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GOVERNOR



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December 1, 2023

The Honorable Ronald D. Kouchi
President and Members of the Senate
Thirty-Second State Legislature
State Capitol, Room 409
Honolulu, Hawaii 96813

The Honorable Scott K. Saiki
Speaker and Members of the
House of Representatives
Thirty-Second State Legislature
State Capitol, Room 431
Honolulu, Hawaii 96813

Dear President Kouchi, Speaker Saiki, and Members of the Legislature:

For your information and consideration, I am transmitting a copy of the Department of the Attorney General's Report on the Tobacco Enforcement Special Fund, as required by section 28-15(d), Hawaii Revised Statutes (HRS). In accordance with section 93-16, HRS, I am also informing you that the report may be viewed electronically at <http://ag.hawaii.gov/publications/reports/reports-to-the-legislature/>.

If you have any questions or concerns, please feel free to call me at (808) 586-1500.

Sincerely,

Anne E. Lopez
Attorney General

c: Josh Green, M.D., Governor
Sylvia Luke, Lieutenant Governor
Legislative Reference Bureau (Attn: Karen Mau)
Leslie H. Kondo, State Auditor
Luis Salaveria, Director of Finance, Department of Budget and Finance
Stacey A. Aldrich, State Librarian, Hawaii State Public Library System
David Lassner, Ph.D., President, University of Hawaii

Enclosure

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REPORT ON THE TOBACCO ENFORCEMENT SPECIAL FUND

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

Fiscal Year 2022-2023

Submitted to the Thirty-Second State Legislature
Regular Session of 2024

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I. INTRODUCTION

Section 28-15(d), Hawaii Revised Statutes (HRS), requires the Department of the Attorney General (the Department) 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 (the Special Fund).

On July 1, 2000, the Department's Tobacco Enforcement Unit (the Unit) was created to enforce the Tobacco Master Settlement Agreement, the state Tobacco Liability Act, chapter 675, HRS, the state Cigarette Tax and Tobacco Tax Law, chapter 245, HRS, and the state Tobacco Products Reporting Law, chapter 486P, HRS. The Unit is composed of a unit supervisor, a Master Settlement Agreement civil prosecutor, a cigarette tax prosecutor, seven criminal investigators, a legal assistant, and a legal clerk. On June 1, 2023, the Unit added an auditor to enhance enforcement efforts.

II. TOBACCO MASTER SETTLEMENT AGREEMENT

A. Background

On November 23, 1998, leading United States tobacco manufacturers entered into the Tobacco Master Settlement Agreement (hereinafter Master Settlement Agreement or MSA) with forty-six states, including Hawaii. In consideration for a release of past, present, and certain future claims against them, the MSA 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 MSA.

B. Master Settlement Agreement Payments

There are three types of MSA payments:

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

| 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 |

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

| Year | Amount of Annual 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 |
| 2011-2012 | 33,096,749.95 |
| 2012-2013 | 33,073,205.78 |
| 2013-2014 | 37,420,086.29 |
| 2014-2015 | 32,022,781.47 |
| 2015-2016 | 33,654,568.07 |
| 2016-2017 | 33,211,083.41 |
| 2017-2018 | 26,149,213.01 |
| 2018-2019 | 34,801,958.14 |
| 2019-2020 | 35,309,044.26 |
| 2020-2021 | 37,461,342.15 |
| 2021-2022 | 38,442,830.77 |
| 2022-2023 | 40,862,842.25 |
| Total | \$818,646,865.43 |

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- (3) Strategic Contribution Payments to Hawaii began on April 15, 2008, and were received on April 15 of each year through 2017.

| 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 |
| 2011-2012 | 15,492,087.49 |
| 2012-2013 | 15,505,806.17 |
| 2013-2014 | 15,238,278.95 |
| 2014-2015 | 15,206,293.27 |
| 2015-2016 | 15,612,254.40 |
| 2016-2017 | 15,538,756.05 |
| Total | \$162,484,686.60 |

In fiscal year (FY) 2022-2023, the State received \$40,862,842.25 in MSA moneys. The total amounts of MSA payments received by Hawaii as of the end of FY 2022-2023 are as follows:

| | |
|---|---------------------------|
| Initial Payments | \$ 65,029,741.67 |
| Annual Payments | 818,646,865.43 |
| Strategic Contribution Payments | 162,484,686.60 |
| 2004 Diligent Enforcement Arbitration Settlement of 2004 to 2017 Diligent Enforcement Arbitration issues* | 58,600,584.78 |
| Total | \$1,104,761,878.48 |

*Note: For more details on "2004 Diligent Enforcement Arbitration Settlement of 2004 to 2017 Diligent Enforcement Arbitration issues," refer to section II.F. (pages 8-9).

C. Tobacco Liability Act (Chapter 675, HRS)

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

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, provides:

It would be contrary to the policy of the State if tobacco product manufacturers who decide not to enter 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 MSA, 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. (Section 675-3, HRS). A non-participating manufacturer (NPM) is a tobacco product manufacturer who has not entered into the MSA.

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 (PM).

In 2022, the Department proposed a bill to enable NPMs to assign their interests in any moneys in qualified escrow accounts to the State. A financial institution, acting as the escrow agent, would then be able to petition in court to transfer funds to the State when an escrow account is abandoned. The bill was signed into law on June 17, 2022 (Act 93, Session Laws of Hawaii 2022), and was codified as section 675-4, HRS. Section 675-4 facilitates the closure of abandoned escrow accounts in a timelier fashion, thus making continued administrative monitoring unnecessary. Section 675-4, HRS, also supports tobacco prevention and control as it allows the transfer of funds from the escrow accounts into the State's Tobacco Settlement Special Fund, under chapter 328L, HRS.

D. Enforcement

The biggest arbitration risk to states arising from the MSA involves the NPM Adjustment. Under the MSA, PMs are able to contest the diligent enforcement of states in hopes of reducing the money that they pay into the MSA. Failure to diligently enforce the Tobacco Liability Act may result in a state losing a significant portion of its MSA payments. "Diligent enforcement" in the context of the MSA enforcement had not been clearly defined and was the subject of the lengthy 2003 Diligent Enforcement (DE) Arbitration, which began in 2010 and concluded in 2013. In the 2003 DE Arbitration, the panel concluded that diligent enforcement was an ongoing and intentional consideration of the requirements of a settling state's qualifying statute, and a significant attempt by a settling state to meet those requirements, taking into account a settling state's

competing laws and policies that may conflict with its MSA contractual obligations. The factors considered by the 2003 panel included: collection rate, lawsuits filed, gathering reliable data, resources allocated to enforcement, preventing non-compliant NPMs from future sales, legislation enacted, actions short of legislation, and efforts to be aware of National Association of Attorneys General and other states' enforcement efforts.

On the issue of what constitutes "Units Sold," the 2003 arbitration panel determined that, "as a matter of law," the model statute definition of "Units Sold" is "unambiguous and binding." "Units Sold" is defined in Exhibit T to the MSA as follows:

"Units Sold" means the number of individual cigarettes sold in the State by the applicable tobacco product manufacturer (whether directly or through a distributor, retailer or similar intermediary or intermediaries) during the year in question, as measured by excise taxes collected by the State on packs (or "roll-your-own" tobacco containers) bearing the excise tax stamp of the State [Emphasis added.]

Simply put, the 2003 arbitration panel held that a state's obligation to collect escrow was limited to the NPM cigarettes that could be measured by packs bearing the excise tax stamp of a state.

Hawaii's diligent enforcement efforts and regulatory scheme include identifying NPMs and the number of NPM cigarettes sold in Hawaii in each calendar year; notifying NPMs of their obligation to establish and fund an escrow in accordance with chapter 675, HRS; and filing complaints in court against NPMs who fail to comply with chapter 675, HRS. 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, Tobacco Products Reporting Law, and related statutes (the Department sends letters to tobacco product manufacturers worldwide to advise them of these obligations);
- (4) Provides assistance to effectuate compliance;
- (5) Supplies relevant information that allows the Department to file lawsuits as necessary to compel compliance with the escrow statutes; and
- (6) Provides the information-gathering and certification protocols necessary to establish and publish the directory of tobacco product manufacturers whose cigarettes and Roll-Your-Own (RYO) tobacco products are authorized for sale in Hawaii.

In 2003, the Unit created a directory of compliant cigarettes and RYO tobacco products. The directory has been posted on the Department's website since October 31, 2003, and has been revised and updated annually, up to and including through FY 2022-2023. At the end of FY 2022-2023, 14 compliant tobacco product manufacturers

(14 PMs and 0 NPMs) were listed in the directory, along with a list of 75 authorized brands of cigarettes and RYO tobacco products.

As part of the Unit's diligent enforcement efforts, in March 2023, the Unit delisted Tabacalera del Este S.A. (TABESA) and deleted all of its Palermo brand cigarettes from the directory due to TABESA's failure to make its quarterly deposit into escrow for its fourth quarter sales made in 2022. Pursuant to an Adherence Agreement that TABESA entered into with Hawaii and other Settling States under the MSA in 2005, TABESA was required to make quarterly deposits into escrow towards its annual MSA payment. TABESA's failure to do so was deemed a breach of its payment obligations under the MSA, which entitled Hawaii to remove any brands listed by TABESA in its directory.

Further, the directory, in conjunction with the Tobacco Products Reporting Law, chapter 486P, HRS, facilitates 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 Unit notifies the tobacco product manufacturer that it must comply with chapter 486P, HRS, including the requirement to register with the Department pursuant to section 486P-5, HRS.

The Unit provides a reporting form to wholesalers and distributors and gathers information from the wholesalers' and distributors' responses and invoices. Based on this information, the Unit verifies that only compliant NPMs and their brands are sold (directly or through distributors, retailers, or similar intermediaries) in Hawaii. In addition, by investigating cigarette brands on store shelves, the Unit verifies that only compliant NPMs and their authorized brands are stamped and sold in Hawaii.

The Unit 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. There have been no NPM sales in Hawaii since 2019, and therefore no escrow payments have been required since 2019. In 2021, one of the larger NPMs unsuccessfully attempted to be reinstated to the Hawaii directory. Soon after, the same company stopped selling NPM cigarettes nationwide.

E. 2003 Diligent Enforcement Arbitration

The first major arbitration arising from the MSA was the 2003 DE Arbitration, which commenced in 2005 but did not conclude until 2013. In the 2003 Diligent Enforcement Arbitration, Hawaii's diligent enforcement was not contested by the PMs, and Hawaii received its 2003 money, albeit years later. Twenty-four other states, along with Washington, D.C., and the Commonwealth of Puerto Rico, entered into an agreement with the PMs, the NPM Adjustment Settlement Agreement, settling the years 2003 through 2012. Several of the non-settling states won their 2003 arbitration hearings, and therefore "won" their disputed 2003 money (to be paid in 2014). Indiana, Kentucky, Maryland, Missouri, New Mexico, and Pennsylvania, however, were found to be non-diligent and lost their hearings. These six states suffered losses of expected

annual MSA payments in 2014 and 2015 in amounts of approximately \$500 - \$600 million, although at least one state reduced some of the impact through court appeals.

F. 2004 and Subsequent Diligent Enforcement Arbitrations

Soon after the 2003 DE Arbitration ended, the 2004 DE Arbitration commenced. In 2017, after nearly two years of pretrial litigation and extensive discovery, the PMs affirmatively challenged Hawaii's diligent enforcement for the calendar year 2004. Hawaii's arbitration was scheduled to begin in August of 2018. In 2018, with the assistance of outside counsel, Hawaii and nine other states signed on to the NPM Adjustment Settlement Agreement with the PMs, resolving the diligent enforcement arbitration issues for the years 2004 through and including 2017. By joining the settlement, Hawaii was spared the cost and uncertainty of ongoing and protracted arbitrations. It was estimated that, had Hawaii not settled the 2004 DE Arbitration, it would have cost Hawaii approximately \$1.5 million dollars in litigation costs alone just for the 2004 DE Arbitration – arbitrations covering each year from 2005 through 2017 would have been separate and more costly.¹

In April 2018, Hawaii received approximately \$58.6 million for the settlement of the years 2004 through and including 2017. Outside litigation costs totaled approximately \$189,000. After Hawaii and nine other states joined the NPM Adjustment Settlement Agreement, nine other states were still involved in the 2004 DE Arbitration. On September 1, 2021, two arbitration panels issued decisions resolving liability for the 2004 DE Arbitration as to eight states. Six states (Idaho, Illinois, Iowa, Maryland, Ohio, and Wisconsin) were found to have diligently enforced. Two states (Missouri and Washington) were found to be non-diligent. On October 27, 2022, a separate arbitration panel found New Mexico to be non-diligent. On August 30, 2023, a New Mexico state court vacated the arbitration panel's decision. The PMs are expected to appeal the court's ruling. The fact that at least two states were found non-diligent means that those states face the potential loss of tens of millions of dollars of their expected annual MSA payments. The arbitration panels placed a great emphasis on efforts the states made to perform audits, and this was a major factor in whether a state was found to be diligent or non-diligent. Based on the panel findings in the most recent arbitrations, the Unit added an auditor to help ensure diligent enforcement efforts would remain robust.

After joining the settlement in 2018, Hawaii still faced potential liability for future years of diligent enforcement arbitration from 2018 and into the future. If Hawaii had not settled years 2018 through 2022, Hawaii would have faced an estimated maximum exposure ranging from \$17.5 million to \$21.2 million per year in lost MSA payments – comprising over half of the payments Hawaii could expect to receive in each year. In 2020, a condition of the NPM Adjustment Settlement Agreement was met that automatically settled the years 2018-2019 for Hawaii and eight other states, thus

¹ Had the State prevailed in the 2004 DE Arbitration, Hawaii would have received \$4,648,059.24, the amount withheld by the industry from the industry's 2004 payment to Hawaii, plus any interest that accrued on the withheld amount.

protecting Hawaii from the risk of arbitration for diligent enforcement in those years. For the settled years, called "transition years," Hawaii and the other states retain 75 percent of the disputed payment amount, while the PMs receive a 25 percent credit. In 2020, Hawaii joined the other states in its group opting to treat years 2020-2022 as transition years, another option available to these states as part of the settlement signed in 2018. This option protects Hawaii from the risk of arbitration through sales year 2022. Also in 2020, Hawaii, along with thirty-four other states, the District of Columbia and Puerto Rico, entered into the 2018 through 2022 NPM Adjustment Settlement Agreement with the PMs, providing Hawaii with additional benefits and protections for potential arbitration in the future. In March 2022, despite having been found by the panel to have diligently enforced in 2004, Illinois signed onto the NPM Adjustment Settlement Agreement. In August 2023, Iowa also signed onto the NPM Adjustment Settlement Agreement, despite also having been found by the panel to have diligently enforced in 2004. Along with the District of Columbia and Puerto Rico, there are currently 36 states that have signed onto this agreement. Two states, New York and Montana, have entered into separate agreements.

In April 2023, the State received its annual MSA payment in the amount of \$40,862,842.25, and payments are current, subject to some adjustments over time. Hawaii is settled through sales year 2022 for arbitration relating to the NPM adjustment, and further settlement discussions have started to address additional years.

Hearings for the 2005-2007 NPM Adjustment arbitration, before a new panel, have now commenced. Hawaii's settlement includes the 2005-2007 period, so Hawaii will not be a party to the arbitration but will potentially still be involved due to the requirements of the settlement.

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." Conf. Comm. Rep. No. 98, in 2000 House Journal, at page 898; in 2000 Senate Journal, at page 776. With these concerns in mind, the Cigarette Tax and Tobacco Tax Law, chapter 245, HRS, 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 has been 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 could be sold or offered for sale to the public unless affixed with the stamp as required by chapter 245, HRS. Beginning in 2000, the Unit worked closely with licensed wholesalers and dealers and the Department of Taxation (DOTAX) to facilitate the implementation of the cigarette stamp program. In January 2001, the Unit began conducting inspections for compliance with the program.

In 2005, the Department proposed a bill to amend chapter 245, HRS, 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 help prevent evasion of state taxes.

In 2023, the Department supported Senate Bill No. 975, which established the offense of unlawful shipment of tobacco products; amended the definition of "tobacco products" in chapter 245, HRS, to include and subject "electronic smoking device" (ESD) and "e-liquid" to taxation and regulation under DOTAX; imposed an excise tax of seventy percent of the wholesale price of each ESD or e-liquid sold, used, or possessed by a wholesaler or dealer on and after January 1, 2024; increased the license and permit fees for wholesalers, dealers, and retailers of tobacco products; repealed chapter 28, part XII, HRS, relating to the Electronic Smoking Device Retailer Registration Unit under the Attorney General; and repealed section 245-17, HRS, relating to Delivery Sales. The bill was signed into law on June 6, 2023 (Act 62, Session Laws of Hawaii 2023). From the time the bill passed, the Unit has been working with the Department of Health, DOTAX, the Governor's Office, and members of the public to address the impact of Act 62.

B. Cigarette Tax Revenue Collections

Since the implementation of the tax stamp program on January 1, 2001, the state has collected a total of \$2,315,923,189. Cigarette tax revenue collections increased significantly through FY 2010-2011. At its peak in FY 2010-2011, revenues reached a high of \$135,647,918. From FY 2011-2012 until the present, however, cigarette tax revenue collections have decreased almost every year. In FY 2022-2023, DOTAX

reported cigarette tax revenue collections of \$76,802,634, a reduction of 10 percent from FY 2021-2022, and a reduction of 43 percent from FY 2010-2011.

This downward trend in cigarette tax revenue collections is expected to continue. The Unit’s diligent enforcement efforts to comply with the MSA and statutory obligations will be impacted by this drastic decrease in funding, as most of the Unit’s funding is derived from cigarette tax revenue collections. If the Unit is unable to maintain its diligent enforcement efforts, Hawaii’s future annual MSA payments will be at risk. To address this issue, in 2023, the Department proposed bills (House Bill No. 982/Senate Bill No. 1280) to stabilize funding for the Unit. The bills sought to increase the amount of funds that the Special Fund can carry over from \$500,000 to \$750,000 at the end of the fiscal year; increase the portion of the cigarette tax stamp fee allotted to the Special Fund from 1.5 percent to 2.0 percent and thereby increase the total cigarette stamp fee from 1.7 percent to 2.2 percent; and increase the sum of moneys received from the MSA annually from \$350,000 to \$750,000. These bills will carry over to the 2024 Regular Session, and the Department will continue to support legislation to stabilize funding for tobacco enforcement efforts.

Cigarette Tax Revenue Collections 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 |
| FY 2011-2012 | 130,994,721 |
| FY 2012-2013 | 120,095,909 |
| FY 2013-2014 | 114,112,465 |
| FY 2014-2015 | 121,629,882 |
| FY 2015-2016 | 116,382,902 |
| FY 2016-2017 | 114,926,266 |
| FY 2017-2018 | 110,762,991 |
| FY 2018-2019 | 102,793,762 |
| FY 2019-2020 | 102,444,639 |
| FY 2020-2021 | 98,140,929 |
| FY 2021-2022 | 85,131,574 |
| FY 2022-2023 | 76,802,634 |
| Total | \$2,315,923,189 |

C. Enforcement

The Unit 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. As of July 2023, DOTAX reported that 1,206 retailers located in the state held retail tobacco permits: 749 in the City and County of Honolulu, 181 in the County of Hawaii, 198 in the County of Maui, and 78 in the County of Kauai.

- In FY 2022-2023, 1,696 compliance inspections were conducted statewide: 1,342 on Oahu, 144 on the island of Hawaii, 65 on Kauai, 127 on Maui, 3 on Lanai, and 15 on Molokai.
- Since April 1, 2001, enforcement activities have resulted in more than 160 felony arrests, numerous investigations, and seizure of more than 3,419,248 illegal cigarettes and 289.28 pounds of tobacco leaves. Historically, arrests have been made on Hawaii, Kauai, Maui, Molokai, and Oahu.
- In FY 2022-2023, 13 criminal tobacco investigations were conducted. A total of 202 cartons of cigarettes (the equivalent of 40,400 cigarettes) were seized at the Daniel K. Inouye International Airport (seven investigations), at the United States Post Office (four investigations), at the Air Cargo office (one investigation), and at Honolulu Harbor (one investigation), as a result of cooperative efforts between the Department, United States Customs and Border Protection, United States Coast Guard, Homeland Security, National Oceanic and Atmospheric Administration, and the United States Postal Service.
- Since April 1, 2001, the Unit has prosecuted 139 tobacco cases, resulting in criminal fines of \$197,600. This data has not changed in the last year. When the MSA first went into effect there were many prosecutions, but with the MSA and the threat of prosecution, retailers came into compliance, and the Unit actively maintains compliance through inspections and education.
- In total, 75 cigarette prosecutions have resulted in court-ordered forfeiture of cigarettes. In addition, in 99 instances, the Department secured forfeiture of confiscated cigarettes via civil administrative forfeiture orders, stipulations, or agreements. For the same reasons noted above, this data has not changed in the last year.

D. Gray Market

Gray market cigarettes are American-made or foreign-made cigarettes – usually major American brands – sold by the manufacturers specifically for sale outside of the United States that nevertheless end up in the United States. Gray market cigarettes cut into the market share of the PMs. 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 and are considered contraband. Foreign-made 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 (predominantly from the Philippines and Southeast Asia) and the South Pacific and have been 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.

Historically, to address the gray market and other contraband cigarette problems, the Department has established relationships and has 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; the Internal Revenue Service; United States Customs and Border Protection; the United States Postal Service; and the Royal Canadian Mounted Police regarding gray market cigarettes and other contraband 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.

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 Unit searches for counterfeit Hawaii tax stamps to prevent their circulation.

In FY 2022-2023, the Unit met with other states and worked with DOTAX to add additional security features to the stamps used in the cigarette tax stamp program. As a result of these efforts, DOTAX will be entering into a new contract with the stamp vendor which will include stamps that, for the first time, will have unique numbering, variable image, and microprint. The Unit hopes to work with DOTAX to implement additional security features to the stamps in the coming years.

F. Half-Stamping

Historically, vendors have attempted 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 Unit made arrests for half-stamping and seized

12,879 packs, of which 2,639 packs were half-stamped and 10,240 packs were unstamped. The Unit continues to ensure that the application of tax stamps complies with the stamping requirements set forth by rules adopted by DOTAX.²

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 Act³) was passed in March 2010. In March 2021, Congress amended the PACT Act to include new regulations regarding the delivery and sales of electronic nicotine delivery systems (ENDS), which includes vapes and e-cigarettes and flavored and smokeless tobacco.

On a weekly basis, the Unit investigators make multiple checks for illegal online sales of tobacco products. In FY 2022-2023, the Unit investigators initiated five investigations into Craigslist internet offerings and one investigation into OfferUp for the sale of tobacco products without a tobacco retail permit within the State of Hawaii. The investigations resulted in listings being removed from Craigslist and OfferUp promptly after the investigations were initiated.

As noted above, interdiction activities also took place in conjunction with United States Customs and Border Protection and the United States Postal Service resulting in parcels of cigarettes and loose tobacco being seized as prohibited mailed items and treated as contraband in violation of the PACT Act.

IV. FY 2022-2023 RECEIPTS INTO THE TOBACCO ENFORCEMENT SPECIAL FUND

| | |
|---|--------------------|
| Master Settlement Agreement funds | \$ 350,000 |
| Cigarette tax stamp fees/interest/fines/misc. | 1,137,399 |
| Total | \$1,487,399 |

V. FY 2022-2023 APPROPRIATIONS AND EXPENDITURES

In FY 2022-2023, there was a total appropriation of \$1,798,566 for the MSA and cigarette tax stamp enforcement. The appropriation was funded in part by \$350,000 from moneys received from the MSA and \$1,137,399 from cigarette tax stamp fees.

² Section 18-245-3, Hawaii Administrative Rules, provides that stamps or stamping indicia shall be securely affixed to the bottom of each cigarette package in such a manner that the stamps or stamping indicia are clearly visible, legible, and complete.

³ 18 U.S.C. § 1716E (2010).

Expenses for FY 2022-2023 totaled \$1,258,326.99, which leaves an appropriation balance of \$540,239.01. Now that the Unit is fully staffed, including a new auditor, it is expected that expenses will increase in the coming years.

TOBACCO ENFORCEMENT SPECIAL FUND
Fiscal Year 2022-2023

| | | |
|--|---------------------|-----------------------|
| APPROPRIATION | | \$1,798,566.00 |
| PERSONNEL COSTS | | |
| Salaries and Fringe | \$1,055,330.15 | |
| OPERATIONAL EXPENSES & OVERHEAD COSTS | | |
| Supplies | 1,577.34 | |
| Membership Dues and Subscriptions | 2,570.60 | |
| Telephone | 9,262.63 | |
| Printing and Binding | 59.34 | |
| Mileage | 4,030.55 | |
| Travel Costs | 13,245.05 | |
| Lease Rent | 75,698.60 | |
| Rental of Equipment | 5,609.48 | |
| Repairs and Maintenance | 157.44 | |
| Services of Fee Basis (other than State Employees) | 1,356.44 | |
| Special Fund Assessments paid to B&F | 89,429.37 | |
| Total Operational Expenses & Overhead Costs | \$202,996.84 | |
| TOTAL COSTS | | \$1,258,326.99 |
| APPROPRIATION BALANCE | | \$540,239.01 |