

# Organizing the Federal Enforcement Effort against Illicit Traffic in Tobacco Products

## An Agenda for a New Administration

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## **Organizing the Federal Enforcement Effort Against Illicit Traffic in Tobacco Products: An Agenda for a New Administration**

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### **Abstract**

The illicit trade in tobacco products (ITTP) is substantial and growing. The federal government does not now have adequate capacity to control that traffic; other urgent priorities have compelled the responsible agency to substantially abandon enforcement efforts. Since the economic motivation for ITTP is high and unlikely to decrease under any currently probable scenario, the volume of ITTP is likely to grow. The resources required to bring any illicit market under control are roughly proportional to the size of the market. Thus, current neglect increases the future difficulty of the problem.

The incoming administration will have the opportunity to bring the illicit tobacco market under better control, thus contributing to the prevention of smoking-related harm while also reducing tax losses at the federal, state and local levels. Several options for improving the effectiveness of enforcement and compliance exist, some with minimal budgetary implications. However, some of them involve reassignment of responsibilities among federal agencies, in particular the transfer of criminal enforcement power over tobacco from the Justice Department's Bureau of Alcohol, Tobacco, Firearms, and Explosives (BATFE), whose current policies lead it to neglect ITTP, to the Treasury Department's Alcohol and Tobacco Tax and Trade Bureau (ATTTB). Such a reorganization would involve substantial administrative effort and might encounter substantial resistance.

The tobacco industry should offer all feasible support to the most effective and efficient option for improved control. The industry's self-interest in supporting increased control of ITTP should be publicly acknowledged, balanced by the fact that reducing ITTP is also in the public interest for reasons of tax, health and criminal policy.

### **1. The Illicit Trade**

Illicit trade in tobacco products (ITTP) is considerable in the United States. ITTP diverts revenue from state, local, and federal agencies to illicit entities, where it fuels transnational crime, corruption, and terrorism. ITTP's revenue deprivations, associated criminal risks, and potential for continued growth have been recognized by multiple countries and United States agencies, including the Departments of State, Treasury, and Justice.<sup>1</sup>

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<sup>1</sup> ATF Congressional Budget Submissions and Department of Justice Inspector General, *Report: The Bureau of Alcohol, Tobacco, Firearms and Explosives' Efforts to Prevent the Diversion of Tobacco*, September 2009 Report 1-2009-005; Financial Action Task Force Report, *Illicit Tobacco Trade*, June 2012; Department of State, "The Global Illicit Trade in Tobacco: A Threat to National Security," December 2015

ITTP's effect on domestic revenue is particularly significant due to tobacco's heavy taxation. A 2015 National Research Council report estimated annual state and local tax losses in the range from almost \$3 billion to almost \$7 billion.<sup>2</sup> (That wide range reflects the paucity of data about the size of ITTP.) These losses are almost certainly an underestimate of revenue loss from ITTP, as the estimate was solely for interstate smuggling of licitly manufactured tobacco products, which impacts only states and localities' revenue. The most recent estimate of federal tax losses estimated hundreds of millions of dollars, and that was before federal taxes were nearly tripled in 2009.<sup>3</sup> Similarly, the estimate of approximately three to seven billion in state and local tax loss was based upon tax rates through 2009. These rates are rising rapidly. In 2010 New York increased its excise tax from \$1.60 to \$4.35 and in 2013 Massachusetts increased its per pack tax from \$1.00 to \$3.51. These tax increases are in addition to increases in approximately 20 other states, with several of those states raising their tax rate three times since 2010.<sup>4</sup> Taxes are continually increasing at the county and city level as well, such as a \$1.00 Cook County, Illinois increase in 2013 and a Chicago city increase of \$0.50 in 2014.<sup>5</sup> A law passed by ballot initiative in 2016 will increase California's cigarette excise tax from \$ 0.87 to \$2.87, with equivalent increases for other tobacco products and e-cigarettes.<sup>6</sup> One purpose of the completed project will be to examine the extent to which tax increases have increased the federal, state and local tax loss or have been mitigated by reduced consumption. Adding in losses from the (smaller) markets in illicitly manufactured cigarettes and those smuggled from abroad would further swell the total.

Determining, at least roughly, the current magnitude of the total federal, state and local tax loss would help in arriving at an appropriate replacement to the current diminished, divided and uncoordinated federal efforts to combat ITTP. Federal investigations and prosecutions of interstate smuggling and other illegal sales and diversions are now isolated and sporadic, unlikely to create effective deterrence. Current policy limits them to cases involving both large revenue loss and the presence of violent organized crime groups. That limitation is unlikely to have escaped the notice of professional smugglers, who need only avoid violence to avoid investigation by the Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF). A current and reliable estimate of tax loss would establish the potential benefits to be gained by a modest investment in improved ITTP enforcement.

## **2. The Lack of Federal Capacity to Control ITTP**

### **a. ATF**

Criminal enforcement responsibility for interstate trafficking under the Contraband Cigarette Act<sup>7</sup> and enforcement of the Prevent All Cigarette Trafficking Act<sup>8</sup> against non-compliant internet and mail tobacco sellers is delegated by the Department of Justice (DOJ) to the Bureau of Alcohol,

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<sup>2</sup> Reuter, P., & Majmundar, M. *Understanding the US illicit tobacco market: characteristics, policy context, and lessons from international experiences.* (2015)

<sup>3</sup> Department of Treasury, *Report to Congress on Federal Tobacco Receipts Lost Due to Illicit Trade and Recommendations for Increased Enforcement*, (February 4, 2010.)

<sup>4</sup> Campaign for Tobacco-Free Kids, *Cigarette Tax Increases by State Per Year*, (July 14, 2016), [www.tobaccofreekids.org](http://www.tobaccofreekids.org).

<sup>5</sup> Campaign for Tobacco-Free Kids, *Cigarette Tax Increases by State Per Year*, (July 14, 2016), [www.tobaccofreekids.org](http://www.tobaccofreekids.org).

<sup>6</sup> The increase in the tobacco excise tax in California takes effect in April 2017.

<sup>7</sup> Title 18, United States Code, Sections 23451–2346.

<sup>8</sup> Title 18, United States Code, Sections 375–378, as amended.

Tobacco, Firearms and Explosives. However, the ATF's case management policies prioritize investigations into violent crime and substances other than tobacco over ITTP investigations. From 2004 through 2013, ATF consistently requested 2% of its resources for investigations of alcohol and tobacco diversions, a term it used to cover all criminal violations related to those products under ATF jurisdiction. For 2012 and 2013, that would have been approximately \$20 million yearly. The 2013 budget request reported that in 2012 ATF had opened approximately 68 investigations into the diversion of tobacco products, recommended the prosecution of 202 defendants, and seized approximately \$34.9 million in assets. After 2013, ATF Budget Submissions no longer provided estimates of the percentage of resources to be applied either to alcohol or tobacco enforcement. After FY 2014 the Submissions' Table of Contents no longer mention Criminal Diversion of Tobacco from Legal Commerce as a threat to be addressed under the Law Enforcement heading. The FY 2016 Submission explicitly stated that "All of ATF's programs are designed first and foremost to impact violent crime."<sup>9</sup>

The current threats of gun violence and of bombings by terrorists and others may make the choice of ATF's mission priority unavoidable. The consequence has been the orphaning of ITTP enforcement and the near-elimination of tobacco investigations not involving violent criminals. In July 2012, the Assistant Director of Field Operations directed that all new tobacco investigations require a nexus to violent crime except for "rare occasions" where the case involves large-scale fraud, significant tax losses," and organized crime.<sup>10</sup>

In June 2014, the Government Accountability Office (GAO) observed that during the years from 2003 to 2013 when ATF Budget Submissions consistently requested 2% of its budget resources for alcohol and tobacco enforcement, less than one half of one percent of investigations actually involved alcohol or tobacco. The same report reflected that the combined number of alcohol and tobacco investigations opened declined by 85% from 168 to 25 from 2003 through 2013. Taken together with the claim in the 2013 ATF budget request that 68 tobacco investigations had been opened in 2012, the GAO finding would indicate that, after the 2012 directive to work only cases involving violence, tobacco investigations fell from 68 in 2012 to an unspecified *fraction* of 25 cases involving either tobacco or alcohol in 2013.<sup>11</sup> Another source reported, with respect to tobacco, that investigations initiated fell from 100 in 2011 to 11 in 2013.<sup>12</sup> The proposed project would seek reliable statistical data on ATF investigative activity and resulting prosecutions in order to judge the impact of ATF's 2012 policy change and to compare that impact with available data on the incidence of ITTP during the same time period.

#### b. TTB

The Alcohol and Tobacco Tax and Trade Bureau (TTB), located in the Treasury Department, is the agency charged with collection of the tobacco excise tax from manufacturers. It originally pursued only civil enforcement, but eventually recognized the advantage of adding criminal deterrence and implemented a criminal-investigative capability. Special Agents were provided

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<sup>9</sup> ATF budget requests for FY 2009-2016 available at <https://www.atf.gov/about/budget-performance>

<sup>10</sup> Turk, R. Tobacco Enforcement Program. Memorandum from Assistant Director (Field Operations) to All Special Agents in Charge. Washington, DC: Bureau of Alcohol, Tobacco, Firearms and Explosives. (2012) <http://blog.timesunion.com/capitol/archives/200087/atf-document-shows-why-investigators-are-laying-off-tobaccoinvestigations-in-ny/> [January 2017].

<sup>11</sup> GAO Report to Congressional Requesters. *Bureau of Alcohol, Tobacco, Firearms and Explosives: Enhancing Data Collection Could Improve Management of Investigations*. (June 2014)

<sup>12</sup> Reuter, P., & Majmundar, M. *Understanding the US illicit tobacco market: characteristics, policy context, and lessons from international experiences*. (2015)

by the IRS on a reimbursable basis. That effort was funded with an initial \$3 million, two-year appropriation in 2010 for six Special Agents, and funding for 10 Special Agents has been requested for FY 2017. TTB now allocates \$2 million of its revenue collection budget to criminal enforcement and \$3 million to civil enforcement and compliance programs. The criminal budget, which includes vehicles, training and other expenses, has been \$2 million since 2012, out of a total agency budget of \$100 to \$110 million during those years.

In FY 2015, the last year for which TTB has published a tobacco excise-tax collection amount, collections were \$13.6 billion. The 2017 TTB President's Budget reported that, since 2011, criminal-enforcement efforts have resulted in opening 91 cases for investigation involving \$551 million in tax liability and \$124 million in criminal seizures. The high ratio of fiscal returns to expenditures suggests that increasing the TTB enforcement budget would yield a surplus. TTB currently has no jurisdiction over interstate smuggling offenses – its remit goes only to the collection of federal tax – but with statutory changes it could fill the gap left by ATF's de-emphasis of tobacco enforcement. (See Section 4.)

### **3. The Economic Motivation**

The great majority of tax loss described in Section 1, The Illicit Trade, results from interstate smuggling from low-tax to high-tax jurisdictions. As of August 1, 2016, per-pack cigarette taxes in Chicago and New York City were \$6.16 and \$5.85, respectively. Taxes in states within easy range for smuggling by vehicle, such as Missouri for Chicago and Virginia for New York City, were \$0.17 and \$0.30, respectively. When the manufacturer's sales price, including the federal excise tax, combined with the excise tax in the selling state results in a per-pack cost of one third or less of the legal retail price in a nearby high-tax jurisdiction, the profit motive for smuggling is substantial.

Theoretically, eliminating or substantially reducing the incentive for smuggling by harmonizing tobacco tax rates is the most obvious step toward reducing ITTP. Practically, state and local governments in high-tax jurisdictions are usually eager for revenue sources, and have shown no readiness to reduce the tax incentive for smuggling. The prospects for persuading a jurisdiction such as New York to give up a lucrative funding source, when the tax also serves a public health function, are not favorable.

By the same token, low taxes, where they exist, reflect the local balance of political forces. Low-tax states currently suffer no revenue loss from the interstate smuggling trade and even benefit from taxes paid on cigarettes bought to be smuggled out of the state.<sup>13</sup> Elected officials in tobacco-producing states are expected to protect their constituents' jobs and the state's economic interests.

In the United States, there seems to be no instance on record in which two or more jurisdictions have negotiated a harmonization of cigarette taxes to reduce interstate smuggling; whatever might have taken place informally, no interstate compact on the topic can be found. Similarly, there appear to be no instances of states voluntarily reducing or increasing tobacco taxes specifically to discourage smuggling. In 2011 New Hampshire reduced its per pack tax by \$0.10

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<sup>13</sup> Missouri is the lowest cigarette tax state at \$ 0.17 per pack. The Chicago area, in an adjoining state, has the highest tax rate in the country. Missouri has a population of approximately 6 million. California has a population of approximately 40 million. According to the website [www.tobaccofreekids.org](http://www.tobaccofreekids.org) Missouri cigarette sales were 496 million packs. California sales were 867 million packs.

after discussion of the comparative tax advantage over neighboring states.<sup>14</sup> North Carolina abolished its state tax stamp for the same reason. New Hampshire then returned to the original rate in 2013 after tobacco-tax revenues failed to increase to the anticipated extent. Thus, voluntary harmonization of tax rates would not appear to be on the horizon.

Still, tax harmonization – reducing differences among state and local tax rates – would be the most immediate and certain method of reducing ITTP.<sup>15</sup> The economic incentive for interstate smuggling would be reduced or eliminated assuming all state and local taxes were included in the harmonization or equalization. Any increase in the federal tax rate would make non-federal tax rates a smaller percentage of the per-pack price, but would not necessarily reduce the absolute dollar difference between high- and low-tax jurisdictions and the advantage enjoyed by smuggled cigarettes. There would still be an economic incentive for interstate smuggling unless some other part of the equation were changed.

One way to change that equation would be a federal tax rebate or similar scheme for state and local taxes paid.<sup>16</sup> A rebate-type arrangement could mean that a federal tax-rate increase would effectively raise taxes only in jurisdictions with lower cigarette taxes. On the other hand, it would mean that those low-tax jurisdictions could raise local taxes (and revenues) without increasing the prices their cigarette consumers had to pay.

The *de facto* disparity in a rebate's effect on different states guarantees that both in the legislative process and after adoption the concept must be explained and defended on both practical and legal grounds, particularly in view of the Constitutional provision that all excises shall be uniform throughout the United States. To have funds available to finance a rebate the increased federal tax would still have to be collected from the manufacturer. The entity eligible for the rebate, however, would be the wholesaler in the distribution chain that pays the state excise tax. The rebate presumably could be claimed only after proof of payment of state and local taxes was submitted to federal authorities. That delay would be a substantial liquidity factor to the state taxpayers and might provoke opposition. Local sales taxes could be exempted from the rebate scheme or a mechanism would have to be found to avoid having to pay smaller rebates to a much larger universe of retailers, which would complicate the rebate scheme, while increasing administrative costs and opportunities for fraud.

Answers to these issues and related legal issues are necessary to a determination whether and what sort of rebate scheme is feasible and should be resolved by further research and analysis.

Another approach suggested by experts would be to reduce the Medicaid match for states that do not adopt a federally established minimum tax rate.<sup>17</sup> Given the overlap between anti-smoking sentiment and support for health care, this seems implausible politically. More plausibly, the federal government could offer financial incentives for states to keep their taxes within some band around (for example) the national weighted-average state-tax rate. The closer

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<sup>14</sup> “3 states seek to kick habit of raising cigarette taxes,” Associated Press Newswire, March 19, 2011; <http://www.wmur.com/article/tobacco-tax-to-increase-in-nh/5182955>; Inc., H. T. (2016, October 10). Tobacco tax to increase in NH. Retrieved January 25, 2017, from <http://www.wmur.com/article/tobacco-tax-to-increase-in-nh/5182955>

<sup>15</sup> As indicated by the State Department report cited in Section 1, federal tax loss is only a fraction of state and local tax losses that result from interstate smuggling.

<sup>16</sup> Mark A.R. Kleiman, *Did Tobacco Taxes Really Kill Eric Garner?* (National Review, December 12, 2014.)

<sup>17</sup> Frank A. Chaloupka, University of Illinois at Chicago, presentation on *Optimizing the Public Health Impact on Tobacco Taxes*, (March 2, 2016.)

a federal rate were to those of the highest-tax jurisdictions the nearer it would come to eliminating the incentive for interstate smuggling, at some risk of creating increased incentive for international smuggling, diversion from Native American reservations and entirely illicit production. A proposal for a tax increase anywhere near that magnitude could raise the federal rate from its current \$1.01 to well over \$5. Such a significant multiplication of the current rate would provoke the opposition of the tobacco industry, the large and small retailers that market cigarettes to the public, the smoking public itself and some elected representatives. How much of an increase could be proposed without provoking a reaction that would kill its chances of adoption and how much different levels of tax would reduce ITTP are questions that need to be analyzed before such a concept can be advanced for legislative consideration.

Vaporization provides competition not only for licit cigarettes but also for illicit cigarettes. Where taxes on vaporized products are set in terms of parity (on nicotine-content basis) with combusted products, “vaping” loses what might otherwise be a substantial cost advantage. Raising cigarette taxes but not taxes on vaporization products might allow greater tax increases and lower illicit-product market shares than raising taxes across the board.

While enforced federal harmonization of tobacco tax rates would be a partial solution to the interstate smuggling component of ITTP, and equalization would be a complete solution, a very well thought-out plan would be necessary to overcome anticipated resistance. Further research may reveal one or more ways to work out an effective and reasonably efficient tax rebate or other federally imposed system to achieve national equalization of tobacco tax, but such an outcome is by no means assured; even if a workable system could be designed it might not be politically feasible. Until then, it seems likely that non-federal tax rates in high-tax jurisdictions will continue to increase, and the differentials are likely to grow. Every future tax increase or limitation on the availability of cigarettes, such as possible elimination of menthol cigarettes, will provide more profit incentive for ITTP.

#### **4. The Opportunity for the Incoming Administration**

##### **a. Assignment of ITTP Enforcement Responsibility - ATF**

ATF’s de-emphasis of tobacco investigations creates a serious gap in the enforcement of federal laws intended by Congress to support state tobacco tax policy. State and local tax efforts to reduce the continuing loss of billions of dollars in cigarette taxes are not receiving the federal support intended by Congress when it adopted the Jenkins Act (1949), the Contraband Cigarette Trafficking Act (1978) and the Prevent All Cigarette Trafficking Act (2009) to apply federal resources to reduce interstate smuggling. That de-emphasis is clear in ATF’s public statements, and it is difficult to imagine that illicit tobacco traffickers have not become aware of the reduced enforcement effort. The current risk-reward ratio in tobacco smuggling is so much more advantageous to the criminal than the risk-reward available in the illicit traffic in controlled substances that ITTP should be expected to grow as existing criminal enterprises expand and attract new entrants trying to cash in on the opportunity.

The current situation presents an opportunity for a new presidential administration to protect public health and improve the fiscal balance in the states and cities by re-energizing the federal efforts against interstate cigarette smuggling, with expenditures smaller than the additional revenue collected. Several approaches will be considered in the final report. If criminal jurisdiction for non-tax violations of federal cigarette tobacco laws remains with ATF, introduction of a national strategy of focused deterrence could apply existing resources more

effectively by concentrating ATF resources geographically in a way that makes smuggling uneconomic in the areas of initial focus. If the result is, as expected, shrinking ITTP in those areas, attention could then be shifted to other areas, while retaining a residual effort large enough to prevent a large market from re-emerging. Thus, the entire market, too big to control all at once, could be brought under control sequentially.

If no additional resources can be mobilized, even temporarily, from other ATF priorities, ATF could attempt to secure resources from other federal agencies or from state and local agencies, including agencies whose primary mission is tax collection rather than criminal enforcement. Such a program involving ATF, the California Board of Equalization, the U.S. Attorney's Office for the Eastern District of California, and the California Attorney General's Office resulted in convictions as recently as 2014.<sup>18</sup>

#### b. Assignment of Enforcement Responsibility - TTB

Another option would be a governmental reorganization by legislation integrating interstate cigarette smuggling and other criminal ITTP jurisdiction into the Treasury Department's Alcohol and Tobacco Tax and Trade Bureau. As described in Section 1.c., TTB has taken the initiative to develop a criminal-enforcement program to collect tobacco tax at the same time that ATF has deemphasized interstate smuggling investigations. A single strongly motivated agency, with no higher priority than the direct collection of federal tobacco taxes and the support of state and local tax-collection efforts, could then address all aspects of ITTP. A tax-oriented agency is more likely to work with IRS to apply civil tax remedies in interstate-smuggling cases that may not reach a criminal threshold of proof or which for some other reason are not prosecuted by U.S. Attorneys' Offices. One goal of the proposed project would be to explore with TTB and others the tools that would be available in a holistic approach to ITTP, including more frequent non-federal prosecution of and IRS imposition of civil income-tax liability on interstate smugglers and internet and mail sellers. The ultimate goals of an enhanced ITTP program would be deterrence and compliance, whether achieved by prosecution, seizure and forfeiture or imposition of tax liability, and it should be evaluated on compliance-oriented outcome measures rather than on case statistics.

The accomplishments of TTB's criminal enforcement program were reviewed in section 2b.<sup>19</sup> Additional research will be necessary to provide an accurate forecast of what results could be expected if ITTP criminal jurisdiction and accompanying resources were made available to TTB. Currently available statistics are cumulative rather than annual, and for that and other reasons are difficult to analyze. One cannot assume that because criminal enforcement activities received 40% of the \$5 million TTB allocated to tax collection that such activities are responsible for 40% of the \$13.6 billion in tobacco tax collected, as civil enforcement with voluntary collections would seem likely to be more productive than investigations directed against professional criminals. Similarly, one cannot assume that enforcement results are a linear function of resources, and that doubling TTB's criminal-investigations budget of \$2 million would double whatever portion of the \$13.6 billion in collections that was attributable to criminal investigations.

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<sup>18</sup> California Board of Equalization, "Vallejo Tobacco Wholesaler Arrested for Felony Tax Evasion" (August 4, 2014) <https://www.boe.ca.gov/news/2014/110-14-G.pdf>

<sup>19</sup> For TTB figures cited in this section, see Alcohol and Tobacco Tax and Trade Bureau, *FY 2017: President's Budget*, (February 9, 2016.) <https://www.treasury.gov/about/budget-performance/CJ17/15.%20TTB%20CJ.PDF>



While TTB expenditures on civil and criminal enforcement currently result in revenue collection at a rate of 437:1,<sup>20</sup> a similar ratio cannot be expected for resources that would be devoted to ITTP if TTB were given that jurisdiction, because the federal excise tax of \$1.01 per pack has been paid in interstate smuggling cases. Nevertheless, the potential advantages of placing ITTP criminal jurisdiction in a tax-oriented agency, where those offenses will not be eclipsed by higher priority, more-glamorous violent violations, merits examination. That is particularly the case since TTB has demonstrated its enthusiasm and initiative in undertaking both civil and criminal tobacco enforcement in contrast to ATF's de-emphasis of ITTP investigations.

Per a 2014 GAO report, during the period 2003 through 2013, ATF devoted less than one half of one percent of its budget to ITTP and alcohol enforcement combined, even though it requested 2% for that purpose.<sup>21</sup> In each of those years the budget reached or exceeded \$1 billion, meaning that the requested 2% was always \$20 million or more. That is what ATF estimated would have been required to enforce the criminal alcohol and tobacco laws if enforcement of those violations had not been supplanted by the more urgent priority of gun violence and explosives. An additional \$20 million is thus a baseline for the amount of additional resources TTB would require if tasked to assume ITTP (and criminal alcohol violations) responsibility.<sup>22</sup> Of course, if this meant an effective transfer of budget from the Justice Department to Treasury, it would likely be met with resistance.

### c. Cooperation with Other Stakeholders

There is a long history of federal funding to motivate state efforts against national crime problems that heavily impact state and local jurisdictions (e.g., the Law Enforcement Assistance Administration, Organized Crime Drug Enforcement Task Forces, High Intensity Drug Trafficking Areas, Joint Terrorism Task Forces). There are obvious ways in which federal ITTP enforcement can benefit from partnership with state and local law enforcement, tax, and regulatory authorities. No doubt the reduced attention to tobacco by the ATF has limited the extent of such cooperation, with exceptions such as the Task Force in the Eastern District of California previously mentioned. Determining the optimum configuration and level of federal assistance to or cooperation with state and local efforts against ITTP will require examination of analogous programs.

State and local treasuries benefit financially from federal enforcement efforts. That alone may be sufficient inducement to sustain close cooperative relationships, particularly if due publicity is given to the local partners in cases of seizure and prosecution. There almost certainly will be cases developed through federal investigations that for various reasons may be prosecuted in state courts, providing additional motivation for joint efforts. Consequently, it may be appropriate to assume that voluntary cooperation by non-federal authorities should be the norm, and not to consider federal funding to sustain cooperation unless a need is demonstrated after several budget cycles.

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<sup>20</sup> Alcohol and Tobacco Tax and Trade Bureau, *FY 2017: President's Budget*, (February 9, 2016.) <https://www.treasury.gov/about/budget-performance/CJ17/15.%20TTB%20CJ.PDF>

<sup>21</sup> GAO Report to Congressional Requesters. *Bureau of Alcohol, Tobacco, Firearms and Explosives: Enhancing Data Collection Could Improve Management of Investigations*. (June 2014)

<sup>22</sup> Throughout this discussion the focus has been on tobacco offenses. If ITTP jurisdiction were to be transferred to TTB, a corresponding transfer of alcohol jurisdiction would seem to be indicated. TTB already has alcohol-tax collection responsibility and ATF would have little incentive to retain responsibility for a distracting, largely non-violent enforcement area if jurisdiction over tobacco offense were transferred.

It would not be advisable for any new ITTP enforcement proposal to intrude on the budgetary authority of the FDA to conduct compliance inspections and to contract with states to do so. These arrangements now exist with 45 states and the District of Columbia. FDA enforcement actions seem to be largely state-led, and its State Tobacco Retail Compliance Check Inspection Program does not appear to be integrated with federal ITTP enforcement. If a new ITTP initiative were to provide for grants to ITTP Task Forces these grants might in some ways overlap or duplicate FDA funding of its compliance-check program. Such an overlap should be tolerated, because tampering with FDA prerogatives in this area would be regarded with suspicion.

If liaison could be established with state agencies without provoking a hostile FDA reaction, those agencies could be important information resources that should be part of an integrated ITTP strategy. Of the total violations sanctioned by FDA, approximately 85% were either sales to minors or sales without age verification. Retailers that sell to minors may be more prone than average to sell smuggled product. Some formalized method of communication about the identification of suspect retailers, in addition to records of formal FDA sanctions, should be institutionalized.

#### d. Potential Obstacles to Reinvigorated ITTP Enforcement

If ATF retains ITTP jurisdiction there will be a natural reluctance by the DOJ and ATF management to reverse their deliberate decision to apply a “violent crimes only” criterion to tobacco cases. Public concerns about gun violence and terrorist bombings make the policy decision understandable. If ample funds could be provided to address ATF’s violent-crime priorities and leave a surplus for alcohol and tobacco enforcement, then it is possible that ATF would willingly reengage in the ITTP field. Gun violence and terrorism are, however, potentially limitless consumers of investigative resources. Voluntary allocation of ATF resources to ITTP seems a distant hope, feasible only when the threats of gun violence and terrorism are perceived to have lessened.

A proposal to reorganize ITTP enforcement by transferring responsibility for non-tax cigarette crimes to TTB would normally provoke DOJ and ATF resistance to losing jurisdiction and resources, even though circumstances have compelled ATF to pursue other priorities. That normal resistance might be overcome if constant funding of ATF’s violent-crime programs could be maintained. That the 2014 GAO study on improvements to ITTP investigations indicated that even before issuance of the “violent crimes only” only one half of one percent of ATF investigations involved tobacco and alcohol.<sup>23</sup> Since there should be some rough correlation between resources expended and resulting investigations, this would suggest expenditures in the range of \$500,000 to \$600,000 annually.

A compromise solution would be to create dual ATF-TTB jurisdiction over alcohol and tobacco non-tax offenses. That is a possible but not an ideal alternative as it could invite disputes and confuse non-federal counterparts, who should play an important cooperative role in ITTP enforcement.

If ITTP jurisdiction were to be integrated into TTB, staffing would be an issue. TTB does not have its own in-house Section 1811 criminal investigators. It has apparently found a workable

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<sup>23</sup> GAO Report to Congressional Requesters. *Bureau of Alcohol, Tobacco, Firearms and Explosives: Enhancing Data Collection Could Improve Management of Investigations*. (June 2014)

solution for excise-tax criminal investigations using dedicated IRS special agents on a reimbursable basis. Initially six special agents were provided, and TTB's Budget Submission for FY 2017 requests 10 reimbursable positions. So long as this arrangement continues to be cost-effective it could be expanded to cover ITTP offenses, although the skill sets of the investigators would have to include more street-crime investigative techniques rather than following paper trails. Ideally some of the ITTP expertise still existing in ATF could be acquired to preserve some institutional knowledge and transmit investigative skills. The degree of specialization necessary for effective ITTP enforcement seems achievable in the near term with IRS special agents, so long as their dedicated assignment is long enough for them to learn the industry, develop sources and bring cases to fruition, which requires several years.

Because of this necessary duration of an assignment, IRS Criminal Investigation Division special agents may perceive being detailed to TTB as a barrier to career advancement. That would make it difficult to attract IRS special agents to TTB. This possibility and the desirability of a career cadre to transmit ITTP knowledge and specialization suggests the wisdom of eventually creating a dedicated TTB force of special agents. Further study will be required to determine at what scale an internal force of TTB special agents becomes organizationally viable.

Another potential obstacle to be considered is the extent to which legislative changes may be necessary or desirable. A transfer of jurisdiction from Justice to Treasury of ITTP jurisdiction would require a statutory reorganization. As explained in footnote 15, the Patriot Act currently requires the destruction of seized cigarettes, making it impossible to develop financing from industry buybacks of contraband cigarettes. Changing that situation or financing ITTP enforcement from tobacco excise taxes or from forfeitures related to ITTP or tobacco excise-tax violations would also require legislation. However, ample precedent exists for legislation to create a forfeiture fund for ITTP enforcement, which could benefit not only whatever federal agency has investigative jurisdiction but could also provide for additional prosecution support and incentives for state and local agencies in task forces.

#### e. Prosecutorial Support

Several significant cases investigated both by ATF and TTB have been prosecuted federally and no complaints of lack of federal prosecution support for tobacco enforcement have been documented. However, there does not seem to be any coordinated national strategy behind these prosecutions. The strategy of dynamic concentration works best when prosecutorial resources and priorities support investigative priorities. The Department of Justice Strategic Plan for 2014–2018 states Goal No. 1 to be: "Prevent Terrorism and Promote the Nation's Security Consistent with the Rule of Law." ATF's emphasis on firearms and bombs is entirely consistent with that goal. It is uncertain whether the Department would be open to greater investigative and prosecutorial emphasis on ITTP violations and that issue should be addressed in further research. If Justice wished to support a reinvigoration of ITTP enforcement the greatest deterrent could be achieved by prosecutions, creating the perception within the industry and illicit trade that the possibility of prosecution and punishment has been increased. Strategic control of federal prosecution could ensure that initial cases in a renewed ITTP program have strong evidentiary support, involve attractive facts with jury appeal and are likely to result in substantial penalties. In this way, the credibility of the program, deterrence and leverage for investigators seeking to cultivate sources could all be reinforced.

Department of Justice Headquarters (aka Main Justice) could assist in reinvigorating ITTP enforcement by establishing a small unit in the Criminal Division of the Department (or perhaps

within the Criminal Section of the Tax Division) to set policy and to lend support when an Assistant U.S. Attorney encounters difficulties or unfamiliar issues in an ITTP case. More effective case management could be achieved if Main Justice would assume at least temporary authority for supervising ITTP prosecution to bring forward the most appropriate cases to establish the credibility of enhanced ITTP enforcement. A supplement or alternative to such a headquarters element would be training of AUSA's from districts most likely to be presented with ITTP cases for prosecution. Leadership of an anti-smuggling effort at Main Justice and designation of a AUSA in smuggling source or recipient districts, and their full-time dedication to that mission or to task force participation with state authorities where warranted, could greatly assist an investigative program of targeted deterrence. This approach might be more feasible organizationally if an ITTP revolving fund were established, and if that fund could pay for additional prosecutorial efforts.

Without Main Justice involvement, the agency having ITTP jurisdiction (ATF or TTB) could exercise a degree of control over the investigative quality and presentation of cases for prosecution, but would be at the mercy of individual prosecutors as to which cases would be authorized and in what order. The need for control would also extend to cases that are not accepted for federal prosecution but which may be attractive for local prosecution because of the tax loss under state and local law. Local prosecution is an alternative sometimes used in DEA drug cases. The frequency and success of such referrals should be examined in further research, as local referrals may well have to be a major component of a renewed ITTP enforcement program. Except in high-profile, high-dollar cases with publicity impact, AUSAs are unlikely to be receptive to routine ITTP presentations when more glamorous, newsworthy and career-enhancing prosecution opportunities are available.

#### f. Community Attitudes

A potential danger to enhanced ITTP enforcement would be an adverse political reaction from the affected economic interests and the broader community. Much tobacco retailing is done through convenience stores in low-income neighborhoods. Program management should minimize any perception that those neighborhoods and communities are being targeted. Target selection should be diversified. To avoid disproportionate harvesting of low-hanging fruit at the retail level, consideration should be given to using retail violators as sources and witnesses against their suppliers. Buy/bust and sell/bust techniques should be used to reach the full spectrum of ITTP violators. Confidential sources who are willing to inform against their competitors and buyers or sellers willing to inform or testify will sow distrust and disrupt illegal-market relationships.

ITTP, like income-tax evasion, is often seen as a victimless crime. Federal, state and local taxing entities are unsympathetic victims. A program to enhance ITTP enforcement will have a greater likelihood of success if it has the support of multiple stakeholders. Government entities will be motivated by increased revenue collection and public health policy benefits. The industry at various levels will be motivated by the degree to which illegal, non-taxpaying competition is reduced, mostly at the distribution and retail level, and brand reputation is protected from counterfeits.

The use of ITTP by some elements of the tobacco industry as an argument against taxation and regulation has led elements of the public health community to minimize the importance of the issue. Outreach to public health advocates may be needed to convince them that ITTP is a threat to the goal of smoking reduction, both directly and by undercutting public support for tobacco-tax increases, because it reduces their effectiveness in raising revenue and reducing

consumption. Strengthening ITTP enforcement should be presented to such advocates as a necessary component of the larger campaign to use taxes and regulations to control the health effects of smoking.

## **5. Industry Support of ITTP Enforcement**

### **a. Provision of Information and Assistance to Enforcement Authorities**

Reinvigoration of federal ITTP enforcement will require buy-in by the concerned departments, executive decisions and possibly Congressional action. The industry should not be reluctant to openly lobby for reinvigoration of an ITTP program. An effective program would increase state and local tax revenues, raise effective prices – thereby supporting public health goals – and reduce the extent of illicit activity, benefiting public safety.

While awaiting federal action, or in the absence of such action, there are steps the industry could take to support ITTP enforcement. Industry sources can make known their willingness to support law enforcement efforts by providing resources for sell/bust or buy/bust investigations, particularly to smaller jurisdictions that do not enjoy the resources of a federal agency.<sup>24</sup> Security or other personnel should be designated and trained as necessary to provide points of contact and industry expertise to authorities. Outreach programs can raise awareness of ITTP. Relationships with criminal, tax, and regulatory authorities can provide training and convey industry information supporting sell/bust and buy/bust operations.

The experience of the International Criminal Police Organization in applying for observer status at the Conference of the Parties of the Framework Convention on Tobacco Control shows that anti-tobacco sentiment can obstruct law enforcement efforts to work cooperatively with the industry. As reflected in the State Department Report described in Section 1, ITTP is a global crime and tax problem. The Financial Action Task Force Report of June 2012, *Illicit Tobacco Trade*, was issued “...to highlight the vulnerabilities that the ITTP and related ranging predicate offense pose to the manifestation of money laundering and financing of terror.” Despite these law enforcement concerns and the desire of the world’s premier law enforcement cooperation mechanism to address them, Interpol’s application for observer status at the Conference of the Parties of the Framework Convention was rejected in 2014. The rejection came after criticism that PMI had funded a study prepared for Interpol’s Office of Legal Affairs on the nature of illicit trafficking and the international legal framework available to combat ITTP and suggestions that Interpol would thereby be unduly influenced by tobacco interests.<sup>25</sup> Consequently, it must be anticipated that industry support for a mechanism intended to facilitate domestic cooperation with law enforcement, tax, and regulatory authorities may be met with similar criticism.

The best response to such anticipated criticism may be to create an internal industry group openly dedicated to advancing tobacco-industry interests, some of which will coincide with the public interest in more effective cigarette-tax collection. The insurance industry has a non-profit

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<sup>24</sup> Under the PATRIOT Act Amendment of 2005, seized contraband cigarettes must be destroyed but may first be used for law enforcement purposes. In cases where contraband is not readily available, investigative agencies and the industry should have established channels and procedure to allow product to be requested and supplied to support investigations.

<sup>25</sup> 6th Session Moscow, Conference of the Parties to the Framework Convention on Tobacco Control, FCTC/COP/6/4. (12 June 2014.)

entity, the National Insurance Crime Bureau, with membership from all segments of the industry concerned with theft and fraud. As stated on its website, the mission of NICB is to

... work with law enforcement agencies, technology experts, government officials, prosecutors, international crime-fighting organizations and the public to lead a united effort to prevent and combat insurance fraud and crime.

The credit card and financial industry developed a similar organization, now called the Association of Certified Fraud Examiners. The Association has a global membership of 75,000 and is regarded as highly professional, providing an examination and certification of competency process. It publishes study guides, a Fraud Examiner's Manual and a quarterly journal, with an active website. Training programs are held regularly nationally and internationally and are open to members and non-members.

Representative seminar topics include Cyber and Procurement Fraud, Conducting Internal Investigations, Professional Interviewing Skills, Bribery and Corruption, Using Data Analytics to Detect Fraud, Money Laundering Schemes, Financial Statement Fraud and Effective Report Writing. This type of organization and its training outreach could easily be adapted to areas of mutual benefit in the tobacco industry's ITTP interaction with federal and non-federal enforcement, tax, and regulatory authorities. Training seminars to explain the distribution chain, recognition of tax stamps and track and trace markings, detection of counterfeit product, probable smuggling routes, sources and techniques could be offered to appropriate audiences of industry risk-management and security personnel as well as federal and non-federal ITTP counterparts, thereby establishing a network of contacts for cooperation. Protecting the industry's self-interest by cooperating with official law enforcement, tax, and regulatory activities in areas of mutual benefit would be the stated purpose of the entity, neutralizing any claim of a hidden agenda. An expectation that an agency receiving low-cost or free training would have an existing interest in suppressing ITTP or would pay increased attention to it would be implicit in the provision of training.

While awaiting a revitalization of federal ITTP enforcement, or if no such revitalization takes place, the industry could independently make use of its analytical skills and operating data to help identify sources of ITTP. The major tobacco companies maintain active and sophisticated market surveillance systems, including littered-pack and waste-bin surveys and comprehensive inventory controls and tracing. No doubt information exchanges with investigative and tax authorities already take place; these could be intensified under appropriate legal guidance, particularly concerning probable sources of product for smuggling. The feasibility of identifying suspect wholesalers and resellers supplying smugglers and geographic sources for smuggled product by internal data analysis should be explored. Product marking at different levels in the distribution chain offers tracing possibilities. Analysis should be done of the degree of control that manufacturers can legally and economically exert over distributors and the incentives or obstacles to exercising that control. That analysis would depend upon the collection of data on the scope of domestic ITTP, the prevalence of certain fact patterns and the feasibility of particular countermeasures.

#### b. Engaging Tobacco-Control Advocates and the Public

The statutory scheme for federal enforcement efforts against ITTP is clear. It is also clearly not functioning as intended because ATF resources have been drawn away to deal with the threats of gun violence and terrorist bombings. The public in high-tax areas is suffering a substantial loss of tax revenue and of any health benefits that flow from higher prices and reduced

consumption. Widespread illicit cigarette trafficking has a deleterious community effect and in a worst-case scenario is subject to exploitation and control by organized crime groups or as a means of financing terrorism. Reinvigorating or reorganizing federal efforts along the lines suggested in Section 3 could enhance ITTP enforcement at a minimal cost and is an opportunity the incoming presidential administration should not fail to evaluate.

Any proposal to revitalize or reorganize ITTP enforcement will require institutionalized support to be seriously considered. State and local tax authorities have important interests at stake but their support must be mobilized to be effective. If it were willing, the tobacco industry could provide the impetus and a plan to bring such an initiative to the attention of the new administration and its team for the Treasury and tax policy.

Any plan that involves the participation of the tobacco companies to intensify ITTP enforcement and thereby increase smoking costs and reduce consumption will likely be met with suspicion by some tobacco control advocates. This attitude is exemplified by the conclusion of an October 2014 publication by the Secretariat of the Framework Convention on Tobacco Control entitled *The Tobacco Industry and the Illicit Trade in Tobacco Products*:

It is noteworthy that the texts of these two international instruments (the WHO FCTC and its Protocol) acknowledge that the interests of the tobacco industry and the interests of tobacco control are irreconcilable and that partnerships between government and tobacco industry should be avoided.

The United States has not ratified either agreement. Nevertheless, the position of the Secretariat promoting these instruments deserves attention because it is often seen as establishing global tobacco-control policy or at least setting the aspirational standard of tobacco-control groups. The conclusion of the Secretariat seems representative of the suspicion with which some groups regard industry efforts to support ITTP enforcement. Article 5.3 of the Convention states:

In setting their public health policies with respect to tobacco control, Parties shall act to protect these policies from commercial and other vested interest of the tobacco industry in accordance with national law.

Article 8.13 of the Protocol states a more specific concern:

Each Party shall ensure that its competent authorities, in participating in the tracking and tracing regime, interact with the tobacco industry and those representing the interests of the tobacco industry only to the extent strictly necessary in the implementation of this Article.

Examination of this basis for the Secretariat's hostility to industry support of ITTP enforcement reveals that it is not at all applicable in the U.S. context. First, the United States is not a party to the Convention or Protocol and has no immediate prospect of being bound by its obligations. Second, the principal ITTP problem in the United States is interstate smuggling. Whatever track and trace system the U.S. may eventually adopt under the 2009 Family Smoking Protection and Tobacco Control Act may legitimately focus on that national problem, rather than on compliance with the WHO Protocol's mandate to make its industry and presumably tax information accessible to a "global information-sharing focal point" operated by the World Health Organization Secretariat in Geneva. The critical marking in ITTP cases is furnished by the presence or absence of the appropriate state revenue stamp, not track-and-trace markings. Any track-and-trace system, including proprietary systems developed by manufacturers for their own purposes, can help only in identifying the origin of smuggled cigarettes and facilitating investigations.

While tobacco-control advocates in other countries may be concerned with the details of the track-and-trace system to be eventually developed for their jurisdictions, those concerns should not serve to protect interstate smuggling here. Consequently, suspicion over the details of such systems does not provide a coherent rationale for refusing to support efforts that would increase the cost of smoking in areas with a high proportion of smuggled cigarettes and reduce its harmful effects.

The industry should frankly acknowledge that in certain areas ITTP enforcement could serve industry interests as well as the purposes of tobacco-control advocates, while in other areas goals will clash. (In some cases, the interests of different industry participants will differ.) If enhanced ITTP enforcement reduces consumption of counterfeit or foreign cigarettes, U.S. tobacco-manufacturing companies will benefit, but at present those are negligible amounts compared to the interstate smuggling phenomenon.<sup>26</sup> Almost all illicitly trafficked cigarettes are lawfully manufactured domestic cigarettes smuggled into high-tax states, with federal tax paid but the local tax in the target jurisdiction evaded. Manufacturers of smuggled cigarettes stand to gain from increased volume in the short term; in the longer term, the growth of illicit distribution channels could threaten manufacturers' interests by facilitating the distribution of counterfeit product.

Those who would benefit most from suppression of interstate smuggling are law-abiding retailers, including grocery and convenience stores and other small businesses. In high-tax states these retailers would benefit from the reduction of low-cost illegal competition. That point should be communicated to the public and to those groups skeptical of efforts by tobacco manufacturers to suppress domestic ITTP. It would be unfortunate if actions designed to enhance ITTP enforcement, thereby increasing revenue, raising the cost of smoking and reducing tobacco consumption, were neglected because of a failure to recognize that industry interests can coincide with tobacco-control interests in suppressing interstate smuggling.

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<sup>26</sup> See footnote 1, ATF Congressional Budget Submissions and Department of Justice Inspector General, *Report: The Bureau of Alcohol, Tobacco, Firearms and Explosives' Efforts to Prevent the Diversion of Tobacco*, September 2009 Report 1-2009-005; Financial Action Task Force Report, *Illicit Tobacco Trade*, June 2012