

**GAO**

Testimony

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House of Representatives

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# INTERNET CIGARETTE SALES

## Limited Compliance and Enforcement of the Jenkins Act Result in Loss of State Tax Revenue

Statement of Paul L. Jones, Director  
Homeland Security and Justice



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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our work on the extent of compliance by Internet cigarette vendors with the Jenkins Act.<sup>1</sup> The Jenkins Act requires any person who sells and ships cigarettes across a state line to a buyer, other than a licensed distributor, to report the sale to the buyer's state tobacco tax administrator. The act establishes misdemeanor penalties for violating the act. Compliance with this federal law by cigarette sellers enables states to collect cigarette excise taxes from consumers.

However, some state and federal officials are concerned that as Internet cigarette sales continue to grow, particularly as states' cigarette taxes increase, so will the amount of lost state tax revenue due to noncompliance with the Jenkins Act. One research firm estimated that Internet tobacco sales in the United States will exceed \$5 billion in 2005 and that the states will lose about \$1.4 billion in tax revenue from these sales.<sup>2</sup>

My testimony today is based on the results of work that we completed in August of 2002— namely, our report entitled *Internet Cigarette Sales: Giving ATF Investigative Authority May Improve Reporting and Enforcement* (GAO-02-743). Overall, we found that the federal government has had limited involvement with the Jenkins Act concerning Internet cigarette sales. We also noted that states have taken action to promote Jenkins Act compliance by Internet cigarette vendors, but results were limited.

We determined that most Internet cigarette vendors do not comply with the Jenkins Act or notify their customers of their responsibilities under the act. Vendors cited the Internet Tax Freedom Act, privacy laws, and other reasons for noncompliance. A number of Native Americans cited sovereign nation status. GAO's review indicated that these claims are not valid and vendors are not exempt from the Jenkins Act.

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<sup>1</sup>5 U.S.C. §375-378.

<sup>2</sup>*Online Tobacco Sales Grow, States Lose*, Forrester Research, Inc. (Apr. 27, 2001). We were unable to assess the reliability of the estimates because the methodology used in developing it, including key assumptions and data, is proprietary.

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We concluded that states are hampered in attempting to promote Jenkins Act compliance because they lack authority to enforce the act. We suggested that to improve the federal government's efforts in enforcing the Jenkins Act and promoting compliance with the act by Internet cigarette vendors, which may lead to increased state tax revenues from cigarette sales, the Bureau of Alcohol, Tobacco and Firearms (ATF), instead of the Federal Bureau of Investigation (FBI), should be provided with primary jurisdiction to investigate violations of the act.<sup>3</sup> We noted that transferring primary investigative jurisdiction was particularly appropriate because of the FBI's new challenges and priorities related to the threat of terrorism and the FBI's increased counterterrorism efforts.

To perform our work, we obtained information from the Department of Justice (DOJ) and ATF headquarters regarding federal Jenkins Act enforcement actions with respect to Internet cigarette sales. We interviewed officials and obtained documentation from nine selected states<sup>4</sup> regarding states' efforts to promote Jenkins Act compliance by Internet cigarette vendors and estimates of the impact of noncompliance on tax revenues. In addition, we reviewed 147 Internet cigarette vendor Web sites, and we interviewed representatives of five Internet vendors.

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## Background

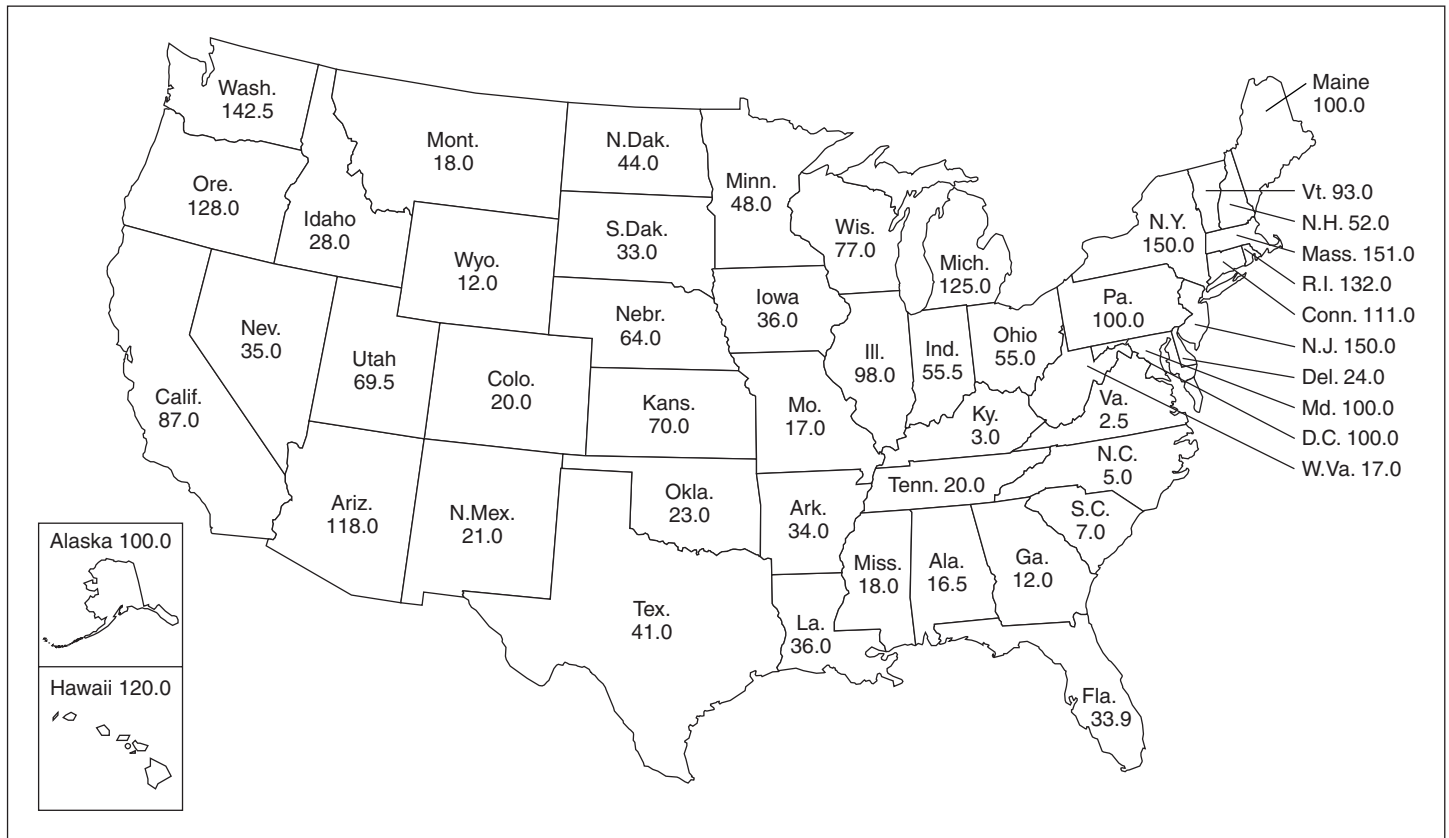
Each state, and the District of Columbia, imposes an excise tax on the sale of cigarettes, which vary from state to state. As of January 1, 2003, the state excise tax rates for a pack of 20 cigarettes ranged from 2.5 cents in Virginia to \$1.51 in Massachusetts (see fig.1). The liability for these taxes generally arises once the cigarettes enter the jurisdiction of the state.

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<sup>3</sup>Since our report was issued, ATF was transferred from the Department of the Treasury to the Department of Justice and is now known as the Bureau of Alcohol, Tobacco, Firearms and Explosives.

<sup>4</sup>We contacted tobacco tax officials in 11 states. Officials in 9 states provided us with information, and officials in 2 states did not provide the information we requested in time for it to be included in our report. We selected the 10 states with the highest cigarette excise tax rates on January 1, 2002, based on the presumption that these states would be among those most interested in promoting Jenkins Act compliance to collect cigarette taxes. Also, we selected one additional state that appeared to have taken action to promote Jenkins Act compliance by Internet cigarette vendors.

**Figure 1: State Cigarette Excise Tax Rates, in Cents, Per Pack of 20 Cigarettes, as of January 1, 2003**



Sources: Developed by GAO based on Federation of Tax Administrators' data, CorelDraw (map).

Many states have increased their cigarette excise taxes in recent years with the intention of increasing tax revenue and discouraging people from smoking. As a result, many smokers are seeking less costly alternatives for purchasing cigarettes, including buying cigarettes while traveling to a neighboring state with a lower cigarette excise tax. The Internet is an alternative that offers consumers the option and convenience of buying cigarettes from vendors in low-tax states without having to physically travel there.

Consumers who use the Internet to buy cigarettes from vendors in other states are liable for their own state's cigarette excise tax and, in some cases, sales and/or use taxes. States can learn of such purchases and the taxes due when vendors comply with the Jenkins Act. Under the act,

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cigarette vendors who sell and ship cigarettes into another state to anyone other than a licensed distributor must report (1) the name and address of the person(s) to whom cigarette shipments were made, (2) the brands of cigarettes shipped, and (3) the quantities of cigarettes shipped. Reports must be filed with a state's tobacco tax administrator no later than the 10th day of each calendar month covering each and every cigarette shipment made to the state during the previous calendar month. The sellers must also file a statement with the state's tobacco tax administrator listing the seller's name, trade name (if any), and address of all business locations. Failure to comply with the Jenkins Act's reporting requirements is a misdemeanor offense, and violators are to be fined not more than \$1,000, or imprisoned not more than 6 months, or both. Although the Jenkins Act, enacted in 1949, clearly predates and did not anticipate cigarette sales on the Internet, vendors' compliance with the act could result in states collecting taxes due on such sales. According to DOJ, the Jenkins Act itself does not forbid Internet sales nor does it impose any taxes.

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## Limited Federal Involvement with the Jenkins Act and Internet Cigarette Sales

The federal government has had limited involvement with the Jenkins Act concerning Internet cigarette sales. We identified three federal investigations involving such potential violations, and none of these had resulted in prosecution (one investigation was still ongoing at the time of our work). No Internet cigarette vendors had been penalized for violating the act, nor had any penalties been sought for violators.

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## FBI Has Primary Investigative Jurisdiction

The Attorney General of the United States is responsible for supervising the enforcement of federal criminal laws, including the investigation and prosecution of Jenkins Act violations.<sup>5</sup> The FBI has primary jurisdiction to investigate suspected violations of the Jenkins Act. However, DOJ and FBI officials were unable to identify any investigations of Internet cigarette vendors or other actions taken to enforce the act's provisions regarding Internet cigarette sales. According to DOJ, the FBI could not provide information on actions to investigate Jenkins Act violations, either by itself

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<sup>5</sup>28 U.S.C. §533 provides that the Attorney General of the United States may appoint officials "to detect and prosecute crimes against the United States..." except where investigative jurisdiction has otherwise been assigned by law.

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or in connection with other charges, because the FBI does not have a section or office with responsibility for investigating Jenkins Act violations and does not track such investigations. Also, DOJ said it does not maintain statistical information on resources used to investigate and prosecute Jenkins Act offenses.

In describing factors affecting the level and extent of FBI and DOJ enforcement actions with respect to the Jenkins Act and Internet cigarette sales, DOJ noted that the act creates misdemeanor penalties for failures to report information to state authorities, and appropriate referrals for suspected violations must be considered with reference to existing enforcement priorities. Since September 11, 2001, it is understood that the FBI's priorities have changed, as unprecedented levels of FBI resources have been devoted to counterterrorism and intelligence initiatives.

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## ATF Has Ancillary Enforcement Authority

ATF, which enforces federal excise tax and criminal laws and regulations related to tobacco products, has ancillary authority to enforce the Jenkins Act.<sup>6</sup> ATF special agents investigate trafficking of contraband tobacco products in violation of federal law and sections of the Internal Revenue Code. For example, ATF enforces the Contraband Cigarette Trafficking Act (CCTA), which makes it unlawful for any person to ship, transport, receive, possess, sell, distribute, or purchase more than 60,000 cigarettes that bear no evidence of state cigarette tax payment in the state in which the cigarettes are found, if such state requires a stamp or other indicia to be placed on cigarette packages to demonstrate payment of taxes (18 U.S.C. 2342).<sup>7</sup> ATF is also responsible for the collection of federal excise taxes on tobacco products and the qualification of applicants for permits to manufacture tobacco products, operate export warehouses, or import tobacco products. ATF inspections verify an applicant's qualification information, check the security of the premise, and ensure tax compliance.

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<sup>6</sup>With ancillary authority to enforce the Jenkins Act, if ATF investigates a possible Contraband Cigarette Trafficking Act violation (i.e., cigarette smuggling), for which it has primary jurisdiction, and determines there is a possible Jenkins Act violation, then ATF may also investigate the Jenkins Act violation and refer it to DOJ for prosecution or injunctive relief.

<sup>7</sup>Certain persons, including permit holders under the Internal Revenue Code, common carriers with proper bills of lading, or individuals licensed by the state where the cigarettes are found, may possess these cigarettes (18 U.S.C. 2341).

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To enforce the CCTA, ATF investigates cigarette smuggling across state borders to evade state cigarette taxes, a felony offense. Internet cigarette vendors that violate the CCTA, either directly or by aiding and abetting others, can also be charged with violating the Jenkins Act if they failed to comply with the act's reporting requirements. ATF can refer Jenkins Act matters uncovered while investigating CCTA violations to DOJ or the appropriate U.S. Attorney's Office for charges to be filed. ATF officials identified three investigations since 1997 of Internet vendors for cigarette smuggling in violation of the CCTA and violating the Jenkins Act.

- In 1997, a special agent in ATF's Anchorage, Alaska, field office noticed an advertisement by a Native American tribe in Washington that sold cigarettes on the Internet. ATF determined from the Alaska Department of Revenue that the vendor was not reporting cigarette sales as required by the Jenkins Act, and its investigation with another ATF office showed that the vendor was shipping cigarettes into Alaska. After ATF discussed potential cigarette smuggling and Jenkins Act violations with the U.S. Attorney's Office for the District of Alaska, it was determined there was no violation of the CCTA.<sup>8</sup> The U.S. Attorney's Office did not want to pursue only a Jenkins Act violation, a misdemeanor offense, and asked ATF to determine whether there was evidence that other felony offenses had been committed. Subsequently, ATF formed a temporary task force with Postal Service inspectors and state of Alaska revenue agents, which demonstrated to the satisfaction of the U.S. Attorney's Office that the Internet cigarette vendor had committed mail fraud. The U.S. Attorney's Office agreed to prosecute the case and sought a grand jury indictment for mail fraud, but not for violating the Jenkins Act. The grand jury denied the indictment. In a letter dated September 1998, the U.S. Attorney's Office requested that the vendor either cease selling cigarettes in Alaska and file the required Jenkins Act reports for previous sales, or come into compliance with the act by filing all past and future Jenkins Act reports. In another letter dated December 1998, the U.S. Attorney's Office instructed the vendor to immediately comply with all requirements of the Jenkins Act. However, an official at the Alaska Department of Revenue told us that the vendor never complied. No further action has been taken.

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<sup>8</sup>The U.S. Attorney's Office determined there was no CCTA violation because the state of Alaska did not require that tax stamps be placed on cigarette packages as evidence that state taxes were paid.

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- Another investigation, carried out in 1999, involved a Native American tribe selling cigarettes on the Internet directly to consumers and other tribes. The tribe was not paying state tobacco excise taxes or notifying states of cigarette sales to other than wholesalers, as required by the Jenkins Act. ATF referred the case to the state of Arizona, where it was resolved with no criminal charges filed by obtaining the tribe's agreement to comply with Jenkins Act requirements.
  - A third ATF investigation of an Internet vendor for cigarette smuggling and Jenkins Act violations was ongoing at the time of our work.

ATF officials said that because ATF does not have primary Jenkins Act jurisdiction, it has not committed resources to investigating violations of the act. However, the officials said strong consideration should be given to transferring primary jurisdiction for investigating Jenkins Act violations from the FBI to ATF. According to ATF, it is responsible for, and has committed resources to, regulating the distribution of tobacco products and investigating trafficking in contraband tobacco products. A change in Jenkins Act jurisdiction would give ATF comprehensive authority at the federal level to assist states in preventing the interstate distribution of cigarettes resulting in lost state cigarette taxes since ATF already has investigative authority over the CCTA, according to the officials. The officials also told us ATF has special agents and inspectors that obtain specialized training in enforcing tax and criminal laws related to tobacco products, and, with primary jurisdiction, ATF would have the investigative authority and would use resources to specifically conduct investigations to enforce the Jenkins Act, which should result in greater enforcement of the act than in the past.

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## States Have Taken Action to Promote Jenkins Act Compliance by Internet Cigarette Vendors, but Results Were Limited

Officials in nine states that provided us information all expressed concern about Internet cigarette vendors' noncompliance with the Jenkins Act and the resulting loss of state tax revenues. For example, California officials estimated that the state lost approximately \$13 million in tax revenue from May 1999 through September 2001, due to Internet cigarette vendors' noncompliance with the Jenkins Act. Overall, the states' efforts to promote compliance with the act by Internet vendors produced few results. Officials in the nine states said that they lack the legal authority to successfully address this problem on their own. They believe greater federal action is needed, particularly because of their concern that Internet cigarette sales will continue to increase with a growing and substantial negative effect on tax revenues.



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## States' Efforts Produced Limited Results

Starting in 1997, seven of the nine states had made some effort to promote Jenkins Act compliance by Internet cigarette vendors. These efforts involved contacting Internet vendors and U.S. Attorneys' Offices. Two states had not made any such efforts.

Six of the seven states tried to promote Jenkins Act compliance by identifying and notifying Internet cigarette vendors that they are required to report the sale of cigarettes shipped into those states. Generally, officials in the six states learned of Internet vendors by searching the Internet, noticing or being told of vendors' advertisements, and by state residents or others notifying them. Five states sent letters to the identified vendors concerning their Jenkins Act reporting responsibilities, and one state made telephone calls to the vendors.

After contacting the Internet vendors, the states generally received reports of cigarette sales from a small portion of the vendors notified.<sup>9</sup> The states then contacted the state residents identified in the reports, and they collected taxes from most of the residents contacted. When residents did not respond and pay the taxes due, the states carried out various follow-up efforts, including sending additional notices and bills, assessing penalties and interest, and deducting amounts due from income tax refunds. Generally, the efforts by the six states to promote Jenkins Act compliance were carried out periodically and required few resources. For example, a Massachusetts official said the state notified Internet cigarette vendors on five occasions starting in July 2000, with one employee working a total of about 3 months on the various activities involved in the effort.

Table 1 summarizes the six states' efforts to identify and notify Internet cigarette vendors about the Jenkins Act reporting requirements and shows the results that were achieved. There was little response by the Internet vendors notified. Some of the officials told us that they encountered Internet vendors that refused to comply and report cigarette sales after being contacted. For example, several officials noted that Native Americans often refused to report cigarette sales, with some Native American vendors citing their sovereign nation status as exempting them from the Jenkins Act, and others refusing to accept a state's certified notification letters. Also, an attorney for one vendor informed the state of

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<sup>9</sup>Cigarette vendors are not required to report to a state unless they sell and ship cigarettes into the state. Consequently, the states do not know if the Internet vendors that were notified but did not respond had any cigarette sales to report.

Washington that the vendor would not report sales because the Internet Tax Freedom Act relieved the vendor of Jenkins Act reporting requirements.

**Table 1: Summary of Six States' Efforts to Promote Jenkins Act Compliance Since 1997**

State	Number of Internet vendors identified and notified	Number of Internet vendors that responded with reports of cigarette sales	Number of residents identified and notified	Number of residents that responded	Amount of taxes, penalties, and interest collected <sup>a</sup>
Alaska	15 <sup>b,c</sup>	2	3	1	\$9,850
California	167 (approx.) <sup>c,d</sup>	20 (approx.)	23,500 (approx.)	13,500 (approx.)	\$1.4 million (approx.)
Massachusetts	262	13	None <sup>e</sup>	None	None
Rhode Island	Number unknown	None <sup>f</sup>	None	None	None
Washington	186	8	800 (approx.)	560 (approx.)	\$29,898
Wisconsin	21	6	696	696	\$80,200

Source: Developed by GAO from states' data.

Note: Massachusetts' data are as of May 2002, Washington's and Wisconsin's data are as of April 2002, Alaska's and Rhode Island's data are as of March 2002, and California's data are through September 2001.

<sup>a</sup> Not all states collected penalties and interest, and some of the amounts paid include sales and use taxes in addition to cigarette excise taxes. Some of the amounts paid by residents were for more cigarette purchases than the vendors reported to the state.

<sup>b</sup> Alaska identified 17 vendors, but did not know where 2 were located and could not notify them.

<sup>c</sup> Alaska and California sent ATF a copy of each letter mailed to Internet cigarette vendors notifying them of their Jenkins Act reporting responsibilities.

<sup>d</sup> California started its Internet/Mail Order Program in May 1999. Through September 2001, 196 vendors had been identified and notified, of which about 85 percent, or approximately 167, were Internet vendors. All 20 vendors that responded were Internet vendors.

<sup>e</sup> At the time of our work, Massachusetts had not notified the residents identified in reports provided by the 13 vendors that responded out of the 262 vendors notified because the state was in the process of developing policy regarding Jenkins Act compliance and reports of residents' Internet cigarette purchases.

<sup>f</sup> No Internet cigarette vendors reported cigarette sales in response to Rhode Island notifying them of their Jenkins Act reporting responsibilities.

Apart from the states' efforts to identify and notify Internet cigarette vendors, state officials noted that some Internet vendors voluntarily complied with the Jenkins Act and reported cigarette sales on their own. The states subsequently contacted the residents identified in the reports to collect taxes. For example, a Rhode Island official told us there were three or four Internet vendors that voluntarily reported cigarette sales to the state. On the basis of these reports, Rhode Island notified about 400 residents they must pay state taxes on their cigarette purchases and billed these residents over \$76,000 (the Rhode Island official who provided this

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information did not know the total amount collected). Similarly, Massachusetts billed 21 residents for cigarette taxes and collected \$2,150 based on reports of cigarette sales voluntarily sent to the state.

Three of the seven states that made an effort to promote Jenkins Act compliance by Internet cigarette vendors contacted U.S. Attorneys and requested assistance. The U.S. Attorneys, however, did not provide the assistance requested. The states' requests and responses by the U.S. Attorneys' Offices are summarized below.

- In March 2000, Iowa and Wisconsin officials wrote letters to three U.S. Attorneys in their states requesting assistance. The state officials asked the U.S. Attorneys to send letters to Internet vendors the states had identified, informing the vendors of the Jenkins Act and directing them to comply by reporting cigarette sales to the states. The state officials provided a draft letter and offered to handle all aspects of the mailings. The officials noted they were asking the U.S. Attorneys to send the letters over their signatures because the Jenkins Act is a federal law and a statement from a U.S. Attorney would have more impact than from a state official. However, the U.S. Attorneys did not provide the assistance requested. According to Iowa and Wisconsin officials, two U.S. Attorneys' Offices said they were not interested in helping, and one did not respond to the state's request.<sup>10</sup>
- After contacting the FBI regarding an Internet vendor that refused to report cigarette sales, saying that the Internet Tax Freedom Act relieved the vendor of Jenkins Act reporting requirements, the state of Washington acted on the FBI's recommendation and wrote a letter in April 2001 requesting that the U.S. Attorney initiate an investigation. According to a Washington official, the U.S. Attorney's Office did not pursue this matter and noted that a civil remedy (i.e., lawsuit) should be sought by the state before seeking a criminal action. At the time of our work, the state was planning to seek a civil remedy.
- In July 2001, the state of Wisconsin wrote a letter referring a potential Jenkins Act violation to the U.S. Attorney for prosecution. According to a Wisconsin official, this case had strong evidence of Jenkins Act noncompliance—there were controlled and supervised purchases

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<sup>10</sup>DOJ noted that federal prosecutors generally do not issue advisory opinions about prosecutive matters, as they may subsequently be presented with the need to make an actual decision based on specific facts. The issuance of such an opinion might create the basis for a legal dispute if a subsequent prosecution were undertaken.

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made on the Internet of a small number of cartons of cigarettes, and the vendor had not reported the sales to Wisconsin. The U.S. Attorney's Office declined to initiate an investigation, saying that it appeared this issue would be best handled by the state "administratively." The Wisconsin official told us, however, that Wisconsin does not have administrative remedies for Jenkins Act violations, and, in any case, the state cannot reach out across state lines to deal with a vendor in another state.

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**States Concerned about Internet Vendors' Noncompliance and Believe Greater Federal Action Is Needed**

Officials in each of the nine states expressed concern about the impact that Internet cigarette vendors' noncompliance with the Jenkins Act has on state tax revenues. The officials said that Internet cigarette sales will continue to grow in the future and are concerned that a much greater and more substantial impact on tax revenues will result. One state, California, estimated that its lost tax revenue due to noncompliance with the Jenkins Act by Internet cigarette vendors was approximately \$13 million from May 1999 through September 2001.<sup>11</sup>

Officials in all nine states said that they are limited in what they can accomplish on their own to address this situation and successfully promote Jenkins Act compliance by Internet cigarette vendors. All of the officials pointed out that their states lack the legal authority necessary to enforce the act and penalize the vendors who violate it, particularly with the vendors residing in other states. Officials in three states told us that efforts to promote Jenkins Act compliance are not worthwhile because of such limitations, or are not a priority because of limited resources.

Officials in all nine states said that they believe greater federal action is needed to enforce the Jenkins Act and promote compliance by Internet cigarette vendors. Four state officials also said they believe ATF should have primary jurisdiction to enforce the act. One official pointed out that his organization sometimes dealt with ATF on tobacco matters, but has never interacted with the FBI. Officials in the other five states did not express an opinion regarding which federal agency should have primary jurisdiction to enforce the act.

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<sup>11</sup>The Excise Taxes Division, California State Board of Equalization, did not make an official analyses of lost revenue. The \$13 million estimate is a projection by the division based on the amount of state excise and use taxes determined as due from cigarette sales reported by out-of-state Internet vendors during the period of May 1999 through Sept. 2001.

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## Most Internet Cigarette Vendors Do Not Comply with the Jenkins Act or Notify Consumers of Their Responsibilities

Through our Internet search efforts, we identified 147 Web site addresses for Internet cigarette vendors based in the United States and reviewed each website linked to these addresses.<sup>12</sup> Our review of the Web sites found no information suggesting that the vendors comply with the Jenkins Act. Some vendors cited reasons for not complying that we could not substantiate. A few Web sites specifically mentioned the vendors' Jenkins Act reporting responsibilities, but these Web sites also indicated that the vendors do not comply with the act. Some Web sites provided notice to consumers of their potential state tax liability for Internet cigarette purchases.

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## Majority of Web sites Indicate that Vendors Do Not Comply with the Jenkins Act

None of the 147 Web sites we reviewed stated that the vendor complies with the Jenkins Act and reports cigarette sales to state tobacco tax administrators.<sup>13</sup> Conversely, as shown in table 2, information posted on 114 (78 percent) of the Web sites indicated the vendors' noncompliance with the act through a variety of statements posted on the sites. Thirty-three Web sites (22 percent) provided no indication about whether or not the vendors comply with the act.

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<sup>12</sup>The 147 Web site addresses appear to represent 122 different Internet cigarette vendors. We made this determination by comparing information such as vendor names, company names, street addresses, P.O. box numbers, and telephone numbers. For example, some Web sites had the same mailing address and telephone number, suggesting they were separate Web sites being operated by one company.

<sup>13</sup>Two Web sites posted statements indicating that customer information would be released if required; however, both sites also stated that the information would not be given out without the customers' permission. The Jenkins Act does not require cigarette sellers to notify customers regarding whether or not they comply with the act's reporting requirements.

**Table 2: Web sites Indicating Internet Cigarette Vendors' Noncompliance with the Jenkins Act**

<b>Web site statement indicating noncompliance</b>	<b>Number</b>	<b>Percent</b>
Do not report sales to state tax authorities	44 <sup>a</sup>	30
Do not comply with the Jenkins Act	1	1
Keep customer information private	43	29
Silent on reporting, but claim cigarettes are tax-free	26	18
<b>Total</b>	<b>114</b>	<b>78</b>

Source: GAO's analysis of Web site data.

<sup>a</sup>One Web site stated that it does not report to state tax authorities and that it does not comply with the Jenkins Act. In determining the number of Web sites indicating noncompliance with the Jenkins Act, we counted this only as a statement that it does not comply with the act.

## Reasons Cited for Noncompliance with the Jenkins Act

Some Internet vendors cited specific reasons on their Web sites for not reporting cigarette sales to state tax authorities as required by the Jenkins Act. Seven of the Web sites reviewed (5 percent) posted statements asserting that customer information is protected from release to anyone, including state authorities, under privacy laws. Seventeen Web sites (12 percent) state that they are not required to report information to state tax authorities and/or are not subject to the Jenkins Act reporting requirements. Fifteen of these 17 sites are Native American, with 7 of the sites specifically indicating that they are exempt from reporting to states either because they are Native American businesses or because of their sovereign nation status. In addition, 35 Native American Web sites (40 percent of all the Native American sites we reviewed) indicate that their tobacco products are available tax-free because they are Native American businesses.<sup>14</sup>

To supplement our review of the Web sites, we also attempted to contact representatives of 30 Internet cigarette vendors, and we successfully interviewed representatives of 5.<sup>15</sup> One of the 5 representatives said that the vendor recently started to file Jenkins Act sales reports with one state.<sup>16</sup> However, the other 4 said that they do not comply with the act and

<sup>14</sup>Fifty-nine percent, or 87, of the 147 Web site addresses reviewed are either Native American-owned or located and/or operated on Native American lands.

<sup>15</sup>We were either unable to reach representatives of the remaining 25 vendors we selected to conduct structured interviews, or they declined to answer questions.

<sup>16</sup>The vendor who said that he does comply with the Jenkins Act told us that he recently started to file reports with the state of Washington after receiving a notice from the state's Department of Revenue. However, he said Washington is the only state he reports to, and he declined to provide us with evidence of his compliance with the act.

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provided us with additional arguments for noncompliance. Their arguments included an opinion that the act was not directed at personal use. An additional argument was that the Internet Tax Freedom Act<sup>17</sup> supercedes the obligations laid out in the Jenkins Act.

Our review of the applicable statutes indicates that neither the Internet Tax Freedom Act nor any privacy laws exempt Internet cigarette vendors from Jenkins Act compliance. The Jenkins Act has not been amended since minor additions and clarifications were made to its provisions in 1953 and 1955; and neither the Internet Tax Freedom Act nor any privacy laws amended the Jenkins Act's provisions to expressly exempt Internet cigarette vendors from compliance. With regard to the Internet Tax Freedom Act, the temporary ban that the act imposed on certain types of taxes on e-commerce did not include the collection of existing taxes, such as state excise, sales, and use taxes.

Additionally, nothing in the Jenkins Act or its legislative history implies that cigarette sales for personal use, or Native American cigarette sales, are exempt. In examining a statute, such as the Jenkins Act, that is silent on its applicability to Native American Indian tribes, courts have consistently applied a three-part analysis. Under this analysis, if the act uses general terms that are broad enough to include tribes, the statute will ordinarily apply unless (1) the law touches "exclusive rights of self-governance in purely intramural matters;" (2) the application of the law to the tribe would abrogate rights guaranteed by Indian treaties; or (3) there is proof by legislative history or some other means that Congress intended the law not to apply to Indians on their reservations. Our review of the case law did not locate any case law applying this analysis to the Jenkins Act. DOJ said that it also could not locate any case law applying the analysis to the Jenkins Act, and DOJ generally concluded that an Indian tribe may be subject to the act's requirements. DOJ noted, however, that considering the lack of case law on this issue, this conclusion is somewhat speculative. ATF has stated that sales or shipments of cigarettes from Native American reservations are not exempt from the requirements of the Jenkins Act.<sup>18</sup>

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<sup>17</sup>P.L. 105-277, Div. C, Title XI, Oct. 21, 1998.

<sup>18</sup>*Industry Circular*, No. 99-2, Bureau of Alcohol, Tobacco and Firearms, June 6, 1999.

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## Few Web sites Provide Notice of the Vendors' Reporting Responsibilities, but Some Provide Notice of Customer Cigarette Tax Liability

Only 8 (5 percent) of the 147 Web sites we reviewed notified customers that the Jenkins Act requires the vendor to report cigarette sales to state tax authorities, which could result in potential customer tax liability. However, in each of these cases, the Web sites that provided notices of Jenkins Act responsibilities also followed the notice with a statement challenging the applicability of the act and indicating that the vendor does not comply. Twenty-eight Web sites (19 percent) either provided notice of potential customer tax liability for Internet cigarette purchases or recommended that customers contact their state tax authorities to determine if they are liable for taxes on such purchases. Three other sites (2 percent) notified customers that they are responsible for complying with cigarette laws in their state, but did not specifically mention taxes. Of the 147 Web sites we reviewed, 108 (73 percent) did not provide notice of either the vendors' Jenkins Act reporting responsibilities or the customers' responsibilities, including potential tax liability, with regard to their states.

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## Conclusions

Our report concluded that states are hampered in attempting to promote Jenkins Act compliance because they lack authority to enforce the act. In addition, violation of the act is a misdemeanor, and U.S. Attorneys' reluctance to pursue misdemeanor violations could be contributing to limited enforcement. Transferring primary investigative jurisdiction from the FBI to ATF would give ATF comprehensive authority at the federal level to enforce the Jenkins Act and should result in more enforcement. ATF's ability to couple Jenkins Act and CCTA enforcement may increase the likelihood it will detect and investigate violators and that U.S. Attorneys will prosecute them. This could lead to improved reporting of interstate cigarette sales, thereby helping to prevent the loss of state cigarette tax revenues. Transferring primary investigative jurisdiction is also appropriate at this time because of the FBI's new challenges and priorities related to the threat of terrorism and the FBI's increased counterterrorism efforts.

To improve the federal government's efforts in enforcing the Jenkins Act and promoting compliance with the act by Internet cigarette vendors, which may lead to increased state tax revenues from cigarette sales, our report suggested that the Congress should consider providing ATF with primary jurisdiction to investigate violations of the Jenkins Act (15 U.S.C. §375-378). In view of the fact that ATF was recently transferred from the Treasury Department to DOJ, it may now be possible for the Attorney General to administratively transfer primary Jenkins Act enforcement authority from the FBI to ATF without involving the Congress in the



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matter. We believe that this possibility deserves further investigation on the part of DOJ.

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Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Subcommittee may have at this time.

For further information, please call me at (202) 512-8777. Other key contributors to this testimony were Darryl W. Dutton, Ronald G. Viereck, Katherine M. Davis, and Shirley Jones.

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