

VIRGINIA STATE CRIME COMMISSION

2016 Annual Report: *Cigarette Trafficking Update*



Cigarette Trafficking Update

Executive Summary

The Crime Commission has continued to monitor cigarette trafficking for the past five years. At the conclusion of a comprehensive review conducted in 2012, the Crime Commission recommended a number of statutory changes, including increasing the penalties for cigarette trafficking. These recommendations were enacted during the 2013 Regular Session of the Virginia General Assembly. Crime Commission members instructed staff to continue to monitor the ongoing trafficking situation in Virginia, assess the impact of the proposed statutory changes, and make any recommendations necessary to address the problem.

Cigarette trafficking remains widespread in the Commonwealth. Virginia has the second lowest tax rate in the nation at 30 cents per pack. This tax rate disparity, as well as geographical location, has resulted in Virginia becoming the primary source state for black market cigarettes. Organized criminal enterprises have brought violent activity to the Commonwealth while amassing large profits by purchasing cigarettes cheaply in Virginia and then selling them illegally in other states. Some of the profits from this illegal activity are also sent overseas. The federal government has identified links between cigarette trafficking and the funding of terrorist groups. Virginia's statutes are being used to combat cigarette trafficking, but the sentences imposed are often low when compared with the enormous amounts of money generated by this crime.

Staff regularly reviewed cigarette trafficking cases and trends. Many of these cases involved the establishment and use of fraudulent businesses to purchase large quantities of cigarettes solely for the purpose of trafficking. Business registrations and sales tax exempt certificates are easily obtained online and are immediately available to the applicant. Virginia loses millions of dollars in sales tax every year due to these fraudulent businesses.

As part of the 2016 study on cigarette trafficking, staff communicated regularly with interested parties and convened multiple meetings to discuss this issue and develop recommendations. As in past years, staff requested data on the number of charges and convictions for cigarette-related offenses from the Virginia Criminal Sentencing Commission.

Staff provided an update to Crime Commission members regarding recent data and general trends in cigarette trafficking at the October meeting. As a result of the findings from the continued study, staff presented the following recommendations at the December meeting:

Recommendation 1: A new section (Virginia Code § 58.1-623.2) should be enacted to create a cigarette exemption certificate issued by the Department of Taxation following a vetting process, which includes a background investigation and verification of a physical place of business.

- Creates an expedited process for active valid ABC licensees and OTP licensees.
- Creates a 30 day waiting period to obtain certificate.
- Allows retailers to purchase cigarettes exempt from sales tax.
- The use of a forged or invalid Virginia cigarette exemption certificate would be punishable under existing Virginia Code § 58.1-1017.3.

The Crime Commission unanimously endorsed Recommendation 1.

Recommendation 2: A new section (Virginia Code § 58.1-623.3) should be enacted requiring that a form be completed and maintained for any cigarette purchase of more than 10,000 sticks or 50 cartons, or when the total value of the purchase is over \$10,000.

- The form should be developed by the Office of the Attorney General.
- The form must be accompanied by photographic identification.
- The form will be available for inspection and transmitted to the Office of the Attorney General on a regular basis.

The Crime Commission unanimously endorsed Recommendation 2.

Recommendation 3: Reduce the number of tax-paid cigarettes that an individual may possess under Virginia Code § 58.1-1017.1 in relation to the charge of possession with intent to distribute contraband cigarettes.

No motion was made for Recommendation 3.

Recommendation 4: Amend two definitions under Virginia Code § 58.1-1000:

- Amend “authorized holder” to disqualify anyone as an authorized holder who has been convicted of a criminal offense under Chapter 10 of Title 58.1.
- Amend “retail dealer” to include the requirement that the retail dealer possess a valid cigarette exemption certificate.

The Crime Commission unanimously endorsed Recommendation 4.

Legislation combining Recommendations 1, 2, and 4 was introduced in both chambers as an omnibus bill during the Regular Session of the 2017 General Assembly. Delegate Richard L. Anderson introduced House Bill 1913 and Senators Janet D. Howell and Thomas K. Norment, Jr., introduced Senate Bill 1390. Both bills were passed and signed by the Governor.

The bills require the Department of Taxation to begin developing guidelines for the issuance of the cigarette exemption certificates. Effective July 1, 2017, purchases of certain quantities of cigarettes will require completion of a form and presentation of photo identification. Effective January 1, 2018, a cigarette exemption certificate will be

required for tax exempt purchases of cigarettes. Additionally, as of that date: i) qualifications for specific authorized holders will change; ii) criminal sanctions for fraudulent use of the cigarette exemption certificate will take effect; and iii) a valid cigarette exemption certificate will need to be presented for the purchase of certain quantities of cigarettes, along with the form and photo identification.

Background

During the 2012 Regular Session of the Virginia General Assembly, Senate Joint Resolution 21 was enacted, which directed the Crime Commission to conduct a comprehensive study on cigarette trafficking. At the conclusion of the study, the Crime Commission recommended a number of statutory changes, including increasing the penalties for cigarette trafficking. These recommendations were enacted during the 2013 Regular Session of the Virginia General Assembly. Crime Commission members instructed staff to continue to monitor the ongoing trafficking situation in Virginia, assess the impact of the proposed statutory changes, and make any recommendations necessary to address the problem.

Cigarettes remain a significant source of tax revenue for Virginia. As seen in Table 1, Virginia has received around \$160 million per year over the past three fiscal years (FY14-FY16) from cigarette tax revenue.

Table 1: Total Cigarette Tax Stamp Revenue Collected, FY06-FY16

Fiscal Year	Cigarette Tax Revenue (Gross \$ in Millions)
2006	\$172.1*
2007	\$172.1
2008	\$168.3
2009	\$167.5
2010	\$158.6
2011	\$155.8
2012	\$174.0
2013	\$169.5
2014	\$161.6
2015	\$159.6
2016	\$158.9

Source: Virginia Department of Taxation.

* Rate increased from \$0.20 to \$0.30 per 20 cigarettes effective 7/1/05.

Despite legislative and investigative efforts, cigarette trafficking has continued throughout the Commonwealth. There are a number of broad categories of cigarette trafficking crimes: purchasing tax paid cartons with the intent to distribute (“smurfing”); fraudulent retail operations for purchasing in bulk; retailers selling cigarettes “off the books;” tax avoidance by wholesalers; tax avoidance by manufacturers; international smuggling; importing counterfeit cigarettes; and forged tax stamps. All of these trafficking schemes, regardless of the methods employed, rely upon tax avoidance.

The main reason that traffickers are drawn to Virginia is the low cigarette tax rate. Virginia has the second lowest cigarette tax rate in the nation at 30 cents per pack, while the mid-Atlantic and New England states have some of the highest cigarette tax rates in the country.¹ New York, for example, has a tax rate of \$4.35 per pack. City and county taxes also can be added to the state excise tax, creating an even higher tax rate. In Chicago, Illinois, this results in the highest combined tax in the nation, \$6.16 per pack.² Moreover, almost half of the states have increased cigarette taxes over the last several years, and many were significant increases.³

The 2017 state excise tax rate for a carton of cigarettes (10 packs) varies significantly by state:⁴

- Virginia: \$3.00
- New Jersey: \$27.00
- Massachusetts: \$35.10
- Rhode Island: \$37.50
- New York: \$43.50
- New York City: \$58.50
- Chicago: \$61.60

As an illustration of the profit that can be made from cigarette trafficking, a single car can transport up to 10 cases of cigarettes (50 cartons per case), resulting in a profit ranging from \$15,000 to \$25,000. A van can be used to transport up to 50 cases of cigarettes, producing a profit of \$80,000 to \$100,000, depending on the state where the cigarettes are trafficked.

In addition to the lower cigarette tax rate, geography also plays a role in making Virginia an attractive location for traffickers. Virginia’s location along the Interstate 95 corridor provides easy access to those mid-Atlantic and New England states with high cigarette tax rates.

¹ See State Cigarette Excise Tax Rates & Rankings (2017). *Campaign for Tobacco-Free Kids*. Retrieved from <https://www.tobaccofreekids.org/research/factsheets/pdf/0097.pdf>

² *Id.*

³ *Id.*

⁴ See State Excise Tax Rates On Cigarettes (2017). *Federation of Tax Administrators*. Retrieved from <https://www.taxadmin.org/assets/docs/Research/Rates/cigarette.pdf>

According to some law enforcement agents, cigarette trafficking has a higher profit margin than illegally trafficked drugs or guns.⁵ The lure of these profits has brought organized crime and gangs, along with the violent criminal activity that often accompanies such groups, to Virginia. Some jurisdictions have reported that cigarette trafficking has been connected to an increase in attendant crimes, such as credit card fraud, money laundering, burglaries, robberies, homicides and murder-for-hire schemes. Using Virginia as a base for their operations, criminal organizations purchase low-cost cigarettes here and resell them illegally in other states for the aforementioned high profits. This criminal activity negatively impacts all legitimate manufacturers, wholesalers, and retailers, and it also deprives governments of needed tax revenue.

Current Law

Based upon the Crime Commission’s endorsement, the General Assembly has enacted numerous criminal and civil penalties for cigarette trafficking over the past four years. The penalties for trafficking tax-paid cigarettes have increased and felony threshold amounts have been lowered.⁶ Similarly, the penalties for trafficking unstamped cigarettes, i.e., cigarettes for which the state excise tax has not been paid, have increased, and the qualifying threshold for this offense has been lowered.⁷ Legislation has made it illegal to purchase cigarettes using a forged business license or a forged or otherwise invalid sales and use tax exemption certificate.⁸ The definition of “authorized holder” has been modified to exclude anyone convicted of a cigarette trafficking offense in any locality, state, or the United States.⁹ A list of ineligible “authorized holders” is maintained by the Attorney General’s Office and is available online on their website.¹⁰

Cigarette trafficking has been added to the list of crimes that may be investigated by multi-jurisdictional grand juries.¹¹ Trafficking stamped cigarettes has been added to the qualifying offenses for Virginia’s RICO statute.¹² The Virginia Code section which permits law enforcement officers to seize and forfeit all “fixtures, equipment, materials, and personal property” used in connection with the sale or possession of counterfeit cigarettes has been expanded to include non-counterfeit, trafficked cigarettes.¹³ There have also been changes to the penalties for trafficking counterfeit cigarettes. The knowing distribution or possession with the intent to distribute counterfeit cigarettes is now a criminal offense; prior to this change, the distribution of counterfeit cigarettes only carried a civil penalty.¹⁴

⁵ “Illegally trafficked cigarettes now have a higher profit margin than cocaine, heroin, marijuana, or guns.” – Virginia State Police Agent (2012); “We’ve had people trading our undercover agents kilos of cocaine for cigarettes. That’s how lucrative it is.” – ATF Agent (2016).

⁶ Va. Code § 58.1-1017.1 (2016).

⁷ Va. Code § 58.1-1017 (2016).

⁸ Va. Code § 58.1-1017.3 (2016).

⁹ Va. Code § 58.1-1000 (2016).

¹⁰ See <http://www.oag.state.va.us/programs-initiatives/tobacco-enforcement#cigarette-trafficking>

¹¹ Va. Code § 19.2-215.1(cc) (2016).

¹² Va. Code § 18.2-513 (2016).

¹³ Va. Code § 19.2-386.21 (2016).

¹⁴ Va. Code § 18.2-246.14 (2016).

Changes to the law have not just involved increasing penalties and broadening the scope of prohibited activities. The Virginia Department of Taxation, the Office of the Attorney General of Virginia, local tax administrators, and the Virginia Department of Alcoholic Beverage Control now all have access to records involving the purchase and sale of cigarettes, thereby enhancing their investigative and administrative capabilities.¹⁵ Both the Virginia Department of Taxation and the Office of the Attorney General of Virginia have been authorized, though not mandated, to accept the electronic receipt of reporting forms from tobacco manufacturers and wholesalers.¹⁶ The Virginia Department of Taxation has also been authorized to accept electronic payments for tax stamps.¹⁷

Cigarette Trafficking Charge and Conviction Data

Staff requested updated data from the Virginia Criminal Sentencing Commission as to the number of charges and convictions related to illegal cigarette trafficking in general district and circuit courts.

Table 2 on the next page shows that the most common charge in general district court falls under Virginia Code § 58.1-1017.1, which captures possession with intent to distribute tax-paid, contraband cigarettes (“smurfing”). It is also noteworthy that a significant number of charges were set forth under the new threshold amount for this Code section effective FY16 (>5,000 but < 40,000; or, > or equal to 40,000). As seen in Table 3, convictions for Virginia Code § 58.1-1017.1 steadily decreased with a small number of convictions attained for the new threshold amounts effective in FY16. Data indicates that there were few convictions under any of the other code sections that capture cigarette trafficking related activities. The low number of charges and subsequent convictions indicate that these crimes may not be serving as a deterrent to cigarette traffickers.

¹⁵ Va. Code § 58.1-1007 (2016).

¹⁶ Va. Code §§ 3.2-4209(A) and 58.1-1008.1 (2016).

¹⁷ Va. Code § 58.1-1009(A) (2016).

Table 2: General District Court Charges for Common Cigarette-Related Offenses, FY14-FY16*

Va. Code Section	Description	FY14	FY15	FY16
§ 58.1-1017(B)	Cigarettes without stamp, sale, purchase, possess, < 3000 pks (FY13); <500 pks (FY14 onward)	3	1	5
§ 58.1-1017(B)	Cigarettes without stamp, sale, purchase, possess, <500 pks, subseq.	0	0	0
§ 58.1-1017(C)	Cigarettes without stamp, sale, purchase, possess, >= 3000 pks (FY13); >= 500 pks (FY14 onward)	14	4	6
§ 58.1-1017(C)	Cigarettes without stamp, sale, purchase, possess, >= 500 pks, subseq.	0	1	0
§ 58.1-1017.1	Possession with intent to distribute tax-paid, contraband cigarettes	109	45	85
§ 58.1-1017.1	Possession with intent to distribute tax-paid, contraband cigarettes, subseq.	8	4	7
§ 58.1-1017.1	Intent/distribute >=100,000 tax-paid cigarettes	14	5	3
§ 58.1-1017.1	Intent/distribute >=100,000 tax-paid cigarettes, subseq.	0	0	0
§ 58.1-1017.1	Intent/distribute >5,000 & <40,000 tax-paid cigarettes	---	---	57
§ 58.1-1017.1	Intent/distribute >5,000 & <40,000 tax-paid cigarettes, subseq.	---	---	4
§ 58.1-1017.1	Intent/distribute >=40,000 tax-paid cigarettes	---	---	27
§ 58.1-1017.1	Intent/distribute >=40,000 tax-paid cigarettes, subseq.	---	---	3

Source: Supreme Court of Virginia - General District Court Case Management System (CMS). * Fiscal year in which charge was filed.

Table 3: General District Court Convictions for Common Cigarette-Related Offenses, FY14-FY16*

Va. Code Section	Description	FY14	FY15	FY16
§ 58.1-1017(B)	Cigarettes without stamp, sale, purchase, possess, < 3000 pks (FY13); <500 pks (FY14 onward)	6	2	4
§ 58.1-1017(B)	Cigarettes without stamp, sale, purchase, possess, <500 pks, subseq.	0	0	0
§ 58.1-1017(C)	Cigarettes without stamp, sale, purchase, possess, >= 3000 pks (FY13); >= 500 pks (FY14 onward)	0	0	0
§ 58.1-1017(C)	Cigarettes without stamp, sale, purchase, possess, >= 500 pks, subseq.	0	0	0
§ 58.1-1017.1	Possession with intent to distribute tax-paid, contraband cigarettes	82	46	28
§ 58.1-1017.1	Possession with intent to distribute tax-paid, contraband cigarettes, subseq.	0	0	0
§ 58.1-1017.1	Intent/distribute >=100,000 tax-paid cigarettes	0	0	0
§ 58.1-1017.1	Intent/distribute >=100,000 tax-paid cigarettes, subseq.	0	0	0
§ 58.1-1017.1	Intent/distribute >5,000 & <40,000 tax-paid cigarettes	---	---	23
§ 58.1-1017.1	Intent/distribute >5,000 & <40,000 tax-paid cigarettes, subseq.	---	---	0
§ 58.1-1017.1	Intent/distribute >=40,000 tax-paid cigarettes	---	---	0
§ 58.1-1017.1	Intent/distribute >=40,000 tax-paid cigarettes, subseq.	---	---	0

Source: Supreme Court of Virginia - General District Court Case Management System (CMS). * Fiscal year in which charge was concluded.

Similar to general district court data, as illustrated in Table 4 on the next page, the most frequently charged offense in circuit court was also for possession with intent to distribute tax-paid, contraband cigarettes. There were also several charges set forth per the new threshold amounts of this Code section. Table 5 indicates that convictions for the same Code section fluctuated between FY14 to FY16 with a handful of additional convictions for the new threshold amounts effective FY16. The data also show that there were almost no convictions under other Code sections related to cigarette trafficking. The relatively low number of charges and convictions in circuit court may be due to a number of factors, including the length of time required to investigate these complex trafficking cases. During this investigation period no data for such cases is reflected in Virginia's court management systems.

**Table 4: Circuit Court Charges for Common Cigarette-Related Offenses,
FY14-FY16***

Va. Code Section	Description	FY14	FY15	FY16
§ 58.1-1017(B)	Cigarettes without stamp, sale, purchase, possess, < 3000 pks (FY13); <500 pks (FY14 onward)	0	0	0
§ 58.1-1017(B)	Cigarettes without stamp, sale, purchase, possess, <500 pks, subseq.	0	0	0
§ 58.1-1017(C)	Cigarettes without stamp, sale, purchase, possess, >= 3000 pks (FY13); >= 500 pks (FY14 onward)	0	1	2
§ 58.1-1017(C)	Cigarettes without stamp, sale, purchase, possess, >= 500 pks, subseq.	5	0	1
§ 58.1-1017.1	Possession with intent to distribute tax-paid, contraband cigarettes	7†	4†	17†
§ 58.1-1017.1	Possession with intent to distribute tax-paid, contraband cigarettes, subseq.	3	6	2
§ 58.1-1017.1	Intent/distribute >=100,000 tax-paid cigarettes	4	0	5
§ 58.1-1017.1	Intent/distribute >=100,000 tax-paid cigarettes, subseq.	0	4	0
§ 58.1-1017.1	Intent/distribute >5,000 & <40,000 tax-paid cigarettes	---	---	7
§ 58.1-1017.1	Intent/distribute >5,000 & <40,000 tax-paid cigarettes, subseq.	---	---	1
§ 58.1-1017.1	Intent/distribute >=40,000 tax-paid cigarettes	---	---	6
§ 58.1-1017.1	Intent/distribute >=40,000 tax-paid cigarettes, subseq.	---	---	1

Source: Supreme Court of Virginia - Circuit Court Case Management System (CMS). * Fiscal year in which charge was filed. † At least one of the charges was the result of an appeal from General District Court. Note: The CMS does not include cases from Alexandria or Fairfax. Virginia Beach rejoined the system in October 2014 after leaving the system in FY09.

Table 5: Circuit Court Convictions for Common Cigarette-Related Offenses, FY14-FY16*

Va. Code Section	Description	FY14	FY15	FY16
§ 58.1-1017(B)	Cigarettes without stamp, sale, purchase, possess, < 3000 pks (FY13); <500 pks (FY14 onward)	3	0	5
§ 58.1-1017(B)	Cigarettes without stamp, sale, purchase, possess, <500 pks, subseq.	0	0	0
§ 58.1-1017(C)	Cigarettes without stamp, sale, purchase, possess, >= 3000 pks (FY13); >= 500 pks (FY14 onward)	2	1	4
§ 58.1-1017(C)	Cigarettes without stamp, sale, purchase, possess, >= 500 pks, subseq.	0	0	1
§ 58.1-1017.1	Possession with intent to distribute tax-paid, contraband cig.	5†	10†	6
§ 58.1-1017.1	Possession with intent to distribute tax-paid, contraband cig., subseq.	2	0	6†
§ 58.1-1017.1	Intent/distribute >=100,000 tax-paid cigarettes	1	4	6
§ 58.1-1017.1	Intent/distribute >=100,000 tax-paid cigarettes, subseq.	0	1	0
§ 58.1-1017.1	Intent/distribute >5,000 & <40,000 tax-paid cigarettes	---	---	3
§ 58.1-1017.1	Intent/distribute >5,000 & <40,000 tax-paid cigarettes, subseq.	---	---	0
§ 58.1-1017.1	Intent/distribute >=40,000 tax-paid cigarettes	---	---	3
§ 58.1-1017.1	Intent/distribute >=40,000 tax-paid cigarettes, subseq.	---	---	1

Source: Supreme Court of Virginia - Circuit Court Case Management System (CMS). * Fiscal year in which charge was concluded. † At least one of the convictions was the result of an appeal from General District Court. Note: The CMS does not include cases from Alexandria or Fairfax. Virginia Beach rejoined the system in October 2014 after leaving the system in FY09.

In sum, the total number of charges and convictions relating to cigarette trafficking continues to be noticeably low overall. As noted in previous Crime Commission reports, this might be due to a number of reasons. First, cigarette trafficking operations can be complicated and require longer amounts of time to investigate. Second, local law enforcement may instead devote time and resources to different types of investigations. Finally, because cigarette trafficking involves activities in multiple states, charges may be filed in other states or at the federal level. However, thus far, the lowered threshold amounts for intent to distribute under Virginia Code § 58.1-1017.1 appear to have a positive impact on the number of charges and convictions seen in general district and circuit courts. Trends will continue to be monitored by Commission staff.

Recent Cases

In May 2016, Qiuyue Chen, Fu Chen, and Ihab Abou El Ela were arrested by the Henrico County Police Department for operating a multimillion-dollar cigarette trafficking ring. The defendants trafficked approximately 10,000 cartons of cigarettes per week to New York in the luggage compartments of charter buses. They set up phony businesses in order to purchase millions of dollars of cigarettes from area Sam's Clubs. They also utilized fake storefronts to launder money. Henrico police conducted a two-year investigation into the operation, including the use of confidential informants, GPS tracking devices, and undercover surveillance with the assistance of other law enforcement agencies and the U.S. Department of Homeland Security. All three suspects were charged with money laundering, racketeering, and possession with the intent to distribute. Four guns, nine vehicles, cash, and gold bars were also seized.¹⁸

In January 2017, Qiuyue Chen pleaded no contest to multiple felony charges as part of a deal with prosecutors. That same month, Ihab Abou El Ela pleaded no contest to one felony charge as part of a deal with prosecutors. Qiuyue Chen's husband, Fu Chen, pleaded no contest to three felony charges in February 2017. On May 10, 2017, Qiuyue Chen was sentenced to four years in prison and fined \$50,000 in civil penalties, while Fu Chen was sentenced to 18 months of home incarceration and fined \$25,000 in civil penalties. Ihab Abou El Ela is scheduled to be sentenced on June 30, 2017.¹⁹

In June 2016, Laila Alayat pleaded guilty in federal court to using shell businesses to purchase \$9.5 million worth of Virginia cigarettes which were then transported to New Jersey for illegal resale. Alayat and others purchased cigarettes from wholesale stores using cash and "structured" purchases of less than \$10,000 so as to avoid the requirement to fill out federal forms. There were 1,735 cash transactions between March 2014 and August 2015 at Sam's Club wholesale stores, totaling \$6.3 million. Three of the six shell businesses, which were created online, were in Richmond and the other three were in Woodbridge. At least five of the businesses never paid any Virginia sales taxes. Alayat has dual citizenship in the U.S. and Jordan and was arrested in February 2016 while attempting to flee to Jordan.²⁰ Alayat faced up to 15 years in prison for conspiracy to traffic contraband cigarettes and witness tampering. She was sentenced to 16 months in federal prison.²¹

¹⁸ Monfort, A. (2016, May 16). Married couple and lover arrested in Henrico's largest cigarette bust. Retrieved from <http://www.nbc12.com/story/31912896/married-couple-and-lover-arrested-in-henricos-largest-cigarette-bust>

¹⁹ Gorman, S. (2017, May 10). Couple sentenced for massive cigarette trafficking operation based in Wyndham home. *Richmond Times-Dispatch*. Retrieved from http://www.richmond.com/news/local/crime/couple-sentenced-for-massive-cigarette-trafficking-operation-based-in-wyndham/article_15bdbdd3-e3b2-53a5-9a52-70f713e30ecb.html

²⁰ Green, F. (2016, June 16). Cigarette trafficking figure pleads guilty. *Richmond Times-Dispatch*. Retrieved from http://www.richmond.com/news/cigarette-trafficking-figure-pleads-guilty/article_2a60d996-0324-58d9-a3fb-8dbf7477cef5.html

²¹ Green, F. (2016, December 1). Cigarette trafficker sentenced in federal court in Richmond to 16 months. *Richmond Times-Dispatch*. Retrieved from http://www.richmond.com/news/local/chesterfield/cigarette-trafficker-sentenced-in-federal-court-in-richmond-to-months/article_73b9da96-dd52-5b66-b84e-5b7683c53433.html

In August 2016, Juan Encarnacion pleaded guilty in Shenandoah County Circuit Court to one count each of money laundering and possessing untaxed cigarettes. He purchased more than 3,000 packs of cigarettes between December 2012 and October 2013 to sell in New York. Encarnacion was indicted on 20 felonies, including racketeering, money laundering, and possession charges. He received a six year suspended prison sentence and two years of supervised probation. As a condition of his sentence, he was barred from entering Virginia except to meet with his probation officer. He was also ordered to pay \$10,000 in restitution to the Virginia Department of Taxation.²²

Fraudulent Business Operations

Cigarette traffickers use fraudulent retail operations to more efficiently purchase cartons of cigarettes in bulk. Many retailers have contracts with cigarette manufacturers to sell no more than five cartons to one individual per day. In order to avoid the purchasing limits placed on individual purchasers, many cigarette traffickers have created fraudulent retail establishments solely for the purpose of purchasing large quantities of cigarettes from wholesalers. Traffickers encounter little difficulty creating such fraudulent businesses. While there is a list of ineligible “authorized holders,” there is not an extensive vetting process for business licenses and sales and use tax certificate applications. Such documents are easily obtained online and available without a waiting period. These fraudulent businesses cost Virginia millions of dollars in lost sales tax every year.

In one specific example of lost tax revenue, a retailer was open for two months and purchased \$290,000 worth of cigarettes from Sam’s Club. The Virginia Department of Taxation never received sales tax for any of those purchases. The loss was estimated to be \$15,370. Hypothetically, if ten fictitious retailers were to operate like this for one year, Virginia would lose an estimated \$922,200 in tax revenue. The Commonwealth stands to lose a significant amount of sales tax revenue as long as fraudulent businesses continue to operate.

The Virginia Department of Taxation reported that it conducted 275 retail inspections in FY16. During the past two years, the Department issued 145 civil penalty assessments for cigarette tax non-compliance and collected \$104,680 in penalties. No warning letters were issued by the Department to retailers in the past three years. The Department of Taxation explained that warning letters are issued to people selling untaxed cigarettes, and the absence of warning letters indicates that this activity is less of a problem than it had been in recent years. The Department of Taxation advised that wholesalers are doing a better job of putting tax stamps on the cigarette packs and reputable retailers often do not have unstamped cigarettes on the shelf, thus giving the Department no reason to issue warning letters.

²² Clark, K. (2016, August 11). New York Man Banned From Virginia After Valley Cigarette Smuggling Case. Retrieved from http://www.dnronline.com/update/new-new-york-man-banned-from-virginia-after-valley-cigarette/article_9c988d64-5fbe-11e6-8857-9b9ed18dc31f.html

In 2015, the Tobacco Enforcement Unit in the Office of the Attorney General advised that they performed 1,724 retail inspections and seized 4,735 packs of cigarettes. As of September 29, 2016, the unit had conducted 1,368 inspections and seized 509 packs of cigarettes. During the course of their investigations, the unit identified a number of fictitious businesses involved in trafficking. In 2015, investigators discovered 147 fraudulent businesses connected to cigarette trafficking. The unit had linked 88 such fraudulent businesses to cigarette trafficking as of September 29, 2016.

Summary and Conclusion

As part of the 2016 study on cigarette trafficking, staff communicated more with interested parties including cigarette manufacturers, wholesalers, retailers, Office of the Attorney General, Department of Taxation, Department of Alcoholic Beverage Control, Northern Virginia Cigarette Tax Board, law enforcement, prosecutors, cigar industry, technology providers, and other interested groups. Staff also convened two large open forums, one on October 11, 2016, and the other on November 28, 2016, bringing all interested parties together to discuss ongoing concerns and develop recommendations.

Staff provided an update to Crime Commission members regarding recent data and general trends in cigarette trafficking at the October meeting. As a result of the continued study, staff presented the following recommendations at the December meeting:

Recommendation 1: A new section (Virginia Code § 58.1-623.2) should be enacted to create a cigarette exemption certificate issued by the Department of Taxation following a vetting process, which includes a background investigation and verification of a physical place of business.

- Creates an expedited process for active valid ABC licensees and OTP licensees.
- Creates a 30 day waiting period to obtain certificate.
- Allows retailers to purchase cigarettes exempt from sales tax.
- The use of a forged or invalid Virginia cigarette exemption certificate would be punishable under existing Virginia Code § 58.1-1017.3.

The Crime Commission unanimously endorsed Recommendation 1.

Recommendation 2: A new section (Virginia Code § 58.1-623.3) should be enacted requiring that a form be completed and maintained for any cigarette purchase of more than 10,000 sticks or 50 cartons, or when the total value of the purchase is over \$10,000.

- The form should be developed by the Office of the Attorney General.
- The form must be accompanied by photographic identification.
- The form will be available for inspection and transmitted to the Office of the Attorney General on a regular basis.

The Crime Commission unanimously endorsed Recommendation 2.

Recommendation 3: Reduce the number of tax-paid cigarettes that an individual may possess under Virginia Code § 58.1-1017.1 in relation to the charge of possession with intent to distribute contraband cigarettes.

No motion was made for Recommendation 3.

Recommendation 4: Amend two definitions under Virginia Code § 58.1-1000:

- Amend “authorized holder” to disqualify anyone as an authorized holder who has been convicted of a criminal offense under Chapter 10 of Title 58.1.
- Amend “retail dealer” to include the requirement that the retail dealer possess a valid cigarette exemption certificate.

The Crime Commission unanimously endorsed Recommendation 4.

Legislation combining Recommendations 1, 2, and 4 was introduced in both chambers as an omnibus bill during the Regular Session of the 2017 General Assembly. Delegate Richard L. Anderson introduced House Bill 1913 and Senators Janet D. Howell and Thomas K. Norment, Jr., introduced Senate Bill 1390. Both bills were passed and signed by the Governor.

The bills require the Department of Taxation to begin developing guidelines for the issuance of the cigarette exemption certificates. Effective July 1, 2017, purchases of certain quantities of cigarettes will require completion of a form and presentation of photo identification. Effective January 1, 2018, a cigarette exemption certificate will be required for tax exempt purchases of cigarettes. Additionally, as of that date: i) qualifications for specific authorized holders will change; ii) criminal sanctions for fraudulent use of the cigarette exemption certificate will take effect; and iii) a valid cigarette exemption certificate will need to be presented for the purchase of certain quantities of cigarettes, along with the form and photo identification.

Acknowledgements

The Virginia State Crime Commission extends its appreciation to the following agencies and organizations for their assistance and cooperation on this study:

Altria/Philip Morris USA

Bailey's Cigarettes (S&M Brands)

Henrico County Police Department

Northern Virginia Cigarette Tax Board (NVCTB)

R. J. Reynolds Tobacco Company (RJR)

Virginia Association of Chiefs of Police (VACP)

Virginia Department of Alcoholic Beverage Control

Virginia Department of Taxation

Virginia Fire Chiefs Association

Virginia Fire Prevention Association

Virginia Manufacturers Association

Virginia Office of the Attorney General (OAG)

Virginia Petroleum Convenience and Grocery Association

Virginia Retail Merchants Association

Virginia Sheriffs' Association

Virginia Wholesalers and Distributors Association and North Carolina Wholesalers Association

7/Eleven