



STATE OF HAWAII

DEPARTMENT OF THE ATTORNEY GENERAL

TOBACCO ENFORCEMENT UNIT'S

FY 2001 ANNUAL REPORT

PURSUANT TO

ACT 249, SESSION LAWS OF HAWAII 2000

AND

ACT 270, SESSION LAWS OF HAWAII 2001

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INTRODUCTION¹

The Tobacco Enforcement Unit (Unit) was formed on July 1, 2000² 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 Market³ 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 6 criminal investigators. An investigator/auditor is being sought to complete the Unit.

In 2001, the State received in excess of \$36 million in MSA settlement moneys. As of December, 2001, the State has received in excess of \$84 million in MSA settlement moneys.

Due to the cigarette tax stamp requirements of HRS Chapter 245⁴ and vigorous enforcement, cigarette tax revenues for the first 10 months of calendar year 2001 jumped \$17 million or approximately 50% more than the comparable period in calendar year 2000!

TOBACCO MASTER SETTLEMENT AGREEMENT

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.

¹ Act 249, Session Laws of Hawaii 2000, 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, 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.

⁴ Cigarette tax stamping began on January 1, 2001.

MSA Payments have been as follows:

--Initial Payments⁵

<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>SUBTOTAL</u>
\$14,860,227.69	\$12,943,949.44	\$11,659,558.77	\$39,463,735.90

--Annual Payments⁶

<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>SUBTOTAL</u>
N/A	\$20,812,530.51	\$24,470,334.60	\$45,282,865.11
			<u>\$84,746,601.01</u>

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 arise⁷.

Enforcement of the MSA and HRS Chapter 675

The relationship between the MSA and HRS Chapter 675 is significant. Taken in tandem 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 consumer's within the State (whether directly or through a distributor, retailer or similar intermediary or intermediaries) to either become a

⁵ 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.

⁶ These annual payments are payments to be received beginning April 15, 2000 and on April 15 of each year thereafter in perpetuity.

⁷ HRS Chapter 675, §675-1.

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 Manufacturers⁸ (NPMs) whose product is being sold in the State. In order to accomplish this task 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.
This was accomplished by the Unit 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.

Ferretting 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 the NPM for each year in which it has sales in Hawaii. One complication is cigarettes being 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.⁹ 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. That point has been made clear with the recent disbursement of

⁸ A non-participating manufacturer is a tobacco product manufacturer who has not entered into the tobacco master settlement agreement.

⁹ In the 2001 legislative session, the Attorney General introduced legislation to further clarify that the resale of military cigarettes is prohibited.

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. What is "Diligent Enforcement"? "Diligent Enforcement" in the context of MSA enforcement has not been clearly defined. It would appear, however, that "Diligent Enforcement" includes identification of the NPMs and the number of NPM cigarettes sold in the State. Notification to the NPMs of their obligations to establish and fund an escrow in accordance with HRS Chapter 675, along with the filing of complaints in court seeking compliance with the HRS Chapter 675 will also serve to evidence "Diligent Enforcement".

MSA Enforcement Activities in Calendar Year 1999

- 1999 NPM sales totaled 3,315,595 cigarettes.
- In 1999 the Unit identified 20 NPMs who sold cigarettes in the State, 12 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 is accumulating additional data on the remaining 8 NPMs in anticipation of litigation.
- Of the 8 NPMs who are non-compliant 6 should have placed amounts in escrow of less than \$75.
- While the overall NPM compliance rate for 1999 is 60%, the 12 who have opened escrow accounts represent 96% 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 15 have opened escrow accounts. The Unit is accumulating additional data on the remaining 11 NPMs in anticipation of litigation.

- Of the 11 NPMs who are non-compliant 8 should have placed in escrow amounts of less than \$75.
- While the overall compliance rate for 2000 is 58%, the 15 who have opened escrow accounts represent 96.9% 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

- 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)¹⁰ 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 went on to recognize 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 to the limitation of 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".

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.

¹⁰ ACT 249 Session Laws of Hawaii (2000), codified as amendments to HRS Chapter 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. Two of the forty 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 Kai. 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 and Kauai.
- Over 400 stores have been inspected statewide for tax stamp compliance.
- Inspections have resulted in over 40 felony arrests and the seizure of over 1,000,000 cigarettes.
- "Gray Market" cigarettes have been identified and 209 cartons of such cigarettes have been confiscated.

Coordination with Federal and other States' Agencies

The Unit has been involved with joint investigations with U. S. Customs of persons smuggling untaxed 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. 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 that are clearly marked "Tax Exempt" have been found in the State¹¹. These cigarettes are manufactured overseas in such places as: the Philippines, Switzerland, 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, and Alaska. The Unit has also been in contact with the U.S. Post Office, Federal Bureau of Alcohol, Tobacco, and Firearms (ATF), and Customs 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.

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 second highest in the nation at \$.05/cigarette or \$1.00/pack of 20¹². A counterfeit tax stamp that is offered for sale at a price¹³ below the \$1.00/pack rate will provide a significant price advantage over those who sell properly stamped cigarettes. Given the amount of counterfeit stamping that pervades the various states it is not a question of if counterfeit stamps will be introduced into Hawaii; rather it is a question of when?

Half-Stamping

Investigations¹⁴ 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 \$1.00. 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., \$.50/per pack).

¹¹ It was through a store inspection that the Unit was able to confiscate 209 cartons of "Gray Market" cigarettes. These cigarettes 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.

¹² At present, only New York at \$1.11/per pack is higher. However, effective January 1, 2002, Washington State's cigarette tax will increase 60 cents per package of 20 cigarettes (from \$0.825 to \$1.425) and 75 cents per package of 25 cigarettes from (\$1.03125 to \$1.78125).

¹³ Counterfeit tax stamps may range in price from \$.15 to \$.20 per stamp.

¹⁴ 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.

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.

The increase is even more dramatic when comparing the period when the tax stamp became effective. The State collected \$51,597,273 in cigarette tax revenues from January, 2001 through October, 2001. The State collected \$34,370,604 in cigarette tax revenues over the same period in 2000. Thus over the comparable 10 months the increase was over \$17 million or approximately 50%!

Cigarette Tax Stamp Revenues for January thru October – 2000 vs. January thru October – 2001

	2000	2001
January	\$3,590,180	\$6,218,988
February	\$2,672,278	\$5,151,921
March	\$3,941,453	\$4,360,968
April	\$3,216,744	\$6,206,979
May	\$3,697,578	\$5,512,420
June	\$2,753,863	\$3,468,793
July	\$3,839,816	\$5,734,134
August	\$3,937,716	\$5,540,853
September	\$2,881,197	\$3,897,993
October	\$3,839,779	\$5,504,224
November*		
December*		
TOTAL	<u>\$34,370,604</u>	<u>\$51,597,273</u>

*Cigarette Tax Revenue figures for November and December, 2001 were unavailable at the time that this report was prepared. November, 2000 Cigarette Tax Revenues were \$3,097,209. December, 2000 Cigarette Tax Revenues were \$3,309,326. For calendar year 2000, including November and December, the total Cigarette Tax Revenues were \$40,777,139.

2001 FUNDING/EXPENDITURES:

Funding for Fiscal Year 2001:

- The 2000 legislature appropriated moneys for MSA and cigarette tax stamp enforcement.
- H.B. 1900, HD1, SD1, CD1 (Executive Budget Bill) appropriated \$200,500 for MSA enforcement.
- SB 2486, SD2, HD2, CD1 (Tobacco Stamp Tax) appropriated \$200,000 for cigarette tax stamp enforcement.

Expenditures for Fiscal Year 2001:

- MSA Enforcement: \$183,570
- Cigarette Tax Stamp Enforcement: \$199,878

	<u>MSA</u>	<u>TAX STAMP</u>
APPROPRIATION	\$200,500	\$200,000
PERSONNEL COSTS		
SALARIES AND FRINGE	\$161,360	\$152,708
OVERHEAD COSTS		
FURNITURE, FIXTURES, & EQUIPMENT	\$6,557	\$6,557
COMPUTERS	\$8,758	\$8,758
TRAVEL	\$3,964	\$3,617
PHONES	\$1,318	\$2,613
OFFICE EQUIPMENT	\$698	\$698
SUPPLIES	\$916	\$1,159
INVESTIGATION EQUIPMENT	-----	\$20,248
EVIDENCE STORAGE	-----	\$3,522
TOTAL EXPENSES	<u>(\$183,571)</u>	<u>(\$199,880)</u>
APPROPRIATION BALANCE	<u>\$16,929</u>	<u>\$120</u>

CONCLUSION

The unit's activities are critical and time-sensitive if the State is to receive its fair share of the "Tobacco Settlement Funds". Further, effective enforcement of the State's Gray Market Statute and Cigarette Tax Stamp requirements will allow the Unit to define, 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.