and law enforcement cracks down on cigarette smuggling. Further, the Surgeon General warned in 2014 that "the use of multiple tobacco products is increasingly common, especially among youth smokers,"[13] which may lead young smokers to switch from cigarettes to cheaper OTP. A key part of the solution is to raise taxes on OTP closer to the rate of cigarettes. While doing so might increase OTP tax evasion, at least initially, "states typically profit more from taxes than they lose from smuggling,"[14] and raising OTP tax rates is highly likely to result in similar public health benefits to raising cigarette taxes.

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Appendix B

Master Settlement Agreement

The 1998 Master Settlement Agreement (MSA) is a contract between 46 states, including New York, and the four major American tobacco companies (the other 4 states had already negotiated separate agreements with the companies). The largest civil settlement ever in the United States, it imposes a host of advertising and promotion requirements on the tobacco companies.[1] It also requires them to compensate the states annually for expenditures on tobacco-related disease.[2] The amount paid by the industry to each state depends on several factors, including the volume of domestic sales made by participating manufacturers.[3] Payments are expected to total $206 billion by 2023.[4] In 2012, New York's MSA payments totaled $737 million.[5]

Although MSA payments are not technically a tax, state tax evasion schemes usually involve avoidance of MSA payments as well. A 2011 study by the Government Accountability found that the evasion of MSA payments "has been a significant problem for states,"[6] with manufacturers underreporting their sales into a state or falsely claiming that sales were made to a buyer in a non-MSA state or Native American territory.[7] This problem is especially significant for New York, which receives a larger amount of MSA volume-based payments than most other states[8] and also one of the highest percentages of contribution fund payments for contributions to the final resolution of the litigation that led to the settlement.[9] New York has designated a proportion of these funds for tobacco control and health insurance programs.[10] Any state efforts to combat illicit tobacco trade are likely to decrease MSA payment evasion as well, further increasing state revenue linked to public health expenditures.

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