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REPORT ON THE TOBACCO ENFORCEMENT SPECIAL FUND

Pursuant to Section 28-15(d), Hawaii Revised Statutes

Fiscal Year 2010 - 2011

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I. INTRODUCTION

Section 28-15(d), Hawaii Revised Statutes (HRS), requires the Department of the Attorney General to submit a report to the Legislature, no later than twenty days prior to the convening of each regular session, providing an accounting of the receipts and expenditures of the Tobacco Enforcement Special Fund.

On July 1, 2000, the Department's Tobacco Enforcement Unit was created to enforce the Tobacco Master Settlement Agreement, the state Tobacco Liability Act, and the state Cigarette Tax and Tobacco Tax Law. The Unit is composed of a unit supervisor, a Master Settlement Agreement civil prosecutor, a cigarette tax prosecutor, an auditor[1], seven criminal investigators, a legal assistant, and a legal clerk.

II. TOBACCO MASTER SETTLEMENT AGREEMENT

A. Background

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

B. Master Settlement Agreement Payments

There are three types of Master Settlement Agreement payments:[2]

(1) Initial Payments were received annually from January 10, 1999 through January 10, 2003.

Fiscal Year		Amount of Initial Payment
1999-2000		27,804,177.13
2000-2001		11,659,558.77
2001-2002		12,701,627.03
2002-2003		12,864,378.74
	Total	$ 65,029,741.67

[1] The auditor position was not filled in FY 2010-2011 in part due to budget restrictions.

[2] In reports to the Legislature before FY 2003-2004, Master Settlement Agreement payments were reported on a calendar year basis. Since FY 2003-2004, Master Settlement Agreement payments have been reported on a cash basis as received in each fiscal year.

(2) Annual Payments began on April 15, 2000, and are scheduled to be received on April 15 of each year in perpetuity.

Fiscal Year	Amount of Initial Payment
1999-2000	20,811,042.90
2000-2001	24,471,822.21
2001-2002	32,674,220.28
2002-2003	31,845,690.90
2003-2004	37,793,157.48
2004-2005	38,357,998.54
2005-2006	35,212,822.31
2006-2007	36,857,166.01
2007-2008	37,299,996.79
2008-2009	41,132,845.88
2009-2010	34,230,792.73
2010-2011	32,453,603.85
Total	$ 403,141,159.88

(3) Strategic Contribution Payments began on April 15, 2008, and are scheduled to be received on April 15 of each year through 2017.

Fiscal Year	Amount of Strategic Contribution Payment
2007-2008	18,762,802.27
2008-2009	19,225,534.21
2009-2010	16,691,299.06
2010-2011	15,211,574.73
Total	$ 69,891,210.27

In fiscal year (FY) 2010-2011, the State received $47,665,178.58 in Master Settlement Agreement moneys. The total amount of Master Settlement Agreement payments received by Hawaii as of the end of FY 2010-2011 are as follows:

Initial Payments	65,029,741.67
Annual Payments	403,141,159.88
Strategic Contribution Payments	69,891,210.27
Total	$ 538,062,111.82

C. Tobacco Liability Act (Chapter 675, HRS)

The Master Settlement Agreement requires the State to diligently enforce the requirements of the "model statute," which was enacted as the Tobacco Liability Act. The Master Settlement Agreement and the Tobacco Liability Act represent affirmative steps toward holding tobacco manufacturers accountable for the harm caused by the sale of cigarettes to citizens of Hawaii. Section 675-1(d), HRS, states:

> 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 by the State to the extent that such manufacturers either determine to enter into a settlement with the State or are found culpable by the courts.

Section 675-1(f), HRS, states:

> It would be contrary to the policy of the State if tobacco product manufacturers who determine not to enter into such a settlement could use a resulting 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.

The Tobacco Liability Act requires any tobacco product manufacturer selling cigarettes to consumers in Hawaii – whether directly or through a distributor, retailer, or similar intermediary or intermediaries – to either participate in and perform its financial obligations under the Master Settlement Agreement, or place funds in an escrow account to establish a reserve fund to guarantee a source of compensation to the State if the tobacco product manufacturer is found culpable by the courts. A non-participating manufacturer (NPM) is a tobacco product manufacturer who has not entered into the Master Settlement Agreement.

NPMs who fail to comply with the escrow requirements enjoy a price advantage over those who comply. This price advantage lures consumers away from and decreases the market share of participating manufacturers. In a recent Master Settlement Agreement disbursement, the amounts due to the states were reduced because of a national increase in NPM market share.

In 2003, the Department created a directory of compliant cigarettes and roll-your-own tobacco products. The directory has been posted on the Department's website since October 31, 2003, and has been revised and updated through FY 2010-2011. At the end of FY 2010-2011, 24 compliant tobacco product manufacturers (17 participating manufacturers and 7 NPMs) were listed in the directory, along with a list of 124 authorized brands of cigarettes and roll-your-own tobacco products.

D. Enforcement

Failure to diligently enforce the Tobacco Liability Act may result in a state losing a significant portion of its Master Settlement Agreement payments. "Diligent enforcement" in the context of the Master Settlement Agreement enforcement has not been clearly defined, but we believe that it includes identifying NPMs and the number of NPM cigarettes sold in Hawaii; notifying NPMs of their obligation to establish and fund an escrow in accordance with chapter

675; and filing complaints in court against NPMs who fail to comply with chapter 675. The Department has developed a system that:

(1) Identifies NPMs and their products;
(2) Gathers and tracks information on NPM products;
(3) Notifies NPMs of their obligations under the Tobacco Liability Act and under chapter 486P, HRS, and related statutes (the Department sends letters to tobacco product manufacturers worldwide to advise them of these obligations);
(4) Provides assistance to effectuate compliance; and
(5) Provides the information-gathering and certification protocols necessary to establish and publish the directory of tobacco product manufacturers whose cigarettes and roll-your-own tobacco products are authorized for sale in Hawaii.

The Tobacco Products Reporting statutes (chapter 486P, HRS) facilitate the time-consuming process of identifying individual manufacturers and their respective brands. When a tobacco product manufacturer is identified as having or intending to have sales in Hawaii, the Department notifies the tobacco product manufacturer that it must comply with chapter 486P, including the requirement to register with the Department pursuant to section 486P-5, HRS.

The Department mails a reporting form to wholesalers and distributors, and gathers information from the responses and invoices submitted by the wholesalers and distributors. Based on this information, the Department has compiled a list of NPMs and their brands sold (directly or through distributors, retailers, or similar intermediaries) in Hawaii. The list is supplemented from time to time by lists of NPMs and brands provided by other states. In addition, the Department identifies NPMs that sell cigarettes in Hawaii by investigating cigarette brands on store shelves.

The Department sends formal demands to NPMs that have sales in Hawaii, requiring that they place appropriate sums in a qualified escrow fund in compliance with the Tobacco Liability Act. In FY 2010-2011, while seven NPMS were listed in the directory, only one NPM sold cigarettes to consumers in Hawaii. This one NPM placed $2,872.15 in its qualified escrow fund – a compliance rate of 100 percent.

III. CIGARETTE TAX AND TOBACCO TAX LAW (Chapter 245, HRS)

A. Background

In 2000, the Legislature recognized the need for a mandatory cigarette tax stamp system "to assess, collect, and enforce the cigarette and tobacco tax." The Conference Committee on S.B. No. 2486, S.D. 2, H.D. 2, C.D. 1 (2000) (Act 249, Session Laws of Hawaii 2000), reported:

> [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 Legislature recognized that obtaining proof of large-scale black market cigarette sales is nearly impossible because the activity is surreptitious and the State's resources are limited. Nonetheless, the Legislature concluded, "judging from the anecdotal evidence existing and continuing over a fifteen-year period that a black market exists." With these concerns in mind, chapter 245 was amended by Act 249 to require that the tax on the sale or use of cigarettes under section 245-3, HRS, shall be paid by licensees through the use of stamps. Beginning on January 1, 2001, a licensee or its authorized agent or designee is required to affix a stamp to the bottom of each individual package of cigarettes prior to distribution. Beginning on April 1, 2001, no individual package of cigarettes shall be sold or offered for sale to the public unless affixed with the stamp as required by chapter 245. Beginning in 2000, the Department worked closely with licensed wholesalers and dealers and the Department of Taxation to facilitate the implementation of the cigarette stamp program. In January 2001, the Department began conducting inspections for compliance with the program.

In 2005, the Attorney General proposed a bill to amend chapter 245 to require a permit for the retail sale of cigarettes and other tobacco products, and to require retailers to keep adequate records. These amendments became effective on December 1, 2006 (Act 131, Session Laws of Hawaii 2005). The Retail Tobacco Permit program addresses the problem of cigarettes and other tobacco products being imported to Hawaii by entities other than known wholesalers and distributors; for example, consumers and retail stores often order cigarettes by Internet, telephone, or mail. The record-keeping requirements of the Retail Tobacco Permit program help law enforcement officers determine the sources of cigarettes and other tobacco products sold at retail, and thus help prevent evasion of state taxes.

B. Cigarette Tax Revenues

Since the implementation of the tax stamp program on January 1, 2001, cigarette tax revenues have increased significantly. Cigarette tax revenues increased from $40,049,539 in FY 1999-2000 to $51,739,469 in FY 2000-2001 (an increase of $11,689,930 or approximately 29 percent) even though the tax stamp program was in effect for only half of FY 2000-2001 and effective enforcement began at the retail level only three months before the end of FY 2000-2001. In FY 2010-2011, cigarette tax revenues of $135,647,918 represent an increase of $15,721,177 over the cigarette tax revenues of $119,926,741, which were reported in FY 2009-2010.

Cigarette Tax Revenues by Fiscal Year	
FY 1999-2000	$ 40,049,539
FY 2000-2001	$ 51,739,469
FY 2001-2002	$ 62,609,477
FY 2002-2003	$ 70,586,392

FY 2003-2004	$ 77,541,843
FY 2004-2005	$ 83,135,360
FY 2005-2006	$ 85,702,483
FY 2006-2007	$ 88,771,666
FY 2007-2008	$ 101,560,051
FY 2008-2009	$ 104,433,576
FY 2009-2010	$ 119,926,741
FY 2010-2011	$135,647,918

C. Enforcement

The Department conducts inspections, including unannounced inspections, of wholesalers and distributors, retail establishments, and cigarette vending machines for compliance with the Cigarette Tax and Tobacco Tax Law. Approximately 1,581 retailers hold Retail Tobacco Permits: 959 on Oahu, 227 on Hawaii, 207 on Maui, 102 on Kauai, 14 on Molokai, 8 on Lanai, 62 mobile vendors, 2 out of state vendors. Inspections have been conducted on all of these islands.

- In FY 2010-2011, 736 compliance inspections were conducted statewide.

- Since April 1, 2001, inspections have resulted in more than 160 felony arrests and seizure of more than 2,456,473 illegal cigarettes. Felony arrests have been made on Hawaii, Kauai, Maui, Molokai, and Oahu.

- In FY 2010-2011, 13 criminal tobacco investigations were conducted and 425 cartons (the equivalent of 85,000 cigarettes) were seized. The 13 investigations resulted from cooperative efforts between the Department and United States Customs and Border Protection, and led to seizures at the Honolulu International Airport.

- Since April 1, 2001, the Department has prosecuted 134 tobacco cases, resulting in criminal fines of $192,100.

- In FY 2010-2011, the Unit successfully prosecuted 7 tax cases, which resulted in criminal fines of $43,000 and restitution in the amount of $406,948.38.

- In total, 70 cigarette prosecutions have resulted in court-ordered forfeiture of cigarettes. In addition, the Department has secured 67 civil administrative forfeiture orders for, or stipulations to, the forfeiture of confiscated cigarettes.

D. Gray Market

Gray market cigarettes cut into the market share of participating manufacturers. Gray market cigarettes include cigarettes that have been imported illegally into the United States in violation of federal law, fail to meet federally mandated labeling requirements, or bear an unauthorized brand or trademark. Gray market cigarettes are manufactured overseas in such places as China, Colombia, the Philippines, Southeast Asia, and Switzerland, representing a multitude of brands and cigarette manufacturers. These cigarettes are often smuggled into Hawaii from Asia, the Philippines, Southeast Asia, and the South Pacific, and are often found in small grocery and liquor stores. Some mainland distributors attempt to mask or re-label "Tax Exempt" cigarettes to avoid prosecution for sale of gray market cigarettes.

To address the gray market problem, the Department has established relationships and has historically shared information with the taxing and regulatory authorities of Alaska, Arizona, California, Florida, Michigan, Oregon, Utah, Vermont, Washington, and Canada. The Department has also historically coordinated with the Bureau of Alcohol, Tobacco, Firearms, and Explosives; Internal Revenue Service; United States Customs and Border Protection; United States Postal Service; and Royal Canadian Mounted Police with regard to gray market cigarettes and other cigarette-related issues.

The Department has worked with United States Customs and Border Protection in joint investigations of persons smuggling contraband cigarettes to Hawaii from foreign countries. This cooperative effort has resulted in more than forty investigations of individuals attempting to bring undeclared or under-declared cigarettes to Hawaii. Gray market cigarettes have been seized at airports in these joint interdiction efforts. In 2001, the Department confiscated 209 cartons of gray market cigarettes that were clearly marked "For Export Only".

E. Counterfeit Tax Stamps

Counterfeit tax stamps cost as little as $0.03 to $0.50 per stamp, and therefore create a significant price advantage over vendors who sell properly stamped cigarettes. The Department searches for counterfeit Hawaii tax stamps in order to prevent their circulation.

F. Half-Stamping

Some vendors attempt to evade the cigarette tax by placing a half-stamp on the bottom of a package of cigarettes, thus stamping two packs for the price of one. Investigations have resulted in arrests for selling half-stamped or partially stamped packs. In November 2001, the Department made arrests for half-stamping and seized 12,879 packs, of which 2,639 packs were half-stamped and 10,240 packs were unstamped.

G. Sales by Internet and Mail

Efforts continue in Hawaii and across the nation to address the problem of Internet sales of cigarettes. Significant federal regulation in the form of the Prevent All Cigarette Trafficking Act of 2009 (PACT ACT) was passed in March 2010.

IV. FY 2010-2011 DEPOSITS TO TOBACCO ENFORCEMENT SPECIAL FUND

Master Settlement Agreement funds	350,000
Cigarette tax stamp fees/interest/fines	1,623,986
Total	$ 1,973,986

V. FY 2010-2011 APPROPRIATIONS AND EXPENDITURES

The Legislature appropriated $1,219,158 for Master Settlement Agreement and cigarette tax stamp enforcement for FY 2010-2011. The appropriation was funded by $350,000 from moneys received from the Master Settlement Agreement and $869,158 from cigarette tax stamp fees.

Expenses for FY 2010-2011 totaled $1,012,872.49. The appropriation balance of $206,285.51 includes savings from budget restrictions and furloughs, which took place in FY 2010-2011, and personnel costs savings from unfilled positions. As a result, funds that might otherwise have been expended reverted to the Tobacco Enforcement Special Fund and State General Fund.

APPROPRIATION			**$1,219,158.00**
PERSONNEL COSTS			
Salaries and fringe		$767,548.60	
OPERATIONAL EXPENSES AND OVERHEAD COSTS			
Lease rent	107,204.11		
Fibre Optic Data Connection	9,996.72		
Travel	12,358.89		
Phones	12,760.50		
Office Equipment	5,224.05		
Supplies	607.99		
Mileage	6,423.86		
Miscellaneous expenses	6,595.78.00		
Litigation expenses	14,319.36		
Administration expenses (estimated allocation)	72,036.512		
TOTAL		$245,323.89	
TOTAL COSTS			$1,012,872.49
APPROPRIATION BALANCE			**$206,285.51**