



SJR 21: Illegal Cigarette Trafficking

September 5, 2012

Overview



- Study Authorization
- Methodology
- Why Does Trafficking Occur?
- Methods Used by Traffickers
- Financial Impact of Trafficking
- Beneficiaries of Trafficking
- November Meeting

Study Authorization



- Senate Joint Resolution 21 (Illegal Cigarette Trafficking) was introduced by Senator Howell during the Regular Session of the 2012 General Assembly.
- The resolution specifically directs focus upon a number of issues related to illegal cigarette trafficking:
 - (i) determine why illegal cigarette trafficking occurs;
 - (ii) identify the methods of illegal cigarette trafficking and the strategies used by smugglers;

Study Authorization



- The resolution directs focus upon (continued):
 - (iii) document the effects and financial impact of illegal cigarette trafficking on State and local governments;
 - (iv) identify the methods used to counterfeit cigarettes and cigarette tax stamps and the prevalence of these methods in the Commonwealth on the availability of counterfeit cigarettes and cigarette tax stamps;
 - (v) determine the beneficiaries of illegal cigarette trafficking;
 - (vi) review statutory options to combat illegal cigarette trafficking;

Study Authorization



- The resolution directs focus upon (continued):
 - (vii) identify potential uses of information technology to prevent illegal cigarette trafficking and assess the costs and benefits of using such technology;
 - (viii) develop a set of policy and legislative recommendations to enhance the Commonwealth's efforts to combat the practice of illegal cigarette trafficking;
 - (ix) identify the unique and challenging public health implications of illegal, non-regulated cigarettes; and,
 - (x) consider such other related issues as the Virginia State Crime Commission deems appropriate.

Methodology



- Staff utilized a number of approaches to address the resolution's mandates, including:
 - Literature review;
 - Meetings and interviews with manufacturers, wholesalers, retailers, and other stakeholders and interested parties;
 - Data requests;
 - Field visits; and,
 - Consultations with local and state law enforcement, NVCTB, the Tobacco Enforcement Unit of the Va. Attorney General's Office, the Va. Dept. of Taxation, and ATF.

Why Does Trafficking Occur?



- Virginia is the 5th leading producer of tobacco in the United States.
- As such, tobacco is an integral part of Virginia's economy.

	Cigarette Tax	OTP Tax	MSA Payments
Fiscal Year 2010	\$ 158.4 million	\$17.7 million	\$121.6 million
Fiscal Year 2011	\$ 155.7 million	\$18.0 million	\$115.1 million
Fiscal Year 2012	\$ 174.0 million**	\$18.7 million**	\$117.4 million

Source: Virginia Department of Taxation

*** Preliminary; tax revenues for FY2012 have not been finalized*

Why Does Trafficking Occur?



- All cigarette trafficking schemes, no matter the methods employed, depend upon tax avoidance.
- Cigarette smuggling and “black market” cigarettes have existed for decades, but recent tax increases in a number of states have greatly increased the potential profits to be made.

Why Does Trafficking Occur?



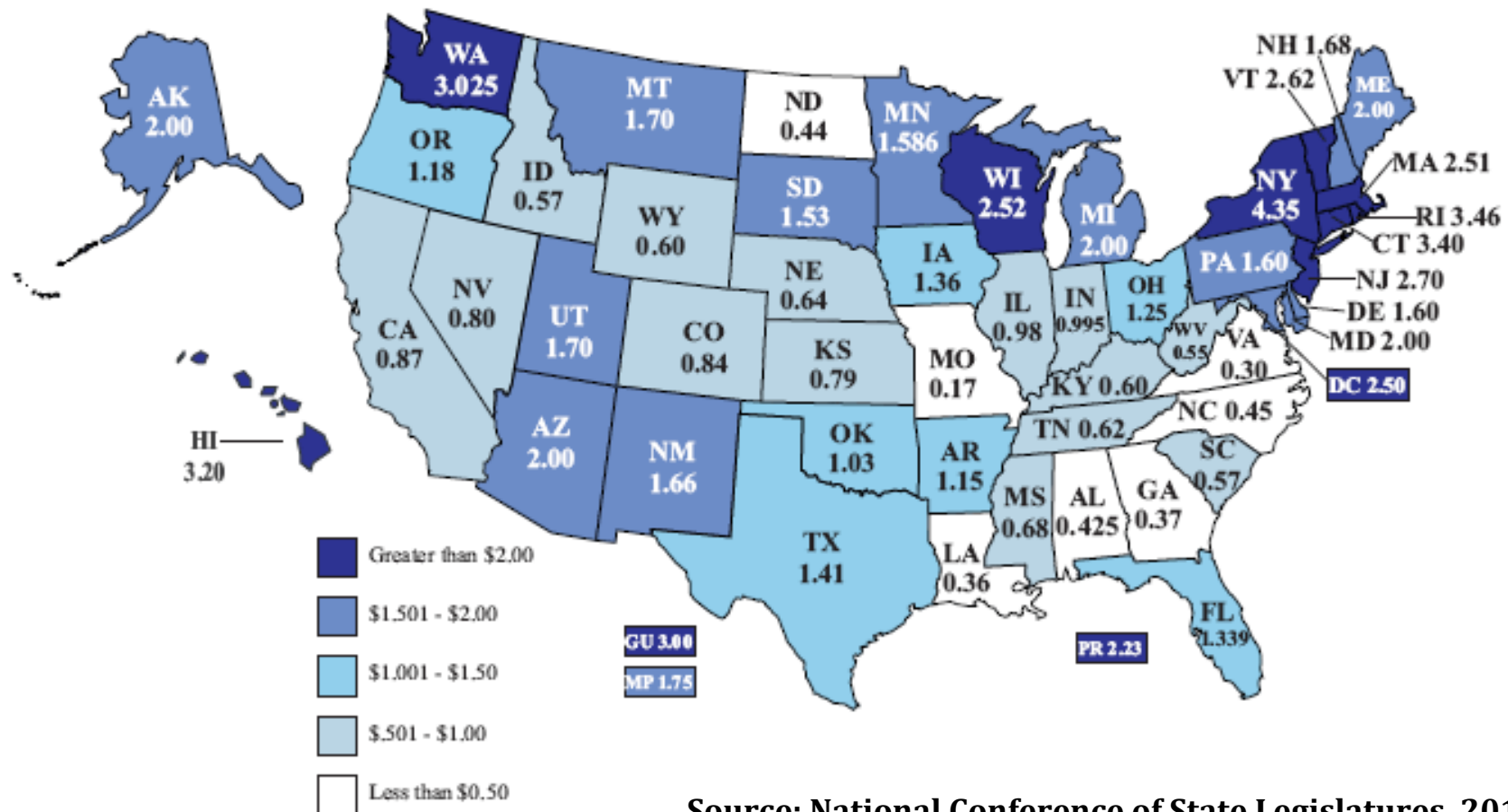
The cost of cigarettes... **Per Carton**

Cost to Manufacture:	\$ 1.50 (Low end)
Federal Excise Tax (FET):	\$ 10.10 (includes 3/09 increase)
USDA (Tobacco Buyout):	\$.60
Master Settlement Agreement (MSA):	<u>\$ 5.00 (Approx.)</u>
Subtotal:	\$ 17.20
Add Profit for Mfg.:	\$.50
Minimum per carton:	\$ 17.90

Does not include costs associated with importing, bonded "fees," shipping and stamping fees and other costs/profit to 2nd and 3rd wholesalers before it hits a retail shop.

Why Does Trafficking Occur?

Enacted State Cigarette Excise Tax Rates - 2011



Source: National Conference of State Legislatures, 2012

Why Does Trafficking Occur?



- The state excise tax rate for a carton of cigarettes (10 packs):
 - **Virginia:** **\$3.00**
 - Pennsylvania: \$16.00
 - New Jersey: \$27.00
 - Rhode Island: \$34.60
 - New York: \$43.50
 - **New York City: \$58.50**

Why Does Trafficking Occur?



- The state excise tax rate for a case of cigarettes (60 cartons):
 - **Virginia:** **\$180.00**
 - Pennsylvania: \$960.00
 - New Jersey: \$1,620.00
 - Rhode Island: \$2,076.00
 - New York: \$2,610.00
 - **New York City: \$3,510.00**

Why Does Trafficking Occur?



State	State Excise Tax Rate/carton		<u>Per Carton</u> Differential		<u>Per Case</u> Differential
Virginia	\$3.00	→	N/A	→	N/A
Pennsylvania	\$16.00	→	\$13.00	→	\$780.00
New Jersey	\$27.00	→	\$25.00	→	\$1,440.00
Rhode Island	\$34.60	→	\$31.60	→	\$1,896.00
New York	\$43.50	→	\$41.50	→	\$2,430.00
New York City	\$58.50	→	\$55.50	→	\$3,330.00

Source: National Conference of State Legislatures, 2012

Why Does Trafficking Occur?



- Representative prices for a premium brand pack of cigarettes in:
 - Virginia: \$5.55
 - Pennsylvania: \$6.93
 - New Jersey: \$8.00
 - Rhode Island: \$8.16
 - New York: \$12.50
 - New York City: \$14.00

Source: Turiciano, 2012.

Why Does Trafficking Occur?



- In Richmond, Virginia, a carton of premium cigarettes costs approximately \$40.00 to \$45.00.
- In New York City, a carton of premium cigarettes costs approximately \$120.00 to \$150.00.
- The profit on a diverted load of 1,500 contraband cartons of cigarettes could easily be \$100,000.00 due to these price differentials.

Why Does Trafficking Occur?



ATF search warrant in Virginia nets over 46,000 packs of untaxed cigarettes.
\$13,800 of cigarette taxes due the Commonwealth

(NVCTB Photo)

Why Does Trafficking Occur?



- The price differential between states can lead to enormous profits when cigarettes are transported from a low cost state like Virginia to a high cost state, like New York.



Photo and Description taken from (King, P. 2008)

54,000 cartons of untaxed cigarettes purchased in and smuggled from Virginia and seized in Queens, New York by New York State Department of Taxation and Finance

Why Does Trafficking Occur?



- The Bureau of Alcohol, Tobacco, Firearms, and Explosives (ATF) estimates the amount of profit that a cigarette trafficker can make, taking cigarettes from Virginia to New York City, as:
 - \$8.50 for a pack of cigarettes
 - \$85.00 for a carton of cigarettes
 - \$5,100.00 for a case of cigarettes
 - \$4,080,000.00 for a single truckload of 800 cases of cigarettes.

Source: ATF Fact Sheet, March 2011.

Why Does Trafficking Occur?



- A separate estimate provided by an ATF agent was as follows:
 - A car can carry 10 cases of cigarettes, with an estimated profit of \$34,000.00
 - A van can carry 50 cases of cigarettes, with an estimated profit of \$170,000.00
 - A U-Haul can carry 200 cases of cigarettes, with an estimated profit of \$670,000.00

Source: Effectively Combating I-95 Cigarette Trafficking Conference, 2012.

Why Does Trafficking Occur?



- Trafficking can also occur intra-state within Virginia due to local tax rate differentials.

Locality	State Tax	City Tax	Total Tax Per Pack	Tax Per Carton (x 10)
Alexandria	0.30	0.80	1.10	11.00
Chesapeake	0.30	0.50	0.80	8.00
Fairfax City*	0.30	0.85*	1.15	11.50
Fairfax County	0.30	0.30	0.60	6.00
Hampton	0.30	0.65	0.95	9.50
Newport News	0.30	0.65	0.95	9.50
Norfolk	0.30	0.75	1.05	10.50
Portsmouth	0.30	0.60	0.90	9.00
Suffolk	0.30	0.50	0.80	8.00
Tazewell*	0.30	0.05*	0.35	3.50
Va Beach	0.30	0.65	0.95	9.50

Why Does Trafficking Occur?



- “Illegally trafficked cigarettes now have a higher profit margin than cocaine, heroin, marijuana, or guns.”
 - Quote from an agent with the Virginia State Police.

Why Does Trafficking Occur?



- “In Fairfax County, Va.,...suspects exchanged one kilogram of cocaine...in exchange for 3,000 cartons of cigarettes. ‘They were willing to trade cocaine for cigarettes. That tells you about the profit margin they saw on the cigarettes,’ said Edgar Domenech, who heads the ATF’s Washington, D.C. field division.”
 - Fields, The Wall Street Journal, July 20, 2009.

Methods Used by Traffickers



- There are numerous techniques used by criminals who engage in illegal cigarette trafficking.
- Tax evasion schemes can take place at all levels of the regular cigarette manufacturing and distribution systems.

Methods Used by Traffickers



- The broad categories of cigarette trafficking crime are:
 - 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.

Methods Used by Traffickers



N.J. man pleads guilty to smuggling 16M cigarettes

by The Associated Press

Tuesday May 26, 2009, 5:31 PM

ALEXANDRIA, Va. -- A New Jersey man pleaded guilty to smuggling more than 16 million cigarettes he bought from undercover federal agents in Virginia to sell in New York and New Jersey.

Mark A. Frondelli, of Parlin admitted in federal court today that he paid more than \$2.3 million in cash in 46 separate transactions with undercover agents between November 2007 and August 2008.

Frondelli bought untaxed cigarettes from the undercover agents and took them for black-market sale to areas like New York City, where required tax stamps cost \$4.25 per pack.

Authorities estimated that state and local governments were cheated out of more than \$2 million in tax revenue from the illegal purchases.

Methods Used by Traffickers: Smurfing



- Smurfing is the “legal” purchase of cartons of cigarettes, and then transporting them out of state, with the intent to sell them.
- Frequently involves small groups of individuals, who are paid to purchase cartons at multiple locations, throughout the course of a day.
- The smurfs then meet at a central location, and the cartons are gathered together for a smuggling run in one or more vehicles.

Methods Used by Traffickers: Smurfing

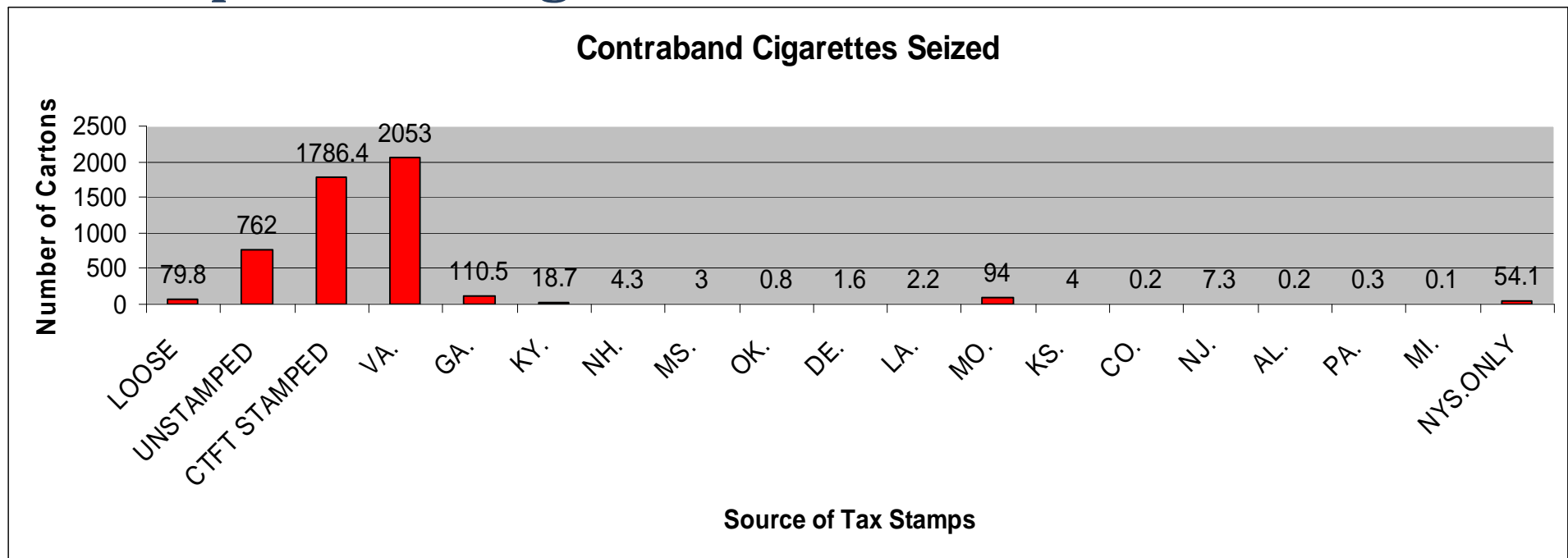


- **Smurfing appears to be very common in Virginia.**
 - A recently published study that examined the extent of cigarette tax avoidance in the South Bronx found that 9.1% of cigarettes there came from Virginia (Kurti et al., 2012).
 - Another study found that 30.1% of all cigarettes in New York City came from out-of-state; of those, 71.4% came from Virginia (Davis et al., 2012).

Methods Used by Traffickers: Smurfing



- Increased numbers of cigarettes bearing VA tax stamps are being seized in NYC.



Source: New York City Sheriff's Office, Tobacco Task Force, Data compiled from August 1, 2011 to August 2, 2012

Methods Used by Traffickers: Smurfing



- The number of cartons of cigarettes that can be trafficked in just a regular car can be surprisingly large.



Source: ATF, shows a vehicle seized by ATF Agents and the Maryland Comptroller's office stopped on I-95.

Methods Used by Traffickers: Smurfing



Source: Seized by Maryland and NVCTB

Methods Used by Traffickers: Retailers



- Fraudulent retail operations are used by traffickers to more efficiently purchase cartons of cigarettes in bulk.
- Many convenience stores and gas stations have contractual agreements with cigarette manufacturers that they will sell no more than five cartons to any individual in a day.
- To circumvent this impediment, some cigarette traffickers have created retail establishments solely for the purpose of being able to purchase large quantities of cigarettes from wholesalers.

Methods Used by Traffickers: Retailers



Source: NVCTB

Methods Used by Traffickers: Retailers



- When fraudulent retail operations are conducted for purposes of cigarette trafficking, it becomes much more likely that Virginia will not receive any tax revenue from the cigarettes purchased.

Methods Used by Traffickers: Retailers



- More than 850 cartons were seized from this van in RI coming from VA with an estimated value of \$80,000.



Source: NVCTB

Methods Used by Traffickers: Retailers



Source: NVCTB

Methods Used by Traffickers: Retailers



Source: NVCTB

Methods Used by Traffickers: Retailers



- Retailers who wish to evade taxes have been known to sell cigarettes “off the books.”
 - A separate stash of cigarettes will be kept, and will be sold to unknowing customers.
 - The state of Virginia is cheated out of sales tax when this occurs.
 - Localities may also be cheated out of the local sales tax, depending upon the location.

Methods Used by Traffickers: Retailers



- Retailers may also:
 - Sell cigarettes without state or city tax stamp;
 - Sell cigarettes with state stamp, but no city stamp;
 - Counterfeit state and/or city stamps;
 - Sell cigarettes with partial/manipulated stamps;
 - Sell cigarettes as a cover for trafficking larger quantities out of state; or,
 - Sell counterfeit cigarettes.

Methods Used by Traffickers: Retailers



- Real case example:
 - Retailer was open for 2 months and purchased \$290,000 worth of cigarettes from Sam's Club.
 - Virginia Tax Department never received sales tax (estimated \$14,500).
- Hypothetical:
 - If 10 retailers operated like this for 1 year, Virginia would lose an estimated \$870,000.

Methods Used by Traffickers: Wholesalers



- Some wholesalers have been found to have distributed cigarettes “off the books,” falsely reporting their numbers.
- In 2010, a Kentucky tobacco wholesaler plead guilty to tax evasion.
 - Between October 2007 and July 2008, Charles H. Wells stole more than \$7 million dollars, by failing to pay taxes and lawsuit settlement fees.
 - The scheme involved falsely claiming the cigarettes were sold to a Mississippi company, when they were actually kept and sold in Kentucky.
 - By not paying taxes, Wells was able to sell his cigarettes more cheaply, increasing his sales volume.

Methods Used by Traffickers: Wholesalers



Joplin businessman charged in 43 count federal indictment

[Joplin Business Journal](#)



Gary Hall

JOPLIN, Mo. — A well-known Joplin businessman is being charged in a 43 count federal indictment with a scheme to avoid paying taxes on cigarettes that cost the state of Oklahoma and Indian tribes \$25 million in tax revenue.

Gary Lester Hall, 66, Joplin, Mo., the president and owner of Sunflower Supply Co., 1001 W. Seventh, Galena, Kan. was taken into custody Oct. 17 by federal authorities. He exercised control over other business entities including Discount Tobacco Warehouse Inc., 402 Grand, Joplin, Mo.; National Tobacco Distributors; Rebel Industries Inc.; Halls Collection Inc.; Shawnee Tobacco Smoke Shop, 19801 NE 23rd Street, Harrah, Okla., and Sunflower Aircraft Inc.

The Bureau of Alcohol, Tobacco, Firearms and Explosives initiated the investigation in April 2006 when the Kansas Highway Patrol in Coffeyville, Kan. stopped a defendant in the case. He was transporting a load of cigarettes worth more than \$200,000 without required documents and appropriate tax stamps.

According to the indictment, "Defendant Gary Hall orchestrated a conspiracy to defraud the State of Oklahoma and various Native American Tribal Nations of approximately \$25 million in taxes due from the sale of cigarettes to retailers located throughout Oklahoma. As part of the conspiracy, Hall utilized several corporate entities under his control including Sunflower Supply Company Inc., Discount Tobacco Warehouse Inc., Rebel Industries Inc., and National Tobacco Distributors Inc., d/b/a Shawnee Tobacco Smoke Shop (Shawnee Tobacco) to facilitate the criminal activities."

Methods Used by Traffickers: Wholesalers



- In 2012, tobacco wholesaler Isidro “Tony” Tavaréz plead guilty to tax evasion in New York.
 - Between December 2005 and December 2012, more than \$700,000 in taxes were not paid.
 - As part of the tax evasion scheme, wholesale invoices from tobacco sellers were forged.

Methods Used by Traffickers: Manufacturers



- Certain manufacturers have used similar schemes to evade taxes, filing false documents and under-reporting their sales.

Methods Used by Traffickers: Manufacturers



- In 2011, Roberto Ribeiro, the president of Belcorp of America, Inc., was indicted for tax evasion.
 - Belcorp was a licensed tobacco importer and manufacturer.
 - It is alleged that just from August to October 2008, Belcorp evaded over \$3 million dollars in taxes, by failing to accurately report the quantities of cigarettes manufactured.
- The tax evasion scheme used by wholesaler Charles H. Wells also involved a conspiracy with a tobacco manufacturer to create false documents and invoices.

Methods Used by Traffickers: Manufacturers



The cost of cigarettes... **Per Carton**

Cost to Manufacture:	\$ 1.50 (Low end)
Federal Excise Tax (FET):	\$ 10.10 (includes 3/09 increase)
USDA (Tobacco Buyout):	\$.60
Master Settlement Agreement (MSA):	<u>\$ 5.00 (Approx.)</u>
Subtotal:	\$ 17.20
Add Profit for Mfg.:	\$.50
<u>Minimum per carton:</u>	<u>\$ 17.90</u>

**AVOIDING THE MSA AND FET MEANS AN IMMEDIATE
\$15.10 PER CARTON PROFIT.**

Methods Used by Traffickers: International Smuggling



- Traffickers will smuggle cigarettes into the United States, not declaring them on shipping invoices, thereby evading taxes.
- Sometimes these cigarettes are legitimately manufactured, but were not intended for the United States market.
- East Coast ports are often used, including Virginia ports.

Methods Used by Traffickers: International Smuggling



Source: Center for Regulatory Effectiveness, 2011.

Methods Used by Traffickers: Counterfeit



- Counterfeit cigarettes are also smuggled into the country.
- These cigarettes are manufactured in illegal factories, often under less than sanitary conditions.

Methods Used by Traffickers: Counterfeit



Source: Center for Public Integrity, 2009, Underground factories in Guangxi, China, picture provided by Philip Morris, Int.

Methods Used by Traffickers: Counterfeit



Counterfeit Cigarettes- They Arrive At Our Nations Ports Daily



Source: NVCTB

Methods Used by Traffickers: Counterfeit



ATF seizes 12 million counterfeit Marlboro cigarettes made in China

By: **FREEMAN KLOPOTT**
Examiner Staff Writer
July 14, 2009

washington**examiner**.com

The Examiner

Federal authorities seized 12 million counterfeit Marlboro cigarettes made in China from a Springfield storage unit, the largest bogus cigarette bust in the region's history, a Bureau of Alcohol, Tobacco, Firearms and Explosives spokesman told *The Examiner*.



(File Photo) (ASSOCIATED PRESS)

Agents came across the 60,000 packs of smokes July 2 after they arrested Bing Feng Mai who had agreed to trade the counterfeit cigarettes for untaxed cigarettes with an undercover ATF agent, court documents filed in Alexandria's federal court said. By then, the undercover agent had sold Mai \$2 million of untaxed cigarettes over a period of four months, an ATF agent wrote in a sworn statement.

Methods Used by Traffickers: Counterfeit



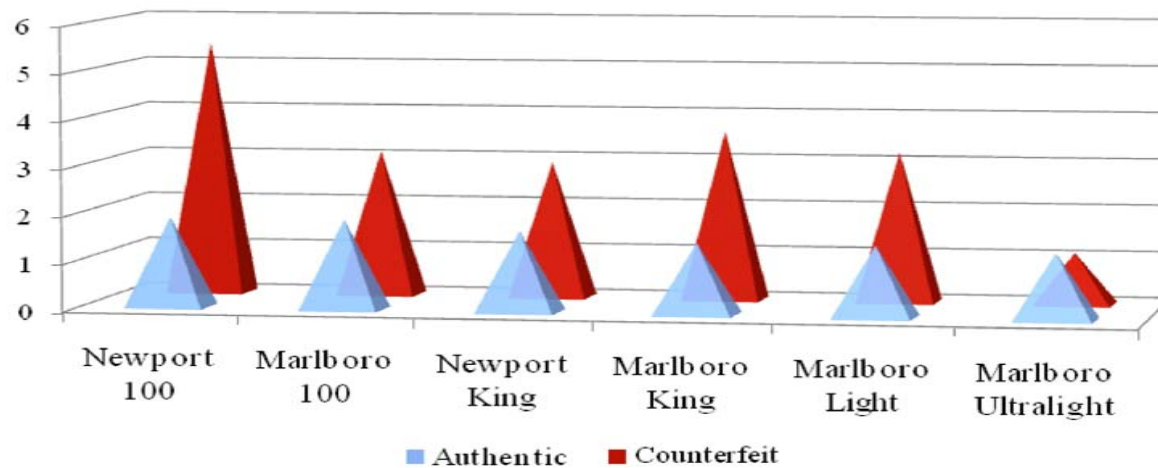
- “Most counterfeit cigarettes...tend to differ in every respect from their legal counterparts, including tobacco, paper, filter tips, and packaging ”(Shen et al., 2010).
- This does more than result in a cigarette that is less pleasant in taste; serious health risks are implicated by counterfeit cigarettes.
- Contaminants and excessive levels of cadmium, thallium and lead have been found in counterfeit cigarettes.

Methods Used by Traffickers: Counterfeit



Thallium Levels Authentic and Counterfeit Cigarettes

(ng/ mg of nicotine: mainstream smoke)



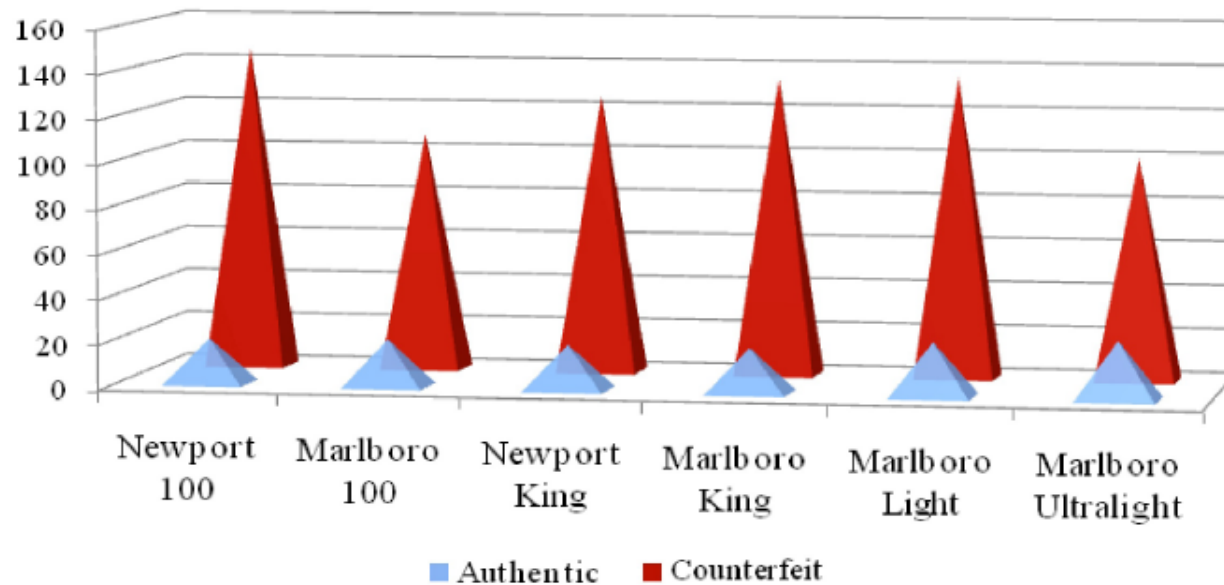
Source: Pappas (2007), Table 1

Methods Used by Traffickers: Counterfeit



Lead Levels Authentic and Counterfeit Cigarettes

(ng/ mg of nicotine: mainstream smoke)



Source: Pappas (2007), Figure 4

Methods Used by Traffickers: Counterfeit



- Related to cigarette trafficking is the collateral crime of forging tax stamps.
- These are used on counterfeit cigarettes, to make them appear legitimate.
- They are also used to help disguise the origin of legitimate cigarettes that are trafficked from one state to another.
- Because tax stamps are small, an individual roll of stamps can be worth \$30,000 or more.
 - Ideal commodity for criminals to trade in their transactions.

Methods Used by Traffickers: Counterfeit



Methods Used by Traffickers: Counterfeit



- The tax stamp used by Virginia has three security features:

Detect counterfeit by scanning product

The number can be traced to a retailer

Can use anti-agent to confirm validity



Methods Used by Traffickers: Counterfeit



- Counterfeit Virginia tax stamps can be detected if they fail any one of the following:
 - Visual comparison;
 - Serial number fails to trace back to wholesaler;
 - Ultraviolet light indicator;
 - Chemical indicator; and,
 - Tagent scan.

Methods Used by Traffickers: Counterfeit



NY bust nets \$6 million in counterfeit cigarette tax stamps

By: The Associated Press

Wednesday, April 9, 2008 1:43 PM EDT

Undercover agents in New York say they've seized millions of counterfeit tax stamps as part of a major investigation into tobacco smuggling.

The fakes would have allowed bootleggers to evade more than \$6 million in taxes if they had been slapped on packs of smuggled cigarettes.

Brooklyn prosecutors say the haul could be the state's largest ever.

A Jordanian national is under arrest. Investigators also seized more than 100 cases of counterfeit Marlboros made in China.

The bust is part of an ongoing investigation into gangs dealing in black market cigarettes.

The arrest comes as some authorities voice concern about whether the state's planned \$1.25 hike in tobacco taxes will further fuel demand for contraband smokes.

Methods Used by Traffickers: Counterfeit



- Digital and other high-tech tax stamps exist, but have been shown to be just as vulnerable to counterfeiting as the stamps currently used in Virginia.
 - It was reported by law enforcement that after California adopted such high-tech stamps, counterfeit versions were found within months.
- Digital stamps can provide detailed tracking data for each pack of cigarettes.

Methods Used by Traffickers: Counterfeit



- These stamps are more expensive than the current Virginia stamps.
- Most of the information which digital stamps could provide can currently be obtained through other means.

Financial Impact of Trafficking



- Trafficking hurts all legitimate manufacturers, wholesalers, and retailers, who are faced with unfair competition in the form of lower prices offered by their competitors.
- Counterfeit cigarettes also can damage the reputation of cigarette manufacturers, who strive to produce a consistent, quality product.

Financial Impact of Trafficking



- The loss of tax revenue hurts local governments, as well as the state of Virginia, and the federal government.
- “Because of its clandestine nature, the extent of illicit trade in tobacco products cannot be measured with certainty.”
 - GAO report, “Illicit Tobacco,” 2011.

Financial Impact of Trafficking



- Nevertheless, the GAO has estimated that illegal cigarette trafficking is a multi-billion dollar a year enterprise, world-wide.
- A 2004 GAO report that focused only on illegal importation of cigarettes reported that over 2 million cartons of smuggled cigarettes were confiscated, with a value of over \$50 million dollars.

Beneficiaries of Trafficking



- Law enforcement, both in Virginia and nationally, have noted that organized crime has moved into the business of cigarette trafficking.
- There are reports that criminals formerly involved with drug smuggling have switched to cigarettes.
 - Just as much money, less violence, much less prison time if caught.

Beneficiaries of Trafficking



Fairfax County Police Department
News Release May 7, 2009

Undercover Operation Nets 143 Criminal Charges

On Wednesday, May 6, over 135 law enforcement personnel participated in concluding a year-long undercover investigation. Operation Build America was launched in May 2008 to better understand the criminal activity taking place in and around the Build America Shopping Center. Community concerns of illegal activities in the shopping center coupled with indicators that crime was in the upswing sprung the operation into motion.

The investigation successfully infiltrated several criminal organizations and businesses operating around the center by first selling them **unstamped, untaxed cigarettes**. Undercover police officers identified nearly 40 people suspected of criminal activity that ranges from property crimes to crimes of violence. **The undercover operation successfully recovered stolen firearms and illegal narcotics including cocaine and marijuana.**

Collectively, 143 criminal arrest warrants and 15 search warrants were issued in this undercover operation.

Beneficiaries of Trafficking



- Operation Smokescreen, a large, inter-agency state and federal operation that took place between 1995 and 2000, discovered a Hezbollah cell, operating in the United States.
 - The cell was generating money through illegal cigarette trafficking, primarily from North Carolina to Michigan.
 - Over \$8 million dollars was illegally earned.

November Meeting



- At our November 13th Commission meeting, the following information will be provided:
 - Conviction data for cigarette trafficking offenses in Virginia and other states;
 - Initial results of Virginia's new "smurfing" law;
 - Statutory options to combat cigarette trafficking; and,
 - Possible policy options and legislative recommendations.



Discussion
