United States Government Accountability Office

GAO

Report to Congressional Committees

March 2011

ILLICIT TOBACCO

Various Schemes Are Used to Evade Taxes and Fees

GAO-11-313

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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.
For more information, contact Loren Yager at (202) 512-4347 or YagerL@gao.gov.

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.

Contents

Abbreviations

ATF	Bureau of Alcohol, Tobacco, Firearms, and Explosives
CBP	Customs and Border Protection
MSA	Master Settlement Agreement
TTB	Alcohol and Tobacco Tax and Trade Bureau

United States Government Accountability Office
Washington, DC 20548

March 7, 2011

The Honorable Tom Harkin
Chairman
The Honorable Michael B. Enzi
Ranking Member
Committee on Health, Education, Labor, and Pensions
United States Senate

The Honorable Fred Upton
Chairman
The Honorable Henry A. Waxman
Ranking Member
Committee on Energy and Commerce
House of Representatives

Tobacco use is the leading cause of preventable death in the United States and a significant contributor to health care costs in this country. According to the Centers for Disease Control and Prevention, smoking accounts for over 400,000 premature deaths per year—including almost 50,000 deaths among nonsmokers due to second hand smoke—and costs the United States an estimated $193 billion in health care expenditures and loss of productivity. Past federal and state legislation has aimed to discourage tobacco use and raise revenues by increasing excise taxes on tobacco products. However, cross-border and illicit trade in tobacco products can undermine these policy objectives by avoiding taxes and increasing the availability of these products to consumers at a lower cost, including youth smokers. Illicit trade in tobacco products, according to U.S. law enforcement agencies, is also a source of financing for both domestic and international criminal activities.

In June 2009, Congress passed the Family Smoking Prevention and Tobacco Control Act,[1] with the purpose of granting the Food and Drug Administration regulatory authority over the manufacture, marketing, and distribution of tobacco products.[2] The Act also directed us to provide information on cross-border and illicit trade in tobacco products, including the monitoring of such trade; cross-border advertising of

[1]Pub. L. No. 111-31, Div. A, 123 Stat. 1776 (2009).

[2]Pub. L. No. 111-31, § 3.

tobacco products; and the health effects resulting from cross-border and illicit trade in tobacco products, including the health effects from differing tax rates applicable to tobacco products.[3] The Act defined cross-border trade as trade across the border of the United States, a State or Territory, or Indian country.[4]

This report examines (1) incentives that are important for understanding cross-border and illicit trade in tobacco products; and (2) the different schemes used to generate profits from cross-border and illicit trade in tobacco products. The results of our work are contained in appendix I. As discussed with your staff, we believe this information about the industry structure and the incentives for illegal trade as well as the different types of schemes used to generate profits is essential to the evaluation and design of policy measures that address illicit trade in those products.

In accordance with our agreement with the Senate Committee on Health, Education, Labor, and Pensions, and the House Energy and Commerce Committee, we will issue a second report in 2011 that will provide additional information and findings on U.S. government efforts to monitor cross-border and illicit trade in tobacco products and will also address cross-border advertising and the health effects from cross-border and illicit trade, as directed by the Act.

To address these objectives, we interviewed subject matter experts with varying backgrounds and points-of-view in order to understand the range of perspectives on illicit trade in tobacco products, including discussions on industry characteristics and varying incentives and methods of illicit trade, among other issues. Our criteria for selecting experts included the type and depth of experience; for instance, whether the expert had authored a widely referenced study or article on the topic, and whether the expert was referred to us by at least one other interviewee as someone knowledgeable about the topic. In addition, we sought representation of relevant organizations and sectors including, where applicable, representatives from government, academia, industry, and professional organizations. The subject matter experts we contacted included officials from the Departments of Health and Human Services, Homeland Security, Justice, and Treasury; the Federal Trade Commission and state agencies; representatives from nongovernmental organizations and major tobacco

[3] Pub. L. No. 111-31, § 302(a).

[4] Pub. L. No. 111-31, § 302(c).

manufacturers; as well as other subject matter experts such as consultants and academics. We conducted a literature review of studies and documents discussing various aspects of cross-border and illicit trade in tobacco products, including industry characteristics, taxation, distribution methods, and the different types of illicit trade. We reviewed reports, studies, and other documents from relevant U.S. agencies; multilateral organizations, including the World Health Organization and the Organization for Economic Cooperation and Development; industry; nongovernment organizations; think tanks; and academic institutions.

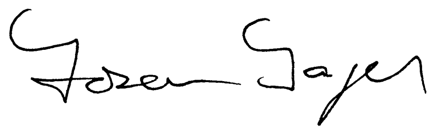
For background purposes, we collected and analyzed tobacco industry data, including data on value of shipments and market concentration by product, manufacturer, and brand. We also obtained data from 2000 to 2010 on U.S. imports and exports of cigarettes and other tobacco products, and on U.S. production and consumption of cigarettes. In addition, we collected and analyzed secondary source data on federal and state excise tax rates on cigarettes and changes in these rates over time. We did not independently verify all tax rates included in this product. We examined the reliability of data provided by industry sources by interviewing representatives to discuss how the data were collected and what checks or testing were performed on the data. For government data, we reviewed recent data reliability assessments conducted by GAO. In both cases, we found the data were sufficiently reliable for background and contextual purposes and to address our objectives. We traveled to Richmond, Virginia, to meet with industry representatives, viewed manufacturing, distribution, and retail facilities, and met with employees at these facilities. Because of its clandestine nature, the extent of illicit trade in tobacco products cannot be measured with certainty.

We conducted our work from May 2010 to March 2011 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions.

We provided a draft of this report to the Assistant Attorney General, the Secretary of Homeland Security, and the Secretary of the Treasury. Staff from the Departments of Homeland Security, Justice, and Treasury provided technical comments on this report and generally concurred with our findings.

We are sending copies of this report to interested congressional committees and to other interested parties. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staff have any questions or wish to discuss the material further, please contact me at (202) 512-4347 or yagerl@gao.gov. Contact points for our offices of congressional relations and Public Affairs may be found on the last page of this report. Individuals who made key contributions to this report are listed in Appendix II.



Loren Yager
Director,
International Affairs and Trade

Background

Timeline of Key Legislative and Industry Events

Other Key Legislation

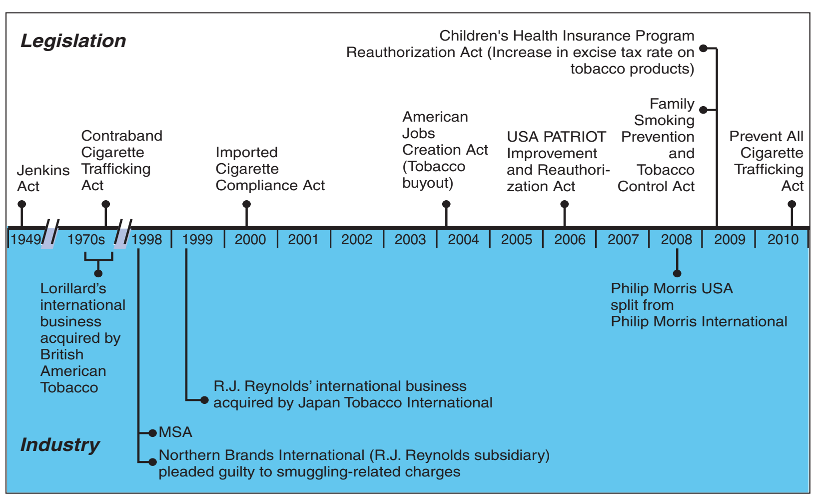
- Imported Cigarette Compliance Act of 2000 prohibited importing cigarettes into the United States bearing registered U.S. trademarks without the trademark owner's authorization. Pub. L. No. 106-476.
- Children's Health Insurance Program Reauthorization Act of 2009 increased federal excise taxes on tobacco products, including raising the tax on small cigarettes from $0.39 to $1.01 per pack, in order to fund the State Children's Health Insurance Program. Pub. L. No. 111-3.
- Prevent All Cigarette Trafficking Act of 2009 amended the Jenkins Act by revising provisions that govern the collection of taxes on cigarettes and smokeless tobacco. Pub. L. No. 111-154 (2010). The amendments included a requirement for Internet and other delivery sellers to pay all applicable state and local excise taxes and affix any related tax stamps before delivering any cigarettes or smokeless tobacco products to any customer in a state. It also amended the federal criminal code to treat cigarettes and smokeless tobacco as nonmailable matter.

As seen in figure 1, federal laws focused on cross-border and illicit trade in tobacco products date back to the Jenkins Act of 1949, which established cigarette sales reporting requirements for state excise tax collection (15 U.S.C. §§ 375-378). Over time, penalties for cigarette trafficking and other crimes involving illicit trade have increased, as have federal agencies' authorities. For instance, the USA PATRIOT Improvement and Reauthorization Act of 2005 lowered the threshold quantity for treatment of cigarettes as contraband from 60,000 cigarettes (300 cartons) to 10,000 cigarettes (50 cartons). Pub. L. No. 109-177 (2006).

Several industry-related events also have impacted cross-border trade in tobacco products. In 1998, 46 states signed the Master Settlement Agreement (MSA) with the four largest U.S. tobacco companies to settle state tobacco-related lawsuits and recover billions of dollars in costs associated with smoking-related illnesses. In addition, the U.S. tobacco industry's three major manufacturers, Philip Morris USA, R.J. Reynolds, and Lorillard, sold or separated from their international businesses, and now focus on the U.S. market.

Federal law enforcement officials stated that some large tobacco manufacturers were previously implicated in illicit trade. For example, in 1998 an R.J. Reynolds subsidiary pleaded guilty and paid $15 million in federal fines for charges related to a scheme in which Canadian-produced cigarettes were exported to the United States and rerouted to Canada to avoid tax payments. However, these officials stated that the large tobacco companies are now cooperating to address tobacco diversion.

Figure 1: Timeline of Key Legislative and Industry Events



Source: GAO analysis.

Note: Jenkins Act, 63 Stat. 884, codified at 15 U.S.C. §§ 375-378; Act Amending Criminal Code Regarding Trafficking in Contraband Cigarettes, Pub. L. No. 95-575, (1978); Imported Cigarette Compliance Act of 2000, Pub. L. No. 106-476; American Jobs Creation Act of 2004, Pub. L. No. 108-357; USA PATRIOT Improvement and Reauthorization Act of 2005, Pub. L. No. 109-177; Children's Health Insurance Program Reauthorization Act of 2009, Pub. L. No. 111-3. Family Smoking Prevention and Tobacco Control and Federal Retirement Reform, Pub. L. No. 111-31,(2009); Prevent All Cigarette Trafficking Act of 2009, Pub. L. No. 111-154.

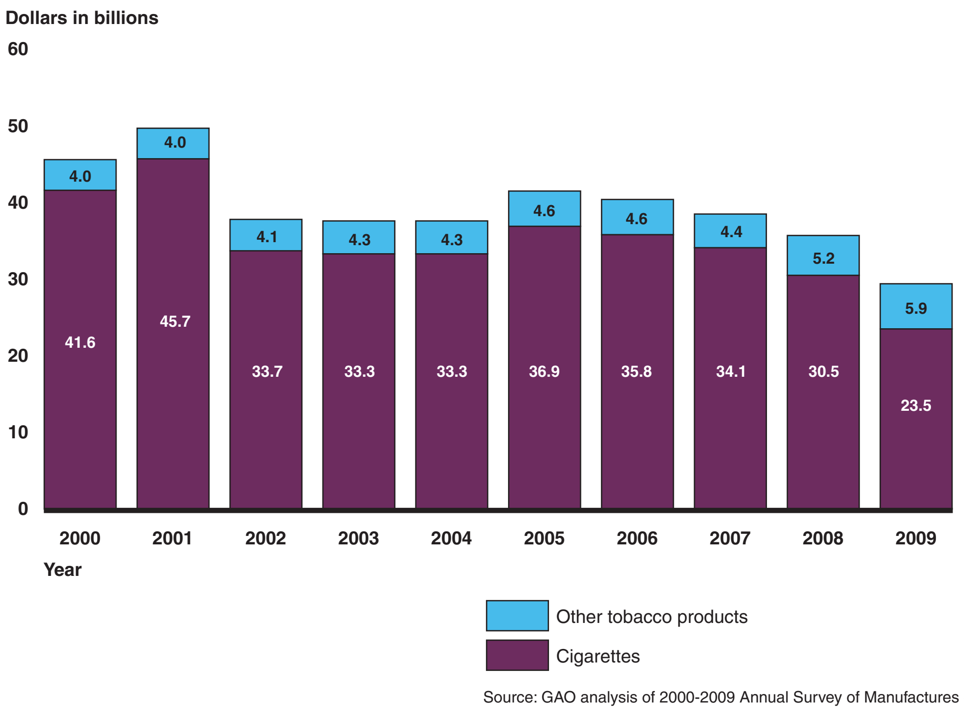
Background: Cigarettes Dominate the U.S. Tobacco Industry

As shown in figure 2, cigarettes vastly outsold other tobacco products—a category of tobacco products that includes cigars, chewing tobacco, snuff, pipe tobacco, and roll-your-own tobacco. For example, in 2009, cigarettes made up 80 percent of the value of tobacco product shipments in the United States, while other tobacco products collectively made up the remaining 20 percent of the market. However, as can be seen in figure 2, other tobacco products' share of the market has increased annually since 2007 as measured by the value of shipments, which represents other tobacco products' share of the total value of all tobacco products produced and shipped by all U.S. producers for both domestic and export markets.

The total value of shipments for all tobacco products also steadily declined during this time period. Total shipments decreased from a high of $49.7 billion in 2001 to $29.4 billion in 2009. Due to cigarettes' dominance of the tobacco industry, this report will focus primarily on cigarettes, although some information pertaining to other tobacco products will be covered.

Other tobacco products that have recently entered the U.S. market include Snus—a moist tobacco product contained in small pouches—and other products that dissolve and release nicotine when placed in the mouth or on the tongue. Some officials have stated that the industry may increasingly shift toward these types of products as cigarettes are more heavily taxed and regulated, but information on the extent of this trend is not yet available.

Figure 2: Tobacco Products by Value of Shipments (2000 – 2009)



Source: GAO analysis of 2000-2009 Annual Survey of Manufactures data.

Note: The value of shipments is defined by the Department of Commerce's Annual Survey of Manufactures as the total value of all products shipped by all producers for both domestic and export markets. For selected products, this can represent value of receipts, value of production, or value of work done.

Background

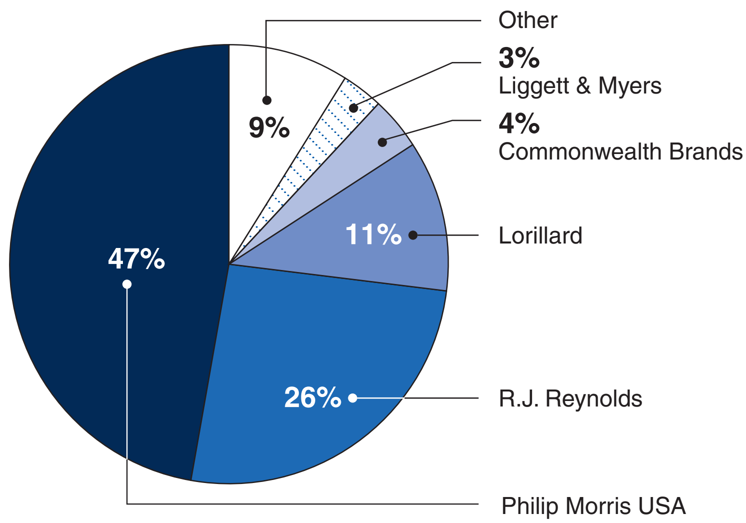
Domestic Tobacco Industry Is Heavily Concentrated by Manufacturer and Brand

As shown in figure 3, U.S. cigarette manufacturing is heavily concentrated within the top three manufacturers—Philip Morris USA, R.J. Reynolds, and Lorillard—which represented 84 percent of cigarettes sold in 2009.

- Philip Morris USA is owned by parent company Altria, which also owns U.S. Smokeless Tobacco Company (manufacturer of Skoal and Copenhagen) and John Middleton (manufacturer of Black & Mild cigars).
- Reynolds American is the parent company for R.J. Reynolds Tobacco Company and also owns the American Snuff Company (products include Kodiak and Grizzly) and Santa Fe Natural Tobacco Company (manufacturer of Natural American Spirit cigarettes).
- Lorillard, the nation's third-largest tobacco company, manufactures Newport and other cigarette brands.
- The fourth- and fifth-largest manufacturers (Commonwealth Brands and Liggett & Myers) together comprised approximately 7 percent of the market.

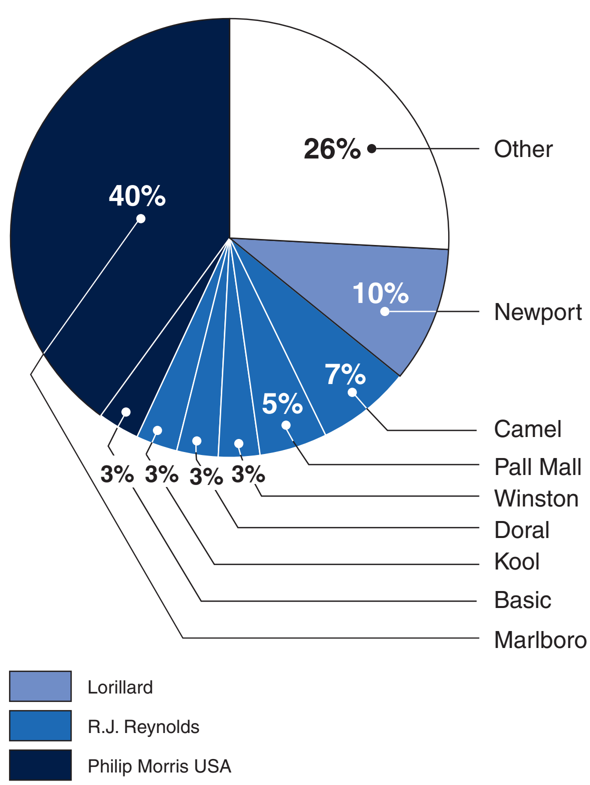
As indicated in figure 4, Philip Morris USA's Marlboro is the leading U.S. cigarette brand, followed by Newport (Lorillard), Camel, and Pall Mall (both manufactured by R.J. Reynolds).

Figure 3: Cigarette Manufacturers by Number of Cigarettes in 2009



Source: GAO analysis of 2009 Tobacco Merchants Association data.

Figure 4: Cigarette Brands by Number of Cigarettes in 2009



Source: GAO analysis of 2009 Tobacco Merchants Association data.

Background

U.S. Cigarette Exports Have Dropped Sharply

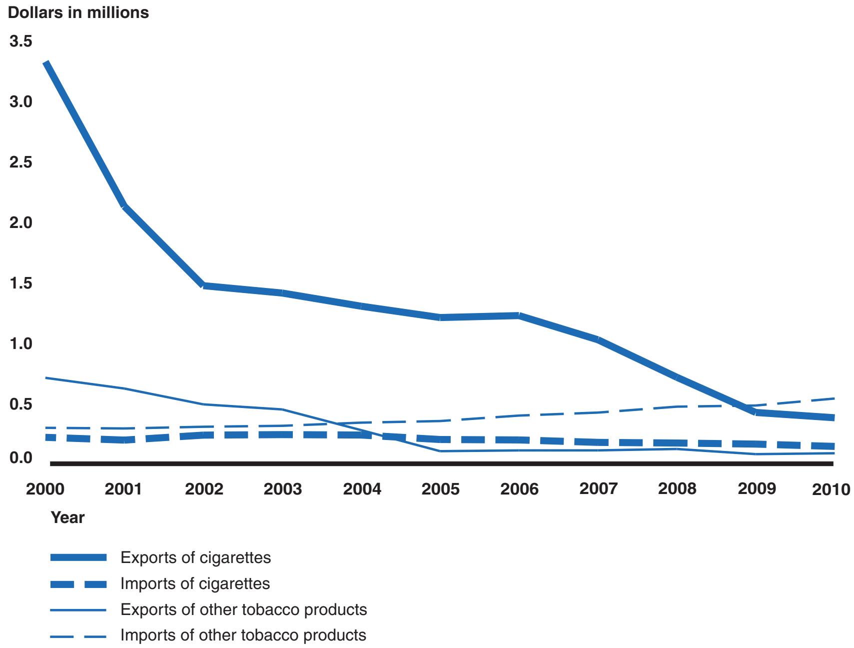
Figure 5 shows trends in U.S. imports and exports for cigarettes and other tobacco products from 2000 to 2010. U.S. cigarette exports declined significantly, from $3.3 billion in 2000 to $373 million in 2010. As discussed earlier, the leading U.S. cigarette manufacturers have split or sold their international businesses and now sell almost exclusively in the U.S. market. Prior to these separations, U.S. companies had expanded overseas production for international markets, which also contributed to the decline in exports during this time period. Reynolds American is the one exception among the leading tobacco companies and manufactures its Natural American Spirit brand cigarettes for export to Asian markets. An official from the Department of the Treasury's Alcohol and Tobacco Tax and Trade Bureau (TTB) reported that smaller manufacturers also continue to export cigarettes.

The leading destination country for U.S. cigarette exports during this period was Japan, which accounted for approximately 83 percent of U.S. exports in 2010.

U.S. imports of cigarettes declined from $212 million in 2000 to $137 million in 2010. The top three source countries for U.S. cigarette imports in 2010 were Canada, South Korea, and Turkey.

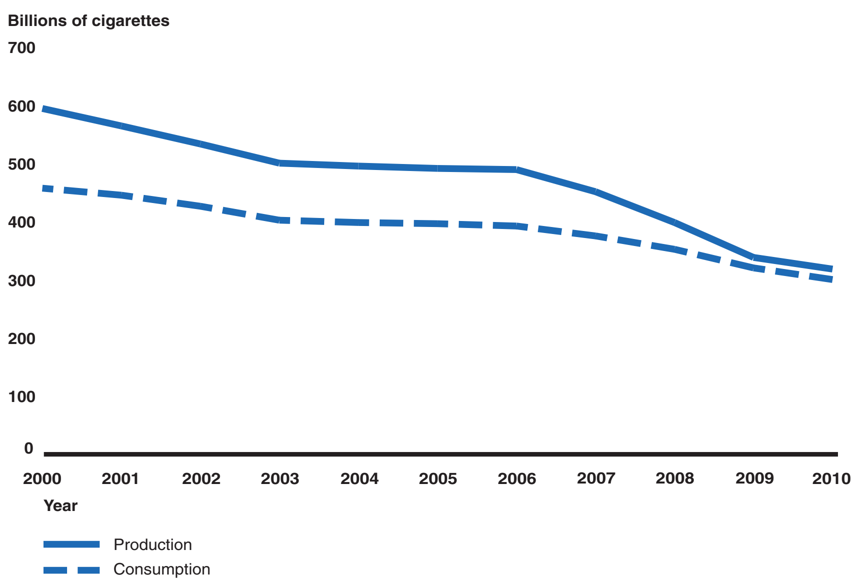
Figure 6 shows trends in U.S. production and consumption of cigarettes from 2000 to 2010. Domestic production of cigarettes declined from 593 billion cigarettes in 2000 to 317 billion cigarettes in 2010, while domestic consumption of cigarettes declined from 456 billion cigarettes in 2000 to 299 billion cigarettes in 2010.

Figure 5: U.S. Imports and Exports of Cigarettes and Other Tobacco Products by Value (2000 – 2010)



Source: GAO analysis of International Trade Commission data.

Figure 6: Production and Consumption of Cigarettes (2000 – 2010)



Source: GAO analysis of Tobacco Merchants Association data.

Background

Cigarette manufacturers must obtain a permit to operate from TTB. Manufacturers pay the federal excise tax for cigarettes to TTB on a semimonthly basis, and the tax liability is imposed when cigarettes leave the manufacturing facilities that are bonded with TTB. According to TTB, there were 40 permitted cigarette manufacturers in 2010.

After the manufacturer pays the federal excise tax, it generally ships the cigarettes to public warehouses or distributors. State and local excise taxes are generally paid by wholesalers or distributors through the purchase of excise tax stamps from state or local taxing jurisdictions.

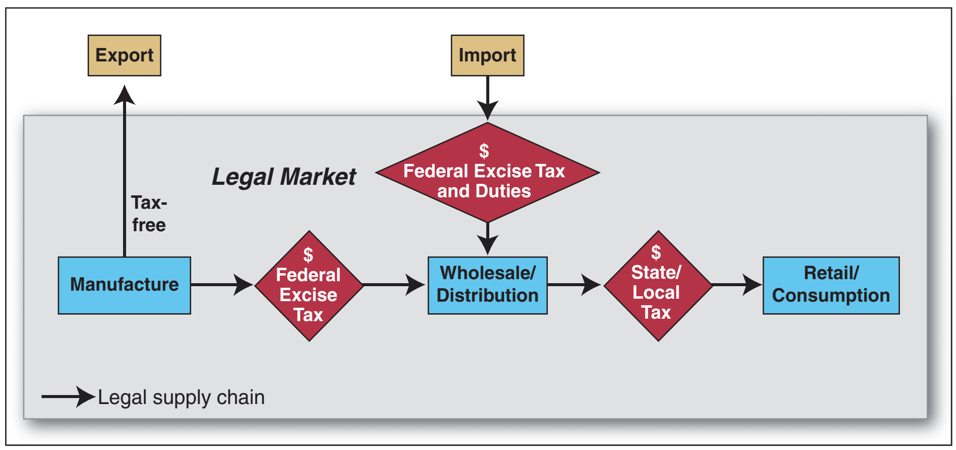
Manufacturers are not required to pay the federal excise tax for direct or indirect exports. Indirect exports can be moved through a foreign trade zone, export warehouse, or Customs-bonded warehouse, such as a duty-free store. Foreign trade zones are secured areas usually located in or adjacent to Department of Homeland Security's Customs and Border Protection (CBP) Ports of Entry where products are not subject to U.S. duty or excise tax. Export warehouses are permitted and bonded by TTB for storing tobacco products prior to exportation.

Imports can also be direct or indirect. With direct importation, cigarettes are cleared through U.S. Customs after duties and excise taxes are paid upon the filing of the consumption entry. Indirect imports can be cleared through Customs for delivery through a Customs-bonded warehouse or a foreign trade zone. Duties and taxes are deferred until the product is withdrawn from the warehouse or foreign trade zone for consumption into the commerce of the United States.

Cigarettes Are Sold Through Supply Chains with Multiple Entities

Figure 7 presents a simplified supply chain for the movement of cigarettes through the legal market, highlighting the major steps in the process and the key points at which taxes and fees are paid. Federal excise taxes are paid by manufacturers when the products leave their facilities, while state and local excise taxes are paid by wholesalers or distributors. Supply chains can differ by manufacturer, and this figure does not represent all of the steps in the distribution process.

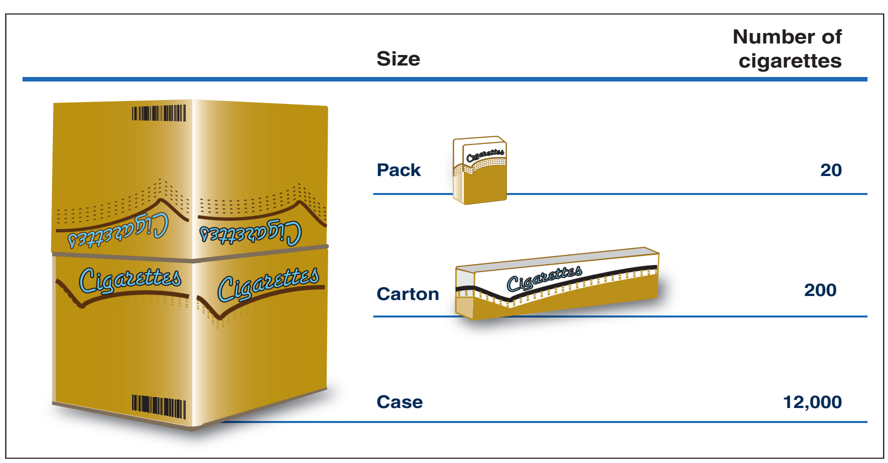
Figure 7: Supply Chain for Legal Cigarettes



Source: GAO analysis.

As indicated in figure 8, cigarettes are typically packaged in groups of 20 per pack and then assembled into cartons containing 10 packs, or 200 cigarettes. Domestic cases typically contain 60 cartons, or 12,000 cigarettes, although some manufacturers may vary the number of cartons in a case. International cases typically contain 10,000 cigarettes.

Figure 8: Number of Cigarettes in a Pack, Carton and Domestic Case



Source: GAO analysis.

Incentives

Cigarette Retail Prices Are Based Largely on Taxes and Other Fees

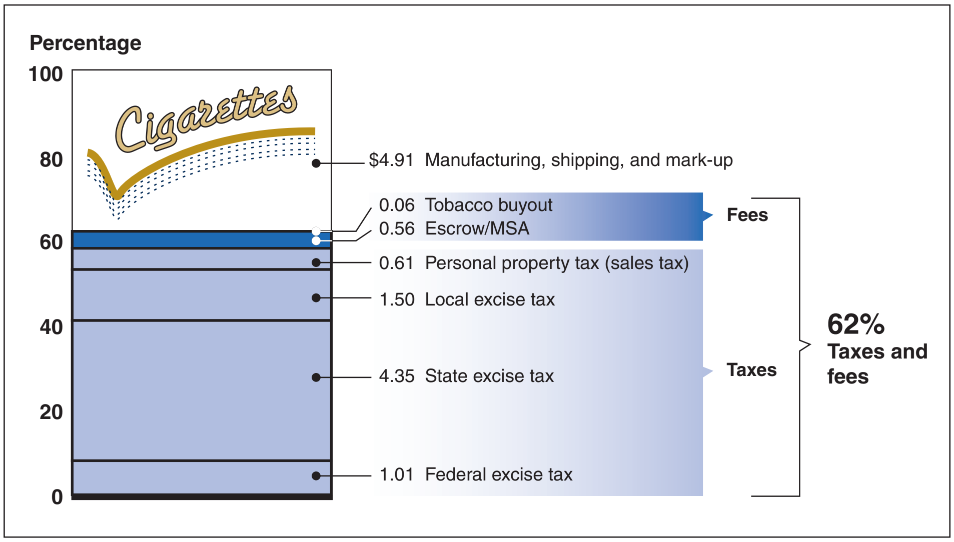
The average retail price for a pack of premium cigarettes in 2010 was $5.95. According to industry representatives, taxes and other fees made up an average of 53 percent of the retail price of a pack of cigarettes, including 34 percent for federal, state, and municipal excise taxes and 19 percent for tobacco settlement payments.

In addition to taxes, cigarette retail prices include MSA payments made by manufacturers. The three original participating manufacturers and more than 45 subsequent participating manufacturers make annual payments to MSA states. According to the National Association of Attorneys General, these payments currently total approximately $7 billion per year. The 46 MSA-settling states also require nonparticipating manufacturers, which have not signed on to the agreement, to make payments into an escrow account according to a separate formula. Four states (Florida, Minnesota, Mississippi, and Texas) settled their cases separately from the MSA-settling states and are, thus, not signatories to the MSA. These four states receive settlement payments from original participating manufacturers, but do not have statutes requiring escrow payments to be made by nonparticipating manufacturers.

According to the National Association of Attorneys General, the market share of nonparticipating manufacturers increased from less than one-half of 1% prior to the MSA to almost 6% in 2009.

The tobacco industry differs from many other industries in that taxes make up the major component of the retail price for its products. This is especially true for cigarettes. Figure 9 provides a breakdown of the various components of the retail price of a pack of premium cigarettes in New York City that was domestically manufactured. Although prices vary at different retail outlets, New York City consumers can pay up to $13.00 or more for a pack of cigarettes. The state and city cigarette taxes make the retail price of cigarettes in New York City among the highest in the country.

Figure 9: Price Components of a $13.00 Cigarette Pack in New York, New York, in 2010



Source: GAO analysis of New York City Department of Finance, National Association of Attorneys General, and Altria data.

Notes:

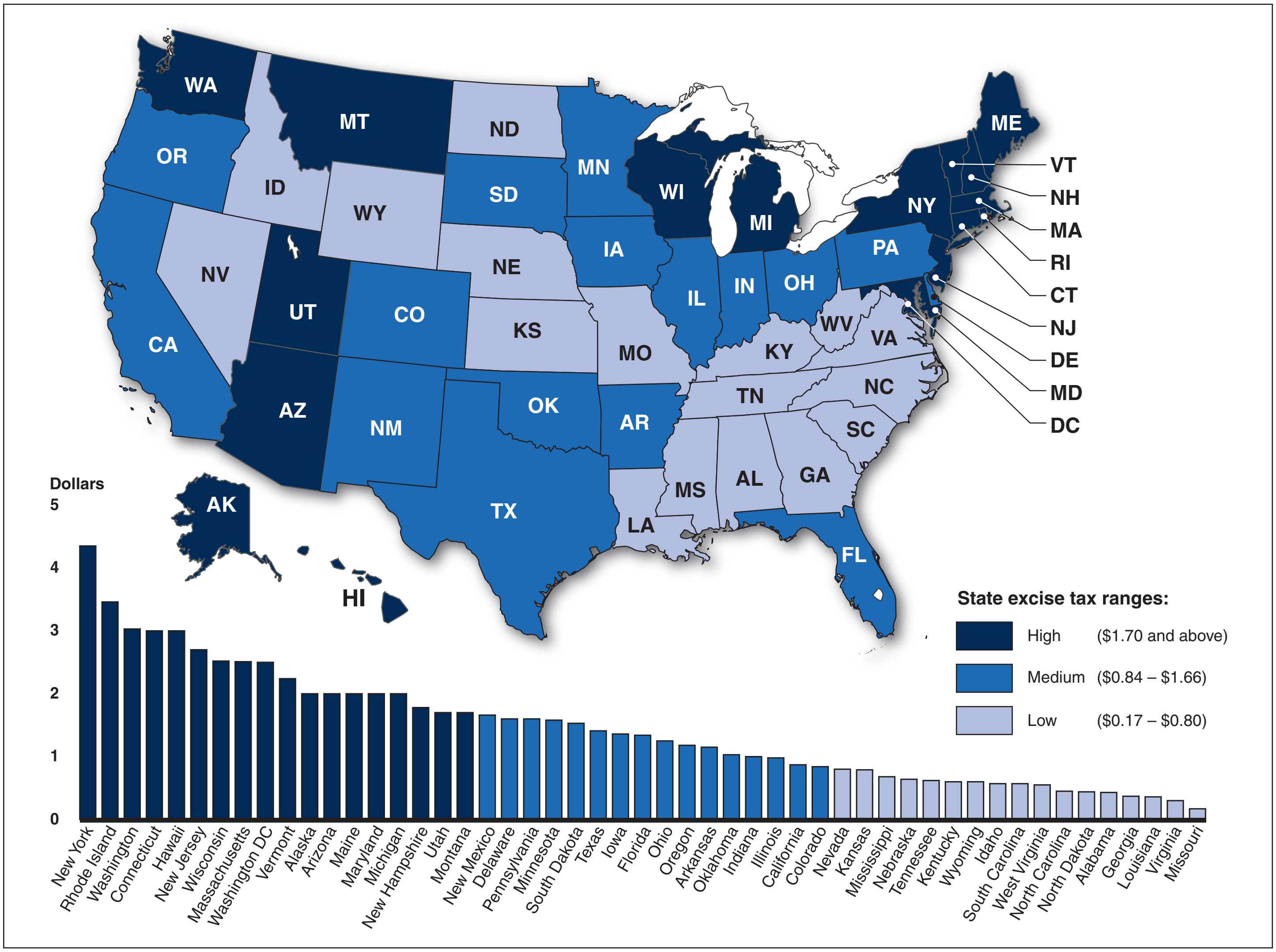
(1) The Tobacco Transition Payment Program (Tobacco Buyout) provides transition payments to tobacco quota holders and producers funded through assessments on tobacco product manufacturers and importers. The program was established in 2004 by Congress following the elimination of the tobacco quota program, a tobacco price support program designed to support and stabilize prices for tobacco farmers. See Pub. L. No. 108-357, Title VI, 118 Stat. 1521. Payments began in 2005 and will continue through 2014. This fee is represented in figure 9.

(2) The Family Smoking Prevention and Tobacco Control Act also established a user fee that is collected from manufacturers and importers of tobacco products, including cigarettes, for the purpose of paying costs related to the Food and Drug Administration's regulation of tobacco products. See Pub. L. No. 111-31, Div A, §§ 101(b)(3), 123 Stat. 1826-27. This user fee is not represented in figure 9.

Incentives: Cigarette Packs Are Taxed at Varying Rates at the State Level

State excise tax rates on cigarettes vary widely, which can create incentives for criminals to engage in cross-border and illicit schemes to profit or take advantage of these tax rate differentials. Figure 10 identifies states with high-, medium-, and low-tax rates for 2010, and shows the range of state tax rates per pack, varying from $4.35 in New York to $0.17 in Missouri. The map also illustrates how low-tax states can become an attractive source of cheaper cigarettes for residents of higher-tax states.

Figure 10: State Cigarette Excise Tax Rates by Pack in 2010



Sources: GAO analysis of Campaign for Tobacco-Free Kids data and Map Resources (map).

Incentives

Cigarette Excise Tax Rates Have Increased in Recent Years

According to the Campaign for Tobacco-Free Kids, states, the District of Columbia, and U.S. territories have raised cigarette excise tax rates more than 100 times since 2002, and 29 states have passed more than one tax increase during that time period. For example, New York raised its state tax rate from $1.11 to $1.50 in 2002, to $2.75 in 2008, and to $4.35 in 2010.

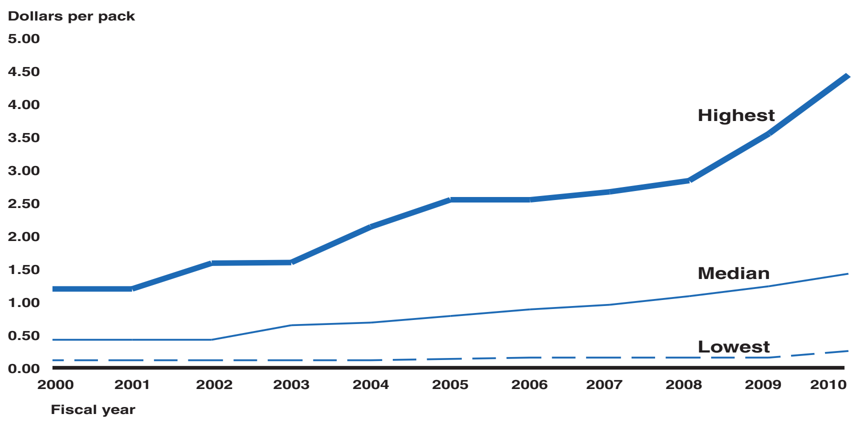
In addition to state taxes, a number of local jurisdictions also have instituted excise taxes on cigarettes and have increased these tax rates in recent years. According to the *Tax Burden on Tobacco*,[1] nearly 520 cities, towns, and counties impose cigarette excise taxes. Municipal cigarette excise taxes were levied in eight states during fiscal year 2009, ranging from $0.01 to $2.00 per pack. By the end of fiscal year 2009, local jurisdictions received an estimated $501 million from their local cigarette excise taxes.

New York City has the highest combined state-local cigarette tax rate with its city tax of $1.50 and state tax of $4.35, totaling $5.85 per pack. Other locations with high combined state-local cigarette taxes include Anchorage, Alaska, (city tax - $2.21, state tax - $2.00 totaling $4.21 per pack), and Chicago, Illinois, (city tax - $0.68, county tax - $2.00, and state tax - $0.98, totaling $3.66 per pack).

The federal excise tax on cigarettes dates to 1864, when it was as low as $0.08 per pack. The tax has increased 21 times since then, including increases from $0.08 to $0.16 in 1983, from $0.24 to $0.34 in 2000, and the 2009 increase from $0.39 to $1.01.

State cigarette excise tax rates have increased over time, and figure 11 shows the trends for the high-, median-, and low-state tax rates since 2000. The states representing the highest, median, and lowest cigarette excise tax rates have changed over time. For example, New York, Massachusetts, New Jersey, and Rhode Island each had the highest tax rate for at least 1 year since 2000.

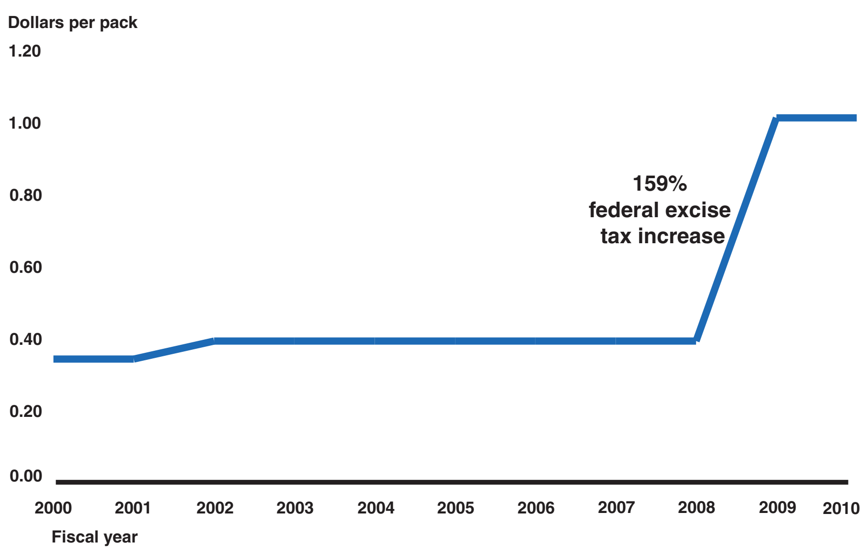
Figure 11: State Cigarette Excise Tax Rates from Fiscal Year 2000 to 2010



Source: GAO analysis of *Tax Burden on Tobacco* data.

In addition, figure 12 shows that the federal cigarette excise tax rate increased two times since 2000, including a sharp increase in 2009 as a result of the Children's Health Insurance Program Reauthorization Act.

Figure 12: Federal Cigarette Excise Tax Rates from Fiscal Year 2000 to 2010



Source: GAO analysis of *Tax Burden on Tobacco* data.

[1] W. Orzechowski and R.C. Walker, *Tax Burden on Tobacco*, *Historical Compilation Volume 44, 2009* (Arlington, VA., 2009).

Incentives

According to experts we interviewed, differing tax rates on tobacco products can create incentives for the tobacco industry to shift toward the manufacture or import of tobacco products with lower tax rates for price-sensitive consumers. Some experts also stated that it may be difficult for regulatory officials to differentiate between tobacco products and the tobacco industry may blur the lines between similar types of tobacco products to avoid higher tax rates. For example, pipe tobacco may be marketed and produced with only minimal differences from roll-your-own tobacco in order to take advantage of the lower tax rate on pipe tobacco. However, TTB officials noted that many shifts in the tobacco market due to differing tax rates are legal as long as those tobacco products meet the definitions provided in the Internal Revenue Code.

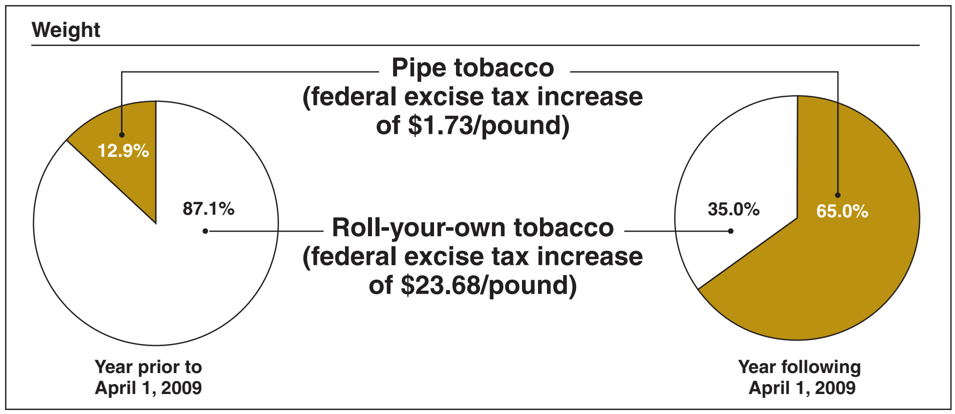
Historically, cigarettes were taxed at a higher rate than small cigars. As a result, some consumers substituted small cigars for cigarettes, according to an expert. However, the price difference between the two products was reduced when the federal government imposed higher but equivalent federal excise tax rates on cigarettes and small cigars in April 2009.

Tax rates on large cigars, which are dependent upon the sale price, were also raised at that time. However, according to TTB, the effect of this raise created an incentive for manufacturers to produce large cigars.

Markets for Other Tobacco Products Shifted Following Changes in Differing Federal Excise Tax Rates

The federal excise tax on roll-your-own tobacco increased significantly from $1.0969 per pound to $24.78 per pound in 2009, while the federal excise tax on pipe tobacco increased at a much lower rate, from $1.0969 per pound to $2.8311 per pound. This large differential in excise tax rate changes led to a large market shift from roll-your-own tobacco to pipe tobacco, as measured by weight (see figure 13).

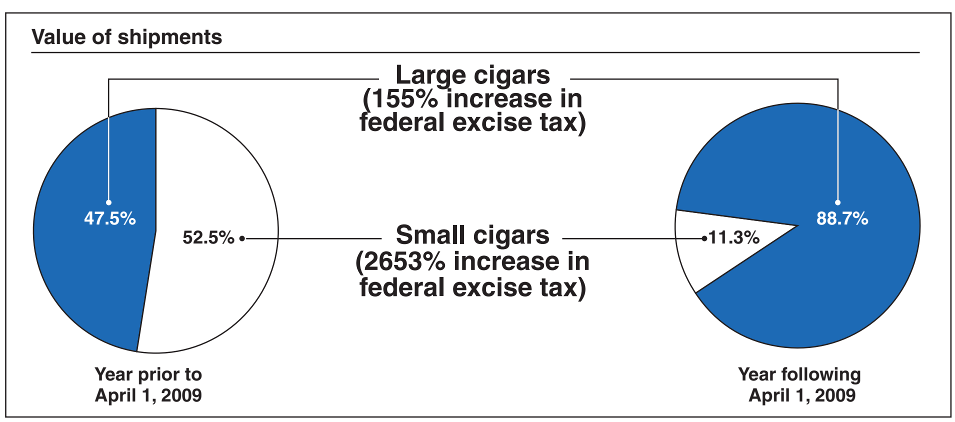
Figure 13: Market Shift Toward Pipe Tobacco Following Sharp Increase in Federal Excise Taxes on Roll-Your-Own Tobacco



Source: GAO analysis of TTB data.

When the federal excise tax was raised on cigarettes from $19.50 per thousand to $50.33 per thousand in 2009, it was also increased significantly on small cigars from $1.828 per thousand to $50.33 per thousand. Tax rates on large cigars were also raised, but the resulting tax structure created an incentive for producers to modify products to qualify as large cigars according to TTB. Figure 14 shows a market shift toward large cigars after April 2009.

Figure 14: Market Shift Toward Large Cigars Following Respective Increases in Federal Excise Taxes on Small and Large Cigars



Source: GAO analysis of TTB data.
Note: Tax increase on large cigars subject to a maximum of $0.4026 per cigar.

Incentives

According to a Department of the Treasury report to Congress, the diversion of tobacco products occurs for two principal reasons: the potential for illicit gains is high and the risk to illegal operators is low. Substantial illicit profit can be derived by selling cigarettes on which taxes have not been paid, particularly since the cost to produce the product is minimal compared to the cost at which it is legally sold.

In terms of risk for illegal operators, tobacco is a legal commodity and can be transported and sold on the open market, making it simple to establish a supply source and distribution channels. In addition, tobacco products are an easy commodity to move in large quantities. Furthermore, according to a Department of Justice Office of the Inspector General report on the Bureau of Alcohol, Tobacco, Firearms, and Explosives (ATF), tobacco diversion is attractive to criminals because it can provide large profits and the criminal penalties are less than the penalties for smuggling drugs.

While both imported and domestically produced cigarettes offer incentives for illicit profits, the ease and convenience of transporting cigarettes across state borders can offer opportunities for profits without some of the difficulties of bringing them across the U.S. border.

Illicit Tobacco Trade Offers High Rewards, Low Risks in Comparison to Other Crimes

Illicit trade in tobacco products offers high rewards when taxes can be evaded. The tax differentials between higher-tax states and lower-tax states can increase the incentives. Figure 15 illustrates the tax differentials between New York City and Richmond, Virginia, by type of packaging. This differential provides an incentive to purchase cigarettes in Richmond, Virginia, for illegal resale in New York City, with a potential illicit profit of up to $3,330 per case.

Figure 15: Tax Differentials for a Pack, Carton, and Domestic Case Between New York, New York, and Richmond, Virginia, 2010

	Pack	Carton	Case
New York City	$6.86	$68.60	$4,116.00
Richmond	1.31	13.10	786.00
Differential	**$5.55**	**$55.50**	**$3,330.00**

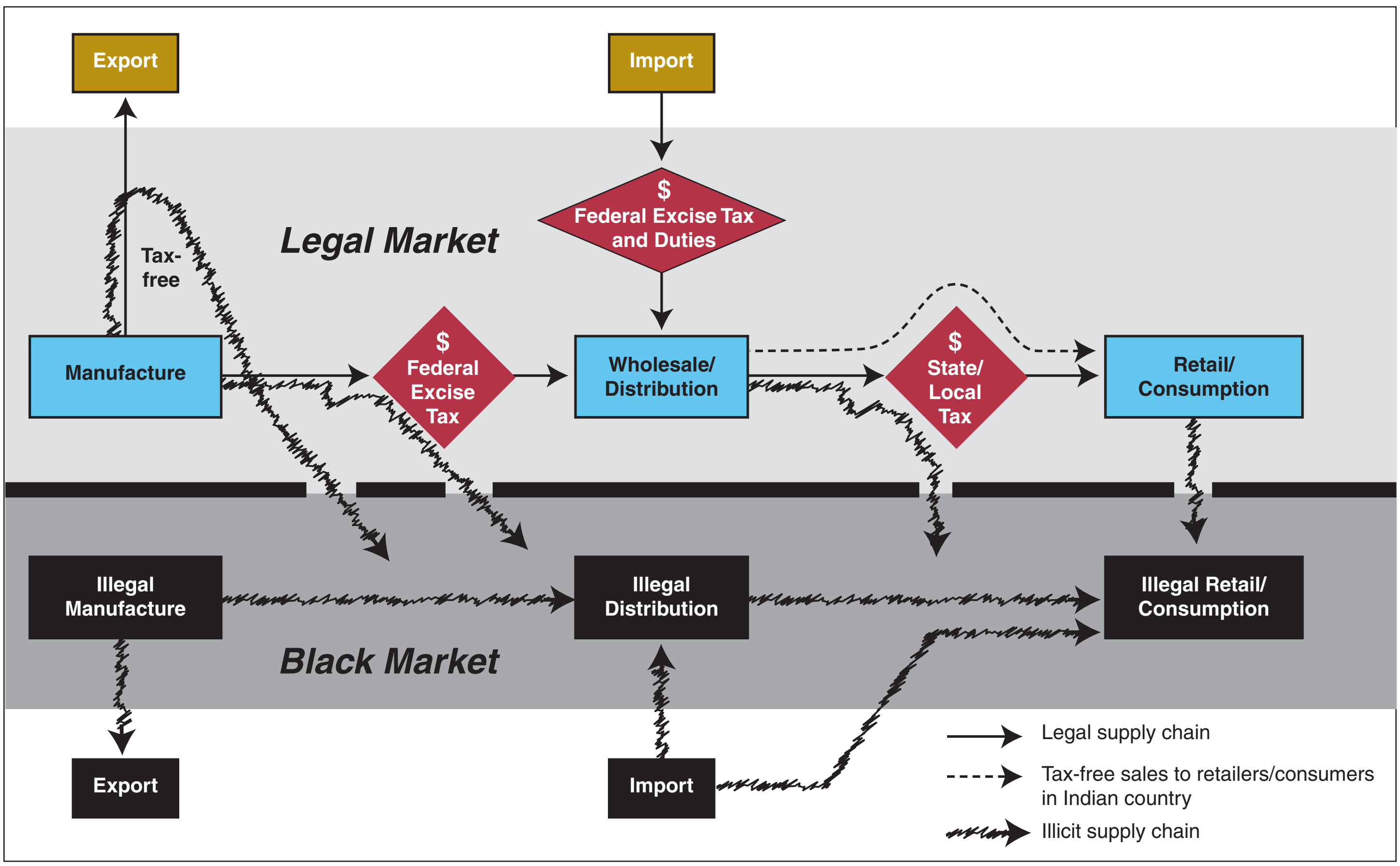
Source: GAO analysis.

Incentives: Opportunities to Evade Excise Taxes and Fees at Multiple Points in the Supply Chain

As can be seen in the legal market section of figure 16, there are multiple opportunities to divert tobacco products from the supply chain in the legal market into the black market before all the appropriate excise taxes and fees are collected. For example, there are some opportunities to divert tobacco products from a retailer in one state after appropriate excise taxes have been paid. In these cases, the tobacco products can be purchased in a state with low excise taxes, like Virginia, and then illegally transported cross-border for illicit resale in a state with higher excise taxes, like New York. Individual consumers can also make cross-border purchases in states with lower excise taxes, an activity prohibited by some states depending on the amount purchased.

Some tobacco products are never legal in the U.S. market, including illegally manufactured and smuggled tobacco products. According to ATF officials, distribution of tobacco products in the black market generally mirrors distribution in the legal market.

Figure 16: Opportunities to Divert Tobacco Products into the Black Market



Source: GAO analysis.

Note: Theft of tobacco products can also occur at any point in the supply chain and is not represented on this supply chain graphic. The graphic also does not represent legal manufacturing on Indian country that may by-pass federal and state excise taxes.

Schemes: A Myriad of Schemes Are Used to Evade Taxes and Other Fees on Tobacco Products

Illicit trade schemes can originate at each point in the tobacco supply chain. Figure 17 gives examples of some illicit schemes, identifies their relationship to the supply chain, and indicates the taxes and fees that can be avoided using each scheme. Schemes that avoid federal excise taxes originate earlier in the supply chain. Federal law enforcement officials identified state governments as key stakeholders because many schemes evade state excise taxes. Schemes can also result in the evasion of MSA or escrow payments, depending on the manufacturer, tobacco product, and state involved.

According to federal and state law enforcement officials and experts, the patterns of smuggling and diversion schemes are not static, but change in response to many factors, including changes in tobacco taxes, tobacco regulations, and law enforcement activity. Officials characterized illicit trade in tobacco products as like a whack-a-mole problem, stating that although illicit trade may decrease immediately following successful law enforcement efforts, these activities usually resume after a period of time. ATF officials also noted that illicit trade in tobacco is often connected to other crime and criminals may use proceeds from illicit trade in tobacco to fund other crimes.

Figure 17: Illicit Trade Schemes Profit by Evading Taxes and Fees

Relationship to supply chain	Examples of illicit trade schemes	Taxes and fees avoided			
		Customs duty	Federal excise tax	State/local excise tax	MSA/ escrow payment
Import	• Smuggling genuine or counterfeit cigarettes into the United States • Purchasing cigarettes from foreign Internet Web sites without appropriate payment of tax	√	√	√	√
Export	• Diverting export-only cigarettes into U.S. commerce	NA	√	√	√
Manufacture	• Manufacturing cigarettes in the United States without a license • Underreporting cigarette production to federal government	NA	√	√	√
Wholesale/ distribution	• Purchasing tobacco products from wholesaler in one state for illegal transportation and resale in another state • Underreporting tobacco product sales to state governments	NA	Paid	√	√
Retail	• Purchasing tobacco products from retailer in one state for illegal transportation and resale in another state • Purchasing cigarettes in Indian country for resale to nontribal members • Purchasing cigarettes from domestic Internet Web sites without appropriate payment of tax	NA	Paid	√	√
Other	• Underreporting cigarette sales to MSA states	NA	Paid	Paid	√

Source: GAO analysis.

Note: In some wholesale/distribution and retail schemes, state excise taxes are paid in the state where the tobacco products are purchased, but unpaid in the state where the tobacco products are illicitly resold.

Schemes

Smuggling Genuine and Counterfeit Tobacco Products

Smuggling

According to officials from CBP and U.S. Immigration and Customs Enforcement, smugglers have illegally imported cigarettes into the United States by not declaring them at Customs, disguising them, and hiding them behind other commodities.

Officials also described schemes in which one type of tobacco product may be misclassified as another type of tobacco product with a more favorable federal excise tax and rate of duty. For example, CBP officials noted that it is difficult to distinguish between roll-your-own tobacco and pipe tobacco. Also, roll-your-own tobacco imports can be misclassified as pipe tobacco to evade the higher federal excise taxes on roll-your-own.

According to an official from Immigration and Customs Enforcement, tobacco products may also be smuggled into the United States through the Customs in-bond system by falsifying manifests. In addition, ATF officials stated that an investigation has targeted smuggling through a foreign trade zone.

An official from TTB also noted that large amounts of cigarettes purchased from foreign-based Internet Web sites are brought into the United States without the payment of federal excise taxes.

Relationship to supply chain	Examples of illicit trade schemes	Taxes and fees avoided			
		Customs duty	Federal excise tax	State/local excise tax	MSA/ escrow payment
Import	• Smuggling genuine or counterfeit cigarettes into the United States • Purchasing cigarettes from foreign Internet Web sites without appropriate payment of tax	√	√	√	√

Source: GAO analysis.

A range of schemes have been used to evade duties and excise taxes on both genuine and counterfeit tobacco products as they are imported into the United States and distributed in the black market. According to CBP officials, smugglers have imported counterfeit tobacco products by falsely declaring them as other commodities. For example, a recent CBP press release revealed that more than 22,000 cartons of counterfeit Marlboros were intercepted after being shipped from China and seized at the Los Angeles/Long Beach seaport complex. The counterfeit cigarettes, pictured in figure 18, were falsely declared as hang tags and hang plugs.

Figure 18: Seizure of Counterfeit Cigarettes

Source: CBP.

In another case, ATF investigated the unlawful sales of cigarettes through a foreign-based Internet Web site. ATF's records stated approximately 156,000 cigarette orders packaged for delivery to persons across the United States were seized. ATF estimated that losses in federal and state tax revenue resulting from this illegal operation exceeded $425 million.

Schemes

Diverting Cigarettes Manufactured for Export

<u>Export Diversion</u>

Officials from ATF and TTB reported that cases targeting the diversion of export-only cigarettes into U.S. commerce are currently being investigated. Domestically manufactured cigarettes may be exported without the payment of federal excise taxes. However, these cigarettes must bear an export mark such as "U.S. Tax Exempt For Use Outside U.S."

According to experts we spoke with, export diversion may be less prevalent following the decline in cigarettes produced for export by the three largest cigarette manufacturers. However, smaller manufacturers still produce cigarettes for export and an expert told us that export-diversion schemes may be shifting to cigarettes produced by these smaller manufacturers.

Cigarettes and other tobacco products can also be smuggled from the United States into foreign countries.

Relationship to supply chain	Examples of illicit trade schemes	Taxes and fees avoided			
		Customs duty	Federal excise tax	State/local excise tax	MSA/ escrow payment
Export	• Diverting export-only cigarettes into U.S. commerce	NA	√	√	√

Source: GAO analysis.

Individuals may illegally divert cigarettes manufactured for export from the United States for illicit resale in the United States and evade federal excise taxes as a result. In one case, a criminal organization purchased large quantities of cigarettes labeled for export in Miami and illegally introduced them into U.S. commerce after presenting false documents, including fraudulent Mexican documents, to CBP reflecting that the cigarettes had been exported to Mexico. In reality, the contraband cigarettes had been diverted and sold to customers in New York without the payment of federal or state excise taxes. Figure 19 provides an example of cigarette packs with and without export markings.

Figure 19: Packs of Domestically Manufactured Cigarettes With and Without Export Marking

Source: Department of Homeland Security.

Note: Pack without marking is on left. Packs with markings are center and right.

Schemes

Diverting Domestically Manufactured Cigarettes

Unlicensed Manufacturing

According to an official from TTB, unlicensed manufacturing is one of two primary illicit manufacturing schemes used to evade taxes on domestically produced cigarettes. In general, unlicensed manufacturers do not submit tax returns and monthly reports to TTB, nor do they pay federal excise taxes on the cigarettes they produce.

Underreporting Production

The other primary illicit manufacturing scheme, according to a TTB official, is underreporting on tax returns the amount of domestically produced cigarettes that leave a manufacturing facility bonded with TTB. Tax returns form the basis of the federal excise tax payments and underreporting the amount of cigarettes subject to tax results in the evasion of federal excise taxes.

Relationship to supply chain	Examples of illicit trade schemes	Taxes and fees avoided			
		Customs duty	Federal excise tax	State/local excise tax	MSA/ escrow payment
Manufacture	• Manufacturing cigarettes in the United States without a license • Underreporting cigarette production to federal government	NA	√	√	√

Source: GAO analysis.

According to many government officials and experts, most unlicensed cigarette manufacturing occurs in northern New York on land controlled by the St. Regis Mohawk tribe. A New York official estimates that there are between 15 and 18 unlicensed cigarette manufacturers on this land. According to TTB officials, only two of the unlicensed manufacturers have permit applications pending with TTB. Most of these unlicensed cigarette manufacturers produce “rollies” or “baggies,” containing 200 cigarettes, as shown in figure 20. According to an U.S. Immigration and Customs Enforcment official, these packages may sell for as little as $20. This price is significantly less than a carton of premium brand cigarettes that can sell for over $100 in New York City.

Figure 20: Illicit Cigarettes on Land Controlled by the St. Regis Mohawk Tribe

Source: TTB.

In a recent case involving a licensed cigarette manufacturer, the manufacturer evaded federal excise taxes by submitting false tax returns and monthly reports to TTB that underreported the quantity of cigarettes removed from its factory. According to court documents, the manufacturer failed to include nearly 2.45 million packs of cigarettes on its tax returns and reports, resulting in the evasion of $950,000 in federal excise taxes.

Diverting Tobacco Products During Distribution

Schemes

Interstate Trafficking

According to federal and state law enforcement officials, there are many different types of diversion schemes at the wholesale and distribution level of the supply chain. ATF officials stated that criminal organizations may purchase state excise tax-paid cigarettes from wholesalers in a state with low state excise taxes, like Virginia, and illegally transport those cigarettes for resale in a state with higher excise taxes, like New York, to capitalize on state excise tax differentials.

Another pattern of interstate diversion entails purchasing cigarettes from a wholesaler in a state that does not use tax stamps to indicate the payment of excise taxes on cigarettes, like North Carolina, South Carolina, or North Dakota, and transporting those cigarettes for resale in a state with higher excise taxes. Counterfeit tax stamps may then be applied to these contraband cigarettes before they are resold to deceive both authorities and consumers.

State law enforcement officials have also cited the interstate diversion of other tobacco products, like cigars or smokeless tobacco, as an increasing concern. Other tobacco products are not stamped when taxes are paid.

Underreporting Sales

Federal and state law enforcement officials reported that wholesalers and distributors can also evade state excise taxes on cigarettes and other tobacco products by falsifying their reports to state governments, including overstating tax-exempt out-of-state sales, or by neglecting to submit the required reports.

Relationship to supply chain	Examples of illicit trade schemes	Taxes and fees avoided			
		Customs duty	Federal excise tax	State/local excise tax	MSA/ escrow payment
Wholesale/ distribution	• Purchasing tobacco products from wholesaler in one state for illegal transportation and resale in another state • Underreporting tobacco product sales to state governments	NA	Paid	√	√

Source: GAO analysis.

Many distribution schemes involve wholesalers and distributors evading state excise taxes on cigarettes or other tobacco products by falsifying their reports to state governments. In a recent California case, for example, distributors of other tobacco products conspired to sell in the state without paying California state excise taxes. The distributors did not accurately report their sales to the California state government and evaded an estimated $650,000 in state excise taxes. According to the Office of the United States Attorney, more than $35 million in California state excise taxes have been evaded by other tobacco products distributors using a number of schemes, including either failing to submit excise tax returns or submitting fraudulent returns, falsifying other commercial documents like invoices, and using dummy corporations or out-of-state distributors to deceive state authorities. Figure 21 shows a distributor's warehouse with other tobacco products that was seized in connection to these cases.

Figure 21: Other Tobacco Products in Warehouse Seized in Connection with California State Excise Tax Evasion

Sources: ATF and California State Board of Equalization.

Schemes

Diverting Tobacco Products Sold at Retail

Interstate Trafficking

Similar to diversion at the wholesale level, tobacco products at the retail level are diverted to capitalize on differentials between state excise taxes. For example, according to federal law enforcement officials, tobacco products sold at retail are purchased at a store in a low-tax state for transportation and illegal resale in a state with a higher excise tax.

Indian Country Sales

Alternatively, state excise tax-free cigarettes can be purchased at retail in Indian country for illegal resale to nontribal members in other locations. Cigarettes sold to tribal members in Indian country are exempt from state taxation but not sales to nontribal members, unless state law or an agreement exempts sales to nontribal members from taxation.

Domestic Internet Web sites

Additionally, delivery sales of tobacco products, like Internet-based sales, have been made without the proper payment of state excise taxes by either the seller or the purchaser. Delivery sales occur when the seller is not in the physical presence of the buyer when the purchase is made (e.g., telephone, mail, or Internet services) or delivered. However, according to the experts we interviewed, the Prevent All Cigarette Trafficking Act of 2009 has limited illegal Internet sales of tobacco products by requiring advance payment of state excise taxes and prohibiting the delivery of tobacco products through the mail.

Relationship to supply chain	Examples of illicit trade schemes	Taxes and fees avoided			
		Customs duty	Federal excise tax	State/local excise tax	MSA/ escrow payment
Retail	• Purchasing tobacco products from retailer in one state for illegal transportation and resale in another state • Purchasing cigarettes in Indian country for resale to nontribal members • Purchasing cigarettes from domestic Internet Web sites without appropriate payment of tax	NA	Paid	√	√

Source: GAO analysis.

Numerous illicit trade schemes involve tobacco products purchased at retail. For example, a retail store on Stillaguamish tribal trust land in Washington sold more than $55 million of contraband cigarettes without the payment of state excise taxes. According to court documents, more than $25 million in Washington state excise taxes were avoided as a result. In another example, law enforcement officials reported that individuals purchased tax-free cigarettes from retail stores similar to the one seen in figure 22 for transportation and illegal resale in New York City.

Figure 22: Tonawanda Retail Store Selling Tax-Free Cigarettes

Source: ATF.

Consumers also purchase state excise tax-free tobacco products from Internet Web sites. However, ATF officials reported the number of domestic Internet Web sites selling tobacco products has decreased from 200 to 30, following the Prevent All Cigarette Trafficking Act of 2009.

Schemes

According to an official from the National Association of Attorneys General, the evasion of MSA payments has been a significant problem for states. Manufacturers that are party to the MSA, including original participating manufacturers and subsequent participating manufacturers, are required to make payments to MSA states that are based on their total domestic sales. This official stated that subsequent participating manufacturers have evaded MSA payments by underreporting on their domestic sales.

Some domestic and international manufacturers are not party to the MSA and are known as nonparticipating manufacturers. ATF officials reported that the evasion of MSA escrow payments by nonparticipating manufacturers is also an issue for state governments. MSA states have created statutes requiring these manufacturers to make payments into escrow accounts and these payments are based on sales into each MSA state. According to an expert we spoke with, a typical MSA escrow fraud scheme involves underreporting cigarettes sales into states. ATF officials explained another common scheme involves falsely reporting that cigarette sales are destined for a non-MSA state or Indian country, when the sale is actually made in a MSA state.

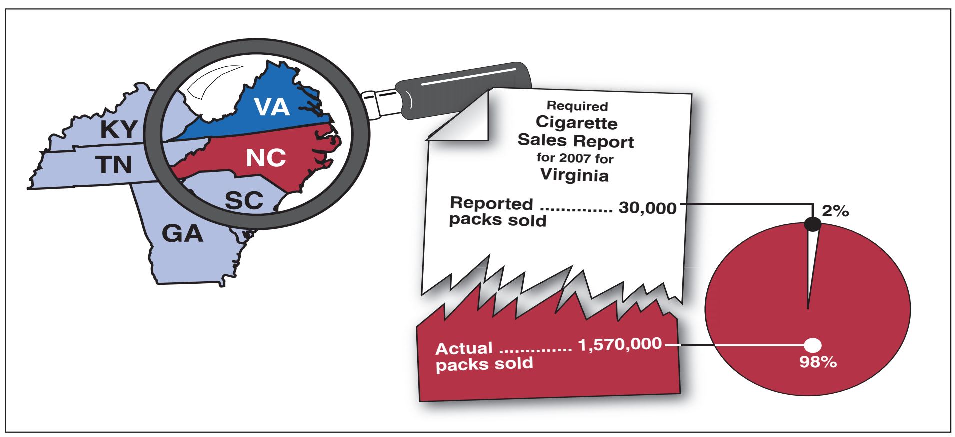
Avoiding MSA Payments

Relationship to supply chain	Examples of illicit trade schemes	Taxes and fees avoided			
		Customs duty	Federal excise tax	State/local excise tax	MSA/ escrow payment
Other	• Underreporting cigarette sales to MSA states	NA	Paid	Paid	√

Source: GAO analysis.

Figure 23 shows a recent case in which a small cigarette nonparticipating manufacturer based in North Carolina evaded MSA escrow payments on cigarettes sold in Virginia, Kentucky, Tennessee, South Carolina, and Georgia. According to court documents, they falsely underreported its sales to these states in order to evade its obligation to make escrow payments. In 2008, for example, they falsely reported it sold 30,000 packs in Virginia in 2007, when in fact it had sold more than 1.5 million packs. This resulted in the evasion of approximately $580,000 in escrow payments owed to the state of Virginia.

Figure 23: Example of MSA Escrow Payment Evasion



Sources: GAO analysis and Nova Development (clip art).

In another case, an importer in New York purchased cigarettes manufactured by a foreign nonparticipating manufacturer. According to court documents, approximately 1 million cartons of these cigarettes were imported and then sold to a distributor in South Carolina. However, only 250,000 cartons were sold and shipped directly to the South Carolina distributor. The other 750,000 cartons were diverted through wholesalers in Mississippi, a non-MSA state. The Mississippi wholesalers then falsely reported that the cigarettes were sold in Mississippi when the cigarettes were actually sold to the distributor in South Carolina. The distributor in South Carolina only reported sales of the 250,000 directly shipped cartons and evaded more than $800,000 in MSA escrow payments and state excise taxes due to South Carolina on the diverted 750,000 cartons.

Appendix II: GAO Contacts and Staff Acknowledgments

GAO Contact

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Staff Acknowledgments

In addition to the contact named above, Christine Broderick (Assistant Director), Brent Corby, Barbara El Osta, Etana Finkler, Jeremy Latimer, and Justine Lazaro made significant contributions to this report. In addition, Pedro Almoguera, Karen Deans, Grace Lui, and Alana Miller provided technical assistance.

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