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Highlights

Highlights of GAO-11-313, a report to congressional committees

Why GAO Did This Study

Federal and state governments have raised excise taxes on tobacco products to discourage tobacco use and increase revenues. Cross-border and illicit trade in tobacco products can undermine these policy objectives by avoiding excise taxes and increasing the availability of these products to consumers at lower cost.

On June 22, 2009, Congress passed the Family Smoking Prevention and Tobacco Control Act (Pub. L. No. 111-31), which directed GAO to report on cross-border and illicit trade in tobacco products. Cross-border trade is defined in the Act as trade across a U.S. border, state, territory, or Indian country. Illicit trade is defined in the Act as any practice or conduct prohibited by law which relates to or facilitates the production, shipment, receipt, possession, distribution, sale, or purchase of tobacco products. This report is the first of two GAO products that will respond to this mandate.

This report examines (1) incentives that are important for understanding cross-border and illicit trade in tobacco products; and (2) different schemes used to generate profits from cross-border and illicit trade in tobacco products. GAO interviewed government officials, industry representatives, and other subject matter experts. GAO collected and analyzed data from these sources and reviewed relevant literature.

View GAO-11-313 or key components.
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ILLICIT TOBACCO

Various Schemes Are Used to Evade Taxes and Fees

What GAO Found

Tobacco products face varying levels of taxation in different locations, creating opportunities and incentives for illicit trade. Cigarettes are taxed at the federal, state, and in some cases, local levels. According to industry representatives, taxes and other fees make up significant components of the final price of cigarettes, averaging 53 percent of the retail price. While the national average retail price of a pack of cigarettes was $5.95 in 2010, in New York City, a pack can cost up to $13.00 or more due to high combined state and city taxes. In contrast, a pack of cigarettes in Richmond, Virginia, can cost approximately $5.00, due to low state cigarette taxes there. The tax differential between a case of cigarettes (typically containing 12,000 cigarettes) in New York City and Richmond is over $3,000, creating incentives for illicit trade and profits. Excise taxes and other fees on tobacco products can be evaded at numerous points in the supply chain. Law enforcement officials told us another incentive to engage in this activity is the fact illicit tobacco penalties are comparatively less severe than other forms of illicit trade.

According to experts we spoke with and literature we reviewed, a wide range of schemes are used by different actors to profit from illicit trade in tobacco products, mainly through the evasion of taxes. Schemes can range from individual consumers purchasing tax-free cigarettes from Internet Web sites, to larger-scale interstate trafficking of tobacco products, to smuggling cigarettes into the country by criminal organizations. For example:

- A California distributor purchased approximately $1.4 million in other tobacco products (e.g., cigars and chewing tobacco) from an out-of-state distributor, who disguised the shipments using falsified documents and black plastic wrapping. The California distributor then sold it to customers and failed to pay state excise taxes.
- A criminal organization attempted to conceal two containers of counterfeit cigarettes and pass them through Customs at the Los Angeles/Long Beach port by declaring them as toys and plastic goods.
- A manufacturer evaded Tobacco Master Settlement Agreement (MSA) escrow payments. The manufacturer underreported its cross-border sales to numerous states, including Virginia. By underreporting its sales to Virginia, the manufacturer evaded approximately $580,000 in escrow payments.

Law enforcement officials reported that patterns of schemes are dynamic and identified links between illicit trade in tobacco and other crimes.