STATE OF HAWAII

DEPARTMENT OF THE ATTORNEY GENERAL

TOBACCO ENFORCEMENT UNIT'S

FY 2002 ANNUAL REPORT

PURSUANT TO

ACT 249, SESSION LAWS OF HAWAII 2000

AND

ACT 270, SESSION LAWS OF HAWAII 2001

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INTRODUCTION[1]

The Tobacco Enforcement Unit (Unit) was formed on July 1, 2000[2] in response to the Attorney General's obligation to enforce the: Tobacco Master Settlement Agreement (MSA); Hawaii Revised Statutes Chapter 675 (HRS Chapter 675, State's Tobacco Liability Act "TLA"); and, the cigarette tax stamp requirements and prohibition against the sale of Gray Market[3] cigarettes as codified in Hawaii Revised Statutes Chapter 245 (HRS Chapter 245).

The Unit is comprised of a unit supervisor, cigarette tax prosecutor, MSA civil prosecutor, legal clerk, legal assistant, and 5 criminal investigators. An investigator/auditor is being sought to complete the Unit.

In 2002, the State received in excess of $43.7 million in MSA settlement moneys. As of December, 2002, the State has received in excess of $130 million in MSA settlement moneys.

Due to diligent enforcement, cigarette tax revenues for Fiscal Year 2002 (FY 2002) increased $10 million or approximately 21% over the comparable period in FY 2001. Moreover, vigorous enforcement has significantly contributed to the $22 million or approximately 56% increase in cigarette tax revenues in FY 2002 over FY 2000.

FY 2000	$40,049,539
FY 2001	$51,739,469
FY2002	$62,609,477

1 Act 249, Session Laws of Hawaii 2000 (which created the cigarette tax stamp law), requires the Department of the Attorney General to report to the Legislature no later than twenty days prior to the convening of each of the regular sessions of 2002 and 2003 on its activities relating to Act 249, including expenses, fines, penalties collected, and forfeitures. In addition, Act 270, Session Laws of Hawaii 2001 (which created the fund to enforce the Tobacco Master Settlement Agreement), requires the Department of the Attorney General to report to the legislature on its activities relating to the receipts and expenditures from the Tobacco Enforcement Special Fund.

2 In keeping with the "Diligent Enforcement" requirements of the MSA the Department of the Attorney General was engaged in on-going and continuous enforcement efforts prior to the establishment of the Unit in July of 2000.

3 Cigarettes that are clearly marked “Tax Exempt” that are not intended for sale in the United States or fail to bear the proper labeling and Surgeon General's Warning as mandated by Federal Law.

TOBACCO MASTER SETTLEMENT AGREEMENT

A. Background

On November 23, 1998, leading United States tobacco manufacturers, entered into a settlement agreement, entitled the Tobacco Master Settlement Agreement (MSA), with 46 states, including Hawaii. The MSA obligates these manufacturers, in return for a release of past, present, and certain future claims against them to pay substantial sums to the settling states (tied in part to the volume of tobacco product sales). The Attorney General of each state is responsible for enforcing the provisions of the MSA.

B. MSA Payments

MSA Payments are comprised of two types:

--Initial Payments: These initial payments are payments to be received annually beginning January 10, 2000 thru January 10, 2003. The last initial payment will be on January 10, 2003.

1999	2000	2001	2002	SUBTOTAL
$14,860,227.69	$12,943,949.44	$11,659,558.77	$12,701,627.03	$52,165,362.93

--Annual Payments: These annual payments are payments to be received beginning April 15, 2000 and on April 15 of each year thereafter in perpetuity.

1999	2000	2001	2002	SUBTOTAL
N/A	$20,812,530.51	$24,470,334.60	$31,351,126.11	$77,957,085.39
				$130,122,448.32

C. Duties of the Attorney General and State's Tobacco Liability Act

In conjunction with the MSA, the Attorney General of Hawaii is tasked with enforcing the State's Tobacco Liability Act (TLA), HRS Chapter 675.

The purpose of the TLA is to hold tobacco product manufacturers accountable for the harm caused by the sale of cigarettes to citizens of the State. As stated in the preamble to HRS Chapter 675:

> It is the policy of the State that financial burdens imposed on the State by cigarette smoking be borne by tobacco product manufacturers rather than the State to the extent that such manufacturers either enter into a settlement with the State or are found culpable by the courts . . . It would be contrary to the policy of the State if tobacco product manufacturers who determine not to enter into such a settlement with the State could use

> a cost advantage to derive large, short-term profits . . . It is thus in the interest of the State to require that such manufacturers establish a reserve fund to guarantee a source of compensation and to prevent such manufacturers from deriving large short-term profits and then becoming judgment-proof before liability may arise[4].

Enforcement of the MSA and HRS Chapter 675

A crucial relationship exists between the MSA and the TLA. The MSA and TLA represent affirmative steps toward holding tobacco manufacturers responsible for the many financial burdens imposed on the State. HRS Chapter 675 requires any tobacco product manufacturer selling cigarettes to consumers within the State (whether directly or through a distributor, retailer or similar intermediary or intermediaries) to either become a participating manufacturer and generally perform its financial obligations under the MSA or place funds into an escrow account to establish a reserve fund to guarantee a source of compensation to the State should such tobacco product manufacturers be found culpable by the courts.

With regard to the enforcement of the MSA and HRS Chapter 675, the Unit has identified 26 Non-Participating Manufacturers; a non-participating manufacturer (NPM) is a tobacco product manufacturer who has not entered into the tobacco master settlement agreement, whose product is being sold in the State. In order to identify such NPMs, it was necessary for the Unit to develop a system that would:

(1) Identify NPMs and their products,
(2) Gather and track information on NPM product,
(3) Notify NPMs of their obligations under HRS Chapter 675. The Unit accomplished this task by mailing 670 letters to tobacco product manufacturers (worldwide) advising them of the requirements of HRS Chapter 675 and related statutes.
(4) Follow through with assistance to effectuate compliance.

How was this done? Armed with a list of wholesalers and distributors the Unit created a reporting form, mailed the form to the wholesalers and distributors, and started to gather information based on responses and invoices submitted to the Unit by the wholesalers and distributors. Based on the information contained in the invoices the Unit compiled a list of NPM manufacturers and brands whose product is being sold in Hawaii. The Unit's list was supplemented by information from Alaska and other states that were willing to share their lists of NPMs and brands. In addition, the Unit will continue to actively investigate and identify brands of cigarettes that are on store shelves in an attempt to identify all of the NPMs who have cigarettes for sale in Hawaii.

Ferreting out individual manufacturers and their respective brands is a time consuming process. Once an NPM is identified as having sales within the State, a notice is sent to the NPM. When an NPM's sales data is accumulated a formal demand is sent to

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[4] HRS Chapter 675, §675-1.

the NPM for each year in which it had sales in Hawaii. One complication is cigarettes ordered and imported to the State by entities other than known wholesalers and distributors, i.e., cigarettes are often ordered via the Internet or by mail order. Retail inspections are the key to uncovering Internet or mail order shipments. In conversations with storeowners the Unit has learned of another complication, peddlers are offering cigarettes bought at military bases to merchants.[5] One may ask, "What does this have to do with enforcement of the MSA?" The simple answer is that NPM sales and untaxed cigarette sales affect the amount of monies available for disbursement under the MSA. An NPM who elects not to join the MSA and who does not comply with the escrow requirements of Chapter 675 enjoys a price advantage over other compliant tobacco manufacturers. This price advantage has the potential of luring consumers away and thus affecting the market share of the participating manufacturers'. That point has been made clear with the recent disbursement of settlement monies where all states' allocations were reduced due to an increase in NPM market share.

It should be noted that the MSA requires the State to "Diligently Enforce" the requirements of the "model statute" (codified as HRS Chapter 675 (TLA)). Failure to "diligently enforce" the TLA may result in a state losing a significant portion of its MSA payments. "Diligent Enforcement" in the context of MSA enforcement has not been clearly defined. However, we believe that "Diligent Enforcement" includes:

(A) Identification of the NPMs and the number of NPM cigarettes sold in the State,
(B) Notification to the NPMs of their obligations to establish and fund an escrow in accordance with HRS Chapter 675, and
(C) The filing of complaints in court seeking compliance with the HRS Chapter 675.

MSA Enforcement Activities in Calendar Year 1999

- 1999 NPM sales totaled 3,845,053 cigarettes.

- In 1999 the Unit identified 20 NPMs who sold cigarettes in the State, 14 of those NPMs have opened escrow accounts. HRS Chapter 675 requires NPMs selling cigarettes (directly or indirectly) to consumers within the State to either join the MSA or place funds into an escrow account to establish a reserve fund to guarantee a source of compensation to the State.

- The Unit initiated lawsuits against 6 NPMs for NPM sales in 1999.

- Of the 6 NPMs who are non-compliant, 3 should have placed amounts in escrow of less than $75.

5 In the 2001 legislative session, the Attorney General successfully introduced legislation to further clarify that the resale of military cigarettes is prohibited.

- While the overall NPM compliance rate for 1999 is 70%, the 14 who have opened escrow accounts represent 96.3% of the NPM product sold in the State.

- Star Tobacco the largest NPM has funded an escrow account for 1999.

MSA Enforcement Activities in Calendar Year 2000

- 2000 NPM sales totaled 4,848,610 cigarettes.

- The Unit identified 26 NPMs who sold cigarettes in the State. Of those 26 NPMs, 17 have opened escrow accounts.

- The Unit initiated lawsuits against 8 NPMs for NPM sales in 2000. The Unit is accumulating additional data on the remaining NPM in anticipation of litigation.

- Of the 9 NPMs who are non-compliant, 5 should have placed in escrow amounts of less than $75.

- While the overall compliance rate for 2000 is 65%, the 17 who have opened escrow accounts represent 95.6% of the NPM product sold in the State.

- Star Tobacco the largest NPM has funded an escrow account for 2000.

MSA Enforcement Activities in Calendar Year 2001

- 2001 NPM sales totaled 8,990,357 cigarettes.

- The Unit identified 22 NPMs who sold cigarettes in the State. Of those 22 NPMs, 14 have opened escrow accounts.

- The Unit initiated lawsuits against 6 NPMs for NPM sales in 2001. The Unit is accumulating additional data on the remaining 2 NPMs in anticipation of litigation.

- Of the 8 NPMs who are non-compliant, 1 should have placed in escrow an amount of less than $75.

- While the overall compliance rate for 2001 is 64%, the 14 NPMs who have opened escrow accounts represent 81% of the NPM product sold in the State.

- Star Tobacco the largest NPM has funded an escrow account for 2001.

MSA Enforcement Activities in Calendar Year 2002

- Lawsuits were filed against 11 NPMs for non-compliance in prior years. Lawsuits were launched against cigarette manufacturers located in China, Greece, India, and Italy.

- Settlement was reached with 1 NPM once the State initiated a lawsuit.

- 3 Non Compliant NPMs joined the MSA.

- Default judgments are being sought as appropriate.

- The Unit is in the process of accumulating data on 20 NPMs.

CIGARETTE TAX STAMP ENFORCEMENT

The 2000 Legislature recognized the need for a mandatory cigarette tax stamp system as a means, "to assess, collect, and enforce the cigarette and tobacco tax". The Conference Committee Report to S.B. No. 2486, S.D.2, H.D. 2, C.D. 1 (2000)[6] states:

> . . . [E]nforcement of the current system of collecting cigarette and tobacco taxes is sporadic, haphazard, and ineffective, resulting in uncollected potential tax revenue. The current system of filing of returns by licensed dealers is in effect a system of voluntary compliance. Persons may try to sell cigarettes and tobacco products without obtaining a license, or could have a license and not file a return or understate the income on the return.

The Conference Committee also recognized that obtaining actual proof of large-scale black market cigarette sales is nearly impossible due to the nature of the activity, which is necessarily surreptitious, and the limited available resources. Nonetheless, the Conference Committee felt that actual proof of magnitude of the black market was unnecessary, "judging from the anecdotal evidence existing and continuing over a fifteen-year period that a black market exists"[7].

With these concerns in mind, HRS Chapter 245 was amended to require that the tax imposed under HRS Section 245-3, upon the sale or use of cigarettes shall be paid by licensees through the use of stamps. As a result, beginning January 1, 2001, a licensee or its authorized agent or designee was required to affix a stamp to the bottom of each individual package of cigarettes prior to distribution. Beginning April 1, 2001, no individual package of cigarettes shall be sold or offered for sale to the general public unless affixed with the stamp as required by HRS Chapter 245[8]. Diligent enforcement on the part of the Unit has determined the evasion of cigarette taxes as amounting to at least $22 million as evidenced by the increase in cigarette tax revenues of $22 million in FY 2002 over FY 2000.

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[6] ACT 249 Session Laws of Hawaii (2000), codified as amendments to HRS Chapter 245.

[7] With these concerns in mind, HRS Chapter 245 was amended to require that the tax imposed under HRS Section 245-3, upon the sale or use of cigarettes shall be paid by licensees through the use of stamps. As a result, beginning January 1, 2001, a licensee or its authorized agent or designee was required to affix a stamp to the bottom of each individual package of cigarettes prior to distribution. Beginning April 1, 2001, no individual package of cigarettes shall be sold or offered for sale to the general public unless affixed with the stamp as required by HRS Chapter 245.

[8] In 2002, the Department of the Attorney General introduced legislation that removed the sunset date of June 30, 2006 from the cigarette tax stamp requirements of Haw. Rev. Stat. 245.

Wholesalers and Distributors

Beginning in July 2001, the Unit worked closely with the wholesalers and dealers (who were licensed stampers) to facilitate the conversion to stamping. The Unit attended numerous meetings in July and August with the Department of Taxation and the licensed stampers to address questions dealing with tax stamping. The Unit also met with the Department of Taxation and the provider of the tax stamps (Meyercord Corporation) to facilitate the acquisition of a tax stamp for the program. Beginning in January 2001, the Unit began to inspect stampers for compliance with the tax stamp program. Six of the 112 felony arrests for tax stamp violations have involved licensed stampers.

Retail Store Inspections and Arrests

Beginning April 1, 2001, the Department of the Attorney General began a vigorous campaign to seek out those who were violating the cigarette tax stamping requirements of HRS Chapter 245.

- There are approximately 1,166 known retail establishments: 766 on Oahu, 165 on Hawaii, 163 on Maui, and 72 on Kauai. This total does not include restaurants, bars, food-vans, or peddlers at swap meets. Inspections have been conducted on all of the major islands. Felony arrests have been made on the islands of Oahu, Maui, Hawaii, and Kauai.

- Over 1,095 establishments have been inspected statewide for tax stamp compliance.

- Inspections have resulted in over 112 felony arrests and the seizure of over 2,000,000 illegal cigarettes.

- "Gray Market" cigarettes have been identified and in excess of 900 cartons of such cigarettes have been confiscated.

- Criminal fines in excess of $100,000 have been assessed against thirty entities (businesses or individuals) for violations of Chapter 245.

Coordination with Federal and other States' Agencies

The Unit has worked with U.S. Customs in joint investigations of persons smuggling contraband cigarettes into the State from foreign countries.

- The Unit has worked with U.S. Customs and has interfaced with the Federal Bureau of Alcohol Tobacco and Firearms, the Royal Canadian Mounted Police, and Canadian Customs and Revenue. In addition, the Unit has developed working relationships with the relevant enforcement agencies in the states of California, Oregon, Washington, and Arizona.

"Gray Market" Contraband

"Gray Market" Cigarettes clearly marked “Tax Exempt” have been found in the State.[9] These cigarettes are manufactured overseas in such places as: the Philippines, Switzerland, China, Southeast Asia, and Colombia representing a multitude of brands and cigarette manufacturers. In order to address the “Gray Market” problem relationships are being established and information is being shared with the taxing and regulatory authorities in California, Oregon, Washington, Michigan, Florida, Vermont, Utah, Alaska, and Canada. The Unit has also been in contact with the U.S. Post Office, Federal Bureau of Alcohol, Tobacco, and Firearms (ATF), Internal Revenue Service, U.S. Customs Service, Canadian Customs Service, and the Royal Canadian Mounted Police with regard to “Gray Market” cigarettes and other cigarette related issues. The Unit is aware of an attempt by certain mainland distributors to mask or re-label “Tax Exempt” cigarettes in order to avoid prosecution for the sale of “Gray Market” cigarettes.

"Gray Market" cigarettes also include cigarettes that have been imported for sale or distribution that fails to meet Federally mandated labeling requirements. These are the types of cigarettes that are seized in the Unit's joint interdiction efforts with U.S. Customs at the airports and are often found at small grocery and liquor stores. These types of cigarettes are most often smuggled into the State from Asia, Southeast Asia, the South Pacific, and the Philippines.

Counterfeit Tax Stamps

In interfacing with the enforcement entities in the states of California, Washington, and Oregon the Unit has become aware of the prevalence of counterfeit tax stamps in these jurisdictions. The motivation for criminal elements to become involved in counterfeit tax stamping is clear: Hawaii’s cigarette tax rate is the fifth highest in the nation at $.06/cigarette or $1.20/pack of 20[10]. A counterfeit tax stamp that is offered for sale at a price[11] below the $1.20/pack rate will provide a significant price advantage over those who sell properly stamped cigarettes. It is important to note that counterfeit Hawaii tax stamps are in circulation. The Unit is engaged in ferreting out the source of the counterfeit tax stamps.

Half-Stamping

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9 The Unit confiscated 209 cartons of "Gray Market" cigarettes that were clearly marked “For Export Only” and their sale would have clearly cut into the market share of the Participating Manufacturers had they made their way into Hawaii's stream of commerce.

10 At present, the states of New York, New Jersey, and Massachusetts have the highest tax rate of $1.50/per pack. Washington has the second highest tax rate at $1.425/per pack. Rhode Island has the third highest tax rate at $1.32/per pack. Michigan has the fourth highest tax rate at $1.25 per pack.

11 Counterfeit tax stamps may range in price from $.15 to $.50 per stamp.

Investigations[12] have resulted in arrests for selling half-stamped or partially stamped packs of cigarettes. By placing a half-stamp on the bottom of a package of cigarettes the cigarette tax is being evaded. The cigarette tax on a pack of cigarettes is equal to $1.20. By placing a half-stamp on the bottom of a pack an entity is able to stamp two packs for the price of one (i.e., $.60/per pack).

Continuing Enforcement

In order to continue its enforcement activities the Unit will be conducting surprise inspections of: wholesalers and distributors; cigarette vending machines; and retail establishments throughout the State. The Unit will also conduct controlled purchases of cigarettes as a spot check of retail compliance.

Cigarette Tax Revenues

There has been a significant increase in the amount of cigarette tax revenues since the implementation of the Tax Stamp program on January 1, 2001. For the fiscal year that ended July 31, 2001, cigarette tax revenues were $11,000,000 or 29% higher than they were FY 2000 even though the tax stamp program was in effect only half of the fiscal year and effective enforcement began at the retail level with only 3 months left in the fiscal year.

FY 2000	FY 2001	INCREASE
$40,049,539	$51,739,469	$11,689,930

The increase is even more dramatic when comparing the fiscal period ending June 30, 2002. The State collected $62,609,477 in cigarette tax revenues for FY 2002. The State collected $40,049,539 in cigarette tax revenues over the same period in FY 2000. Diligent enforcement has yielded an increase of over $22 million or approximately 56%!

FY 2000	FY 2002	INCREASE
$40,049,539	$62,609,477	$22,559,938

$22 million dollars in increased cigarette tax revenues provides clear evidence that the sale of untaxed cigarettes was firmly entrenched and flourishing with sales of at least 22,559,938 packs or 2,255,993 cartons of cigarettes. It is noteworthy that cigarettes of this quantity will easily fill 46 forty-foot shipping containers[13].

- Discussions with Federal and other state law enforcement agencies have made it clear that cigarette tax evasion is rampant in many jurisdictions. Discussions

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12 Arrests were made for half-stamping in November 2001. At that time, the Unit seized 12,879 packs of which, 2,639 packs were half-stamped and 10,240 packs were unstamped.

13 Each 40-foot container holds 960 master cases containing 50 cartons each.

with officials from the State of California indicate that they estimate that tax losses from cigarette smuggling and counterfeit stamps costs the State of California $130 million to $262 million dollars in lost revenue per year. The State of Washington estimates its lost revenues to be $106 million in cigarette tax revenues. The State of Oregon estimates a $20 million to $50 million-dollar gap in actual cigarette consumption versus taxed consumption.

2002 FUNDING/EXPENDITURES:

Funding for Fiscal Year 2002:

- The 2001 legislature appropriated moneys for MSA and cigarette tax stamp enforcement. Act 270 Session Laws of Hawaii (2001), S.B. 992 appropriated:

- $350,000 for MSA enforcement and

- $700,000 for cigarette tax stamp enforcement.

Expenditures for Fiscal Year 2002:

- MSA Enforcement: $147,024

- Cigarette Tax Stamp Enforcement: $441,388

TOBACCO ENFORCEMENT UNIT'S EXPENDITURES FY 2002

	MSA		TAX STAMP	
APPROPRIATION		350,000		$700,000
PERSONNEL COSTS				
SALARIES AND FRINGE	$110,322		$306,396	
OPERATIONAL EXPENSES & OVERHEAD COSTS				
LEASE RENT	$19,897.49		$19,897.49	
FURNITURE, FIXTURES, & EQUIPMENT	$3763.99		$3,763.99	
COMPUTERS	$2,105.63		$7,088.49	
TRAVEL	------		$11,804.49	
PHONES	$2,010.86		$7,810.41	
OFFICE EQUIPMENT	$3,514.47		$3514.47	
SUPPLIES	$4,157.44		$4,157.44	
INVESTIGATION EQUIPMENT	--------		$54,822.80	
EVIDENCE STORAGE	--------		$6,608.48	
MILEAGE	-------		$12,961.52	
MISC. EXPENSES	$2,562.44		$2,562.44	
LITIGATION EXPENSES	------		------	
TOTAL EXPENSES		($147,024)		($441,388)
APPROPRIATION BALANCE[14]		$202,976		$258,612

CONCLUSION

The unit's activities are critical and time-sensitive if the State is to receive its fair share of the "Tobacco Settlement Funds".

Effective enforcement of the State's Gray Market Statute and Cigarette Tax Stamp requirements will allow the Unit to identify and address any problems that the State may have with black/gray market cigarette sales, and increase State tax revenues by providing a more effective means to assess, collect, and enforce the provisions of HRS Chapter 245.

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14 Imbedded in the appropriation balances of $202,976 and $258,612 are personnel costs that were not incurred due to the positions not being filled for the entire fiscal year. Due to the "Temporary" classification of the positions it was difficult for the Unit to find qualified individuals to fill its investigative and support positions. The support positions of clerk and legal assistant were not filled until December 2001. The investigator temporary positions were filled in October 2001. The auditor position is yet to be filled. As a result, funds that would otherwise have been used for salaries in the amount of $51,678.26 reverted to the Tobacco Enforcement Special Fund and $193,604.32 reverted to the Cigarette Tax Enforcement Special Fund. Investigator inspection expenses were limited throughout the fiscal year as a result approximately $60,000 (Travel $35,000 and Overtime $25,000) reverted to the Cigarette Tax Stamp Enforcement Special Fund.

We will be recommending that the 2003 Legislature pass the following measures to assist the Unit with its' mission:

- Legislation that would prohibit the distribution or stamping of cigarettes manufactured by a tobacco product manufacturer who violates the requirements of Chapter 675. These cigarettes would then be treated in a manner similar to "Gray Market" cigarettes and regarded as contraband. Criminal sanctions will be sought for these violations.

- Legislation that expands reporting requirements by Tobacco Product Manufacturers under Chapter 486P in order to better enforce the requirements of Chapter 675. In addition, allowing the Attorney General to seek an injunction against the sale of cigarettes against any entity that fails to adhere to the requirements of Chapter 486P.

- Legislation that harmonizes the treatment of cigarettes seized and forfeited as contraband under the "Gray Market" statute with the forfeiture provisions under the tax stamping provisions of chapter 245.

- If necessary, an appropriation measure that appropriates the funds necessary from the cigarette tax stamp enforcement special fund and tobacco enforcement special fund for Fiscal Year 2004 and Fiscal Year 2005 so that the Unit may continue its mission.