Statement of the
National Association of Convenience Stores
(NACS)
"Tobacco: Taxes Owed, Avoided and Evaded"
United States Senate Committee on Finance
July 29, 2014

This statement is submitted on behalf of the National Association of Convenience Stores ("NACS").

NACS is an international trade association composed of more than 2,200 retail member companies and more than 1,600 supplier companies doing business in nearly 50 countries. The convenience and petroleum retailing industry has become a fixture in American society and a critical component of the nation's economy. In 2013, the convenience store industry generated almost $700 billion in total sales, representing approximately 2.5% of United States GDP. Tobacco products accounted for approximately 37% of convenience stores' in-store sales in 2013.

NACS's underlying policy objective is to enable its members to sell legal products responsibly and be able to do so on a level playing field. Today's hearing on tobacco taxation evasion and avoidance is an opportunity for the Committee to realize and appreciate the exceedingly *unlevel* playing field on which convenience stores in the United States sell tobacco products. Specifically, there exist in the United States today a number of channels through which illicit sales of tobacco products occur:

• Many Native American tribes and tribal retailers are abusing their sovereignty to evade state taxes on sales of tobacco. Such tribes and retailers abuse their ability to sell tax-free to their own members and expand those sales to non-members even though the Supreme Court has said states can tax tribal sales to non-members. Given the large tax component of the price of cigarettes, avoiding taxation can drive many consumers to tribal businesses, resulting in losses for off-reservation businesses and for the states that rely on that revenue.

• Non-face-to-face (*e.g.*, Internet) tobacco sales are far less likely to abide by pertinent tax provisions than sales in brick-and-mortar establishments. Congress took important steps to address this problem when it passed the Prevent All Cigarette Trafficking ("PACT") Act, but continued vigilance by enforcement authorities is needed to build on the progress made to date.

• Certain tobacco manufacturers are evading a recent tax increase applicable to cigarettes, "roll your own" tobacco, and little cigars, by mislabeling their "roll-your-own" tobacco as "pipe tobacco." The United States Congress has already taken steps to address this problem, but it remains pervasive.

• Due to the large disparities in tobacco product taxation in various states, some individuals purchase cigarettes in “low tax” states and transport them to “high tax states” to tell them on the black market. Such sales are at a substantial discount compared to the retail price in the “high tax” states that incorporates state tobacco taxes. Increased federal enforcement efforts are necessary to curtail this practice.

Background

Under the current system of taxation, cigarettes cannot leave the manufacturer unless the federal excise tax is collected. As a result, there is very little federal tax evasion. State excise taxes, however, are collected by private actors in the product’s distribution chain. These tax collection points can be evaded in some circumstances and those avenues of tax evasion can be quite lucrative for those willing to try it.

Congress’s most recent forays into tobacco tax evasion policy are the Prevent All Cigarette Trafficking (“PACT”) Act[1] and the MAP-21 highway reauthorization bill passed in 2012. The PACT Act provided the Department of Justice and states with the enforcement tools they needed to stop the rampant tax evasion by Internet sellers of tobacco. MAP-21 addressed the proliferation of roll-your-own tobacco machines which were popping up in retail settings, along with roll-your-own tobacco that was falsely labeled as “pipe” tobacco. Both of these laws made important progress to deal with these problems but the work in these areas is not finished.

[1] Pub. L. no. 111-154.

Illicit Sales by Native American Tribes and Tribal Retailers

Native American tribes are exempt under federal law from charging state excise taxes on sales of tobacco to members of their own tribes. Unfortunately, many tribes and tribal retailers are abusing this special tax exemption by expanding it to sales of tobacco to non-Native Americans. These tribal retail enterprises have refused to collect lawful state excise and sales taxes when they sell these products to non-Native Americans even though they are required to do so.

Native American tribes have immunity from lawsuits in U.S. courts. This immunity is greater than the immunity granted to the United States or foreign governments – all of which can be sued when they act in a commercial rather than a governmental capacity. Tribes have used this unprecedented immunity as a tool to block state efforts to enforce their tax laws. While the federal government can enforce its laws against tribes, states simply cannot. This is a problem that must be dealt with if we are to avoid continued erosion of state tax collections. Tribes should not have greater immunity than foreign governments and should not be able to use the cover of their sovereignty to evade state tax laws and sell tobacco and other products to state residents without collecting and remitting all taxes.

The results of these abuses are widespread. They can include injury to local businesses (that have trouble competing with the large price advantages unfairly bestowed when taxes are not collected) and substantial losses of state and local tax revenues. In fact, in some states, retailers in close proximity to recognized tribes have experienced a more than 80 percent decrease in cigarette sales, as non-Native American customers have migrated to tax-free purchases on Native American land. These retailers are not only losing out on tobacco sales, but also the ancillary sales that tobacco purchasers would otherwise make. Customers who purchase cigarettes frequently purchase other items in a store when they visit to buy cigarettes. Losing the foot traffic that cigarette sales generate results in losses for a retailer well beyond the sale of just a pack of cigarettes.

The volume of tax evasion happening through reservation sales appears to be increasing. One study found that the volume increased by almost 50% between 2008 and 2011.

[2] In New York State alone, NACS estimates that tribal tax evasion has generated annual losses of almost $600 million in economic activity (totaling billions of dollars in lost revenue for the State) and more than 6,500 jobs. Some convenience stores have been put out of business because of these tax abuses. And, there are some major convenience store businesses that will not open a new store in areas near reservations because of the threat of lost sales to tribal businesses that evade taxes. These lost investments can stunt economic growth.

This problem has become so significant that new tribes should not be recognized without protections in place that prevent tobacco tax evasion and ensure strong enforcement (overcoming tribal sovereignty) if evasion does occur.[3]

When NACS members are forced to compete against tribal competitors who can evade tax law to gain a competitive advantage, the harm is borne not only by the store owners, but also by the taxpayers. America's convenience store owners are an essential part of our economy, and it is not only critical but economically fair to ensure that these small businesses are able to compete on a level playing field.

Non-Face-to-Face Sales

Congress made real progress on the tax problems with Internet and mail order sales of tobacco products with the PACT Act. Individuals and businesses that sell tobacco products via the Internet or mail order frequently do not pay applicable tobacco taxes and do not have sufficient safeguards to prevent sales to minors. Additionally, Internet sellers are typically located in distant states, on tribal lands, or even overseas, making state or local law enforcement more complicated and expensive.

This has serious policy implications. State cigarette taxes have been on the rise for ten years, doubling between 2002 and 2007 alone. With the 2009 reauthorization of the State Children's Health Insurance Program,[4] the tax portion of a pack of cigarettes in some areas can be more than half of the overall prices of the product. As cigarette prices increased at retail stores, more consumers began to buy

[2] Gyindon, G.E., Driezen, P., Chaloupka, F.J., and Fong, G.T., "Cigarette Tax Avoidance and Evasion: Findings from the International Tobacco Control Policy Evaluation Project." Nov. 13, 2013, *available at* http://tobaccocontrol.bmj.com/content/early/2013/11/13/tobaccocontrol-2013-051074/T1.expansion.html.

[3] *See* Department of Interior Proposed Rule, "Federal Acknowledgment of American Indian Tribes," 79 Fed. Reg. 30766 (May 29, 2014).

[4] Pub. L. no. 111-3.

cigarettes online.

[5] This has led to huge losses of government revenues and undercuts state tobacco policy.[6] The State of New York loses at least $1.7 billion a year in tax revenue and 6,700 jobs on account of cigarette tax evasion.[7] Washington State estimates that it loses $336 million per year in unpaid cigarette taxes.[8]

Although a substantial majority of recognized tribes in the United States do not sell tobacco online, those that do often engage in the same tax evasion schemes as tribal brick-and-mortar retailers by selling tax-free products to non-Native Americans. In addition, the Internet makes it easy to sell cigarettes from low tax states into high tax states without collecting the taxes required in the purchaser's state (see below). Internet sellers have exploited this fact to evade taxes.

The advent of the Internet, and particularly by the lure of websites touting "tax-free" cigarette sales in the face of increasing excise taxes, has generated a significant increase in mail order cigarette sales.[9] Often times, these are black market cigarettes that are not regulated in any way. Indeed, the Internet has been a tremendous tool for purveyors of black market cigarettes; absent additional legal obstacles, this trend will continue.

Although there is minimal research quantifying the extent of damage this does to state coffers, a 2001 study by Forrester Research, Inc.[10] projected that because of tax-evading Internet cigarette sales, states lost $200 million in revenues in 2001. Of course, the exponential expansion of the Internet leads one to deduce that this number is dramatically higher today. Indeed, according to one of the most recent formal surveys, there were more than 700 Internet websites selling cigarettes to U.S. consumers in 2006, up from only a handful in the late 1990s.[11]

[5] Ribisl, K.M., Kim, A.E., and Williams, R.S.; "Internet Cigarette Sales Knowledge Asset," Web Site created by the Robert Wood Johnson Foundation's Substance Abuse Policy Research Program; October 2007. *Available at* http://saprp.org/knowledgeassets/knowledge_detail.cfm?KAID=3.

[6] *Id.*

[7] "Cigarette-Tax Evasion Costs New York, Illinois Millions," CSP News, December 13, 2012. *Available at* http://www.cspnet.com/category-news/tobacco/articles/cigarette-tax-evasion-costs-new-york-illinois-millions.

[8] Washington State Department of Revenue, "Cigarette Tax Evasion Estimate – FY 2013." March 12, 2014. *Available at* http://dor.wa.gov/Docs/Reports/Cig_Tax_Evasion_FY13.pdf.

[9] Jamie F. Chriqui, Kurt M. Ribisl, Raedell M. Wallace, Rebecca S. Williams, Jean C. O'Connor, and Regina el Arculli, "A comprehensive review of state laws governing Internet and other delivery sales of cigarettes in the United States." Nicotine & Tobacco Research, Vol. 10, No. 2 (Feb. 2008) 253-265, at 253.

[10] Rubin, R. et al., Online Tobacco Sales Grow, States Lose, Forrester Research, Inc., April 27, 2001, available at: http://www.forrester.com/er/research/brief/excerpt/0,1317,12253,00.html.

[11] Campaign for Tobacco Free Kids, "Internet Sales of Tobacco Products – Reaching Kids & Evading Taxes," April 28, 2008, available at http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/internet.

Enforcement is needed to deal with this problem. Congress did its part on the tax front in the PACT Act, and the Family Smoking Prevention and Tobacco Control Act provided the FDA's Center for Tobacco Products with the power to enforce other laws (such as prohibitions against underage sales) against Internet sellers. These laws need to be enforced in order to stem the tide of tax evasion and illicit sales.

Phony Pipe Tobacco

In 2009, Congress raised tobacco taxes to help fund the State Children's Health Insurance Program ("S-CHIP"). As part of this effort, Congress created a wide disparity between the taxes imposed on "roll your own" ("RYO") cigarette tobacco ($24.78/lbs) and the taxes imposed on pipe tobacco ($2.83/lbs).

Once these tax increases took effect, certain tobacco manufacturers began evading the tax increase on cigarette and RYO by relabeling their RYO tobacco as "pipe tobacco." The newly labeled "pipe tobacco" is in fact RYO tobacco; the only difference between the two products is the label. In fact, at NACS's annual trade show, a manufacturer freely admitted to NACS staff that this was common industry practice. Consumers are well aware that so-called "phony pipe" tobacco is in fact suitable (indeed, designed for) for cigarettes – and it is offered and advertised to be used for that purpose.

In the MAP-21 highway reauthorization legislation enacted in 2012,[12] Congress recognized this growing problem. MAP-21 included a provision stipulating that retailers who provide in-store access to a cigarette-rolling machine that produces cigarettes out of "phony pipe" tobacco are "tobacco manufacturers." This status imposed a variety of regulatory obligations on retailers, and achieved its intended effect of dramatically reducing the number of retailers that would allow their customers to produce cigarettes in the store using "pipe" tobacco. NACS supported that provision, and thanks the Committee for its role in helping pass that legislation.

Nonetheless, more than two years later, the problem still exists. Rather than customers using a retailer's machine to "roll their own" tobacco, they have begun purchasing the phony pipe tobacco and simply rolling their own cigarettes off-site. NACS would welcome the opportunity to work with the Committee to identify further measures that can be taken to end this practice once and for all.

[12] Pub. L. no. 112-14.1

Black Market Sales Arising from State Tax Disparities

There is a wide disparity in the amount that different states tax tobacco products. New York, for example, has a $4.35 tax on each package of cigarettes, while Georgia has a $0.37 tax on each package. This has led to a black market for cigarettes whereby individuals purchase cigarettes in "low tax states" and sell them to smokers in “high tax states,” causing the latter to lose out on significant amounts of revenue. Indeed, smuggled cigarettes make up substantial portions of cigarette consumption in many states, and greater than 25 percent of consumption in 12 states.[13] Enforcement efforts to prevent this type of tax evasion would benefit from more federal efforts. States are at a disadvantage trying to fight these sales on their own due to the fact that many activities furthering the schemes take place in other states. The inherently interstate nature of these crimes puts federal enforcement front and center in the fight against tax evasion.

Conclusion

NACS welcomes the attention that the Committee is bringing to this issue. Please feel free to contact me directly if I can be of any further assistance.

Lyle Beckwith
Senior Vice President
Government Relations
National Association of Convenience Stores
(703) 518-4220
Lbeckwith@nacsonline.com

[13] Henchman, Joseph, Drenkard, Scott. “Cigarette Taxes and Cigarette Smuggling by State.” March 19, 2014. *Available at* http://taxfoundation.org/article/cigarette-taxes-and-cigarette-smuggling-state.