

**STATEMENT OF MICHAEL THORNE-BEGLAND
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**SUBMITTED ON BEHALF OF PHILIP MORRIS USA INC.
TO THE NORTH DAKOTA TAXATION COMMITTEE
ON THE ISSUE OF ILLICIT TRADE IN TOBACCO PRODUCTS**

Altria Client Services Inc., on behalf of Philip Morris USA Inc. (“PM USA”),¹ submits this testimony, upon request of the legislative counsel of North Dakota, on the issue of the illicit trade in tobacco products. Based on our experience working with government authorities to combat contraband activity, we offer the following information for consideration.

PM USA commends the committee for holding hearings on the issue of the illicit cigarette trade. The illicit cigarette trade is very lucrative. A large percentage of the price of legitimate cigarettes consists of taxes, making tax evasion alone a strong incentive for smuggling. In their most recent report on illicit tobacco to Congress the U.S. Government Accountability Office (“GAO”) concluded that tobacco products face varying levels of taxation in different locations, creating opportunities and incentives for illicit trade. According to the Bureau of Alcohol Tobacco, Firearms & Explosives (“ATF”), illicit cigarette sales have dramatically increased in recent years with the sharp rise in excise taxes throughout the United States.

¹ PM USA, a leading domestic manufacturer of cigarettes, is a wholly-owned subsidiary of Altria Group Inc.



The trafficking in contraband cigarettes and other tobacco products results in a variety of harms. It robs the North Dakota government of needed tax revenues. It undermines efforts to prevent youth access to cigarettes. It is associated with other serious criminal activity. Law enforcement authorities report that criminal organizations often use profits from contraband tobacco to fund other more serious crimes, including money laundering, human and narcotics trafficking². Economically, contraband activity creates serious competitive harm to law-abiding manufacturers, wholesalers and retailers who fully comply with all applicable laws. And for Philip Morris USA, contraband can seriously harm the company's trademarks and can erode confidence in the distribution channels through which its products are sold.

In our experience, smuggling or trafficking of untaxed or under-taxed cigarettes is the most common form of cigarette trafficking. Because cigarette excise tax rates vary from state to state, some criminals engaged in the illicit cigarette trade exploit the variance in state excise taxes to generate immense illegal profits at the expense of legitimate, tax-paying businesses. To help address this problem, PM USA believes that all states should require that a wax-based tax stamp be affixed to each pack of cigarettes to signify tax paid status and identify the intended state of sale.

PM USA believes that the application of wax-based state excise tax stamps is an important and cost effective component of a comprehensive approach to address the illicit cigarette trade. These stamps should include security features to aid law enforcement authentication and a serial number or, where applicable, a stamp that denotes that the

² ATF Fact Sheet 2008, 2009, 2010, 2011



cigarettes are tax-exempt, for example qualified Native American sales. Wax-based tax stamps provide law enforcement with an easy, efficient and reliable tool to determine tax paid status and authenticity of the stamp, they help frustrate the activities of criminals attempting to profit from contraband tobacco and they provide multi-state wholesalers with a single stamping system.

Unfortunately, North Dakota currently is only one of three states not requiring tax stamps to be applied to cigarettes sold within its state boundaries. This regulatory void makes it difficult for tax and law enforcement authorities to verify tax paid status of cigarettes found at retail locations, seized during law enforcement actions or found outside of its state boundaries. Without a state excise tax stamp there is no way to physically distinguish legitimate tax-free product from product that is subject to the state excise tax. Thus, North Dakota cigarette excise tax revenue is unprotected. The situation is further complicated by the sale of unstamped and potentially untaxed cigarettes occurring at Native American outlets located in North Dakota. This scenario creates an incentive for the purchase of untaxed cigarettes for illegal resale at non-Native American outlets within North Dakota, as well as outside of the state.

While wax-based tax stamps that are serialized and include security features can cost as little as 50¢ per thousand and provide an efficient and effective new tool for law enforcement, “encrypted” cigarette tax stamps do not add significant benefits not already offered through serialized wax-based stamps. In addition, they impose significant cost on state, law enforcement, on the distribution chainⁱ and can be -- and have been --



counterfeitedⁱⁱ. The Indiana Department of Revenue recently reached a similar conclusion, in their report considering conversion to an encrypted tax stamp system. The Department concluded that maintaining a wax-based system was of greatest benefit to the state. The report concluded:

“[E]ncrypted stamps do not provide a significant impact in reducing contraband cigarette sales. Furthermore, what they may provide, which is highly unclear in itself, cannot justify the minimum estimate of spending \$2.9 million per year of taxpayer money to support implementing an encrypted-stamp program. Nor can it justify the estimated \$12.5 million to \$15 million an encrypted-stamp program would cost Indiana’s cigarette distributors.”ⁱⁱⁱ

We are optimistic that an in-depth analysis of the feasibility and desirability of cigarette tax stamps in North Dakota will support the enactment of tax stamp legislation to address the illicit trade in tobacco through wax-based tax stamps during the next Legislative Assembly. We welcome the opportunity to work with North Dakota to address the issue of contraband cigarettes.

ⁱ Encrypted tax stamps are significantly more expensive than the more commonly used serialized wax-based tax stamps. The price of a 1,000 serialized wax-based tax stamps is about 50¢ while the price of 1,000 encrypted stamps is \$4.77 (about 10 times the cost).ⁱ Additional costs would be incurred by the wholesalers to purchase new stamping equipment which can range between \$100,000 and \$150,000. With encrypted tax stamps, law enforcement must purchase and use an expensive scanning device to “read” the tax stamp. Scanners cost approximately \$800 per device for retailers -- and costs even more for law enforcement because of the features needed for enforcement

ⁱⁱ Encrypted tax stamps are just as susceptible to counterfeiting as wax-based stamps. California introduced encrypted tax stamps in January 2005. The Bureau of Alcohol, Tobacco, Firearms and Explosives has reported that within a month of introduction, counterfeited versions of California stamps were found at retail. In addition, Federal authorities seized 3,800 counterfeit versions of the new encrypted tax stamp in April 2005, and 27,752 in June 2005. And, in October 2005 five individuals were arrested and approximately 18,000 cartons of cigarettes and 103,000 counterfeit California cigarette excise tax stamps were seized. The counterfeit stamps alone had a face value in excess of \$89,000.

ⁱⁱⁱ Indiana Department of Revenue, Changing the Cigarette Tax Stamp: Feasibility Study Report, November 1, 2009



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Excise Tax Stamps Considerations

Some criminals engaged in the illicit cigarette trade exploit the variance in state excise taxes to generate immense illegal profits at the expense of legitimate, tax-paying businesses. To help address this problem, PM USA believes that all states should require that a wax-based tax stamp be affixed to each pack of cigarettes. PM USA believes that the application of wax-based state excise tax stamps is an important and cost effective component of a comprehensive approach to address the illicit cigarette trade. Wax-based stamps provide law enforcement with the tools they need to determine if a tax stamp is genuine and multi-state wholesalers with a single stamping system. These stamps should include security features to aid law enforcement authentication and a serial number or, where applicable, a stamp that denotes that the cigarettes are tax-exempt (e.g. qualified Native American sales). North Dakota is one of only three states that do not require tax stamps on cigarette packs.

While wax-based tax stamps that are serialized and include security features provide an efficient and effective new tool for law enforcement, “encrypted” cigarette tax stamps do not add significant benefits not already offered through serialized wax-based stamps. In addition, they impose significant cost on state, law enforcement, on the distribution chainⁱ and can be -- and have been -- counterfeitedⁱⁱ.



The Indiana Department of Revenue recently published a report that considered conversion to an encrypted tax stamp system and concluded that maintaining a wax-based system was of greatest benefit to the state. The report concludes:

“[E]ncrypted stamps do not provide a significant impact in reducing contraband cigarette sales. Furthermore, what they may provide, which is highly unclear in itself, cannot justify the minimum estimate of spending \$2.9 million per year of taxpayer money to support implementing an encrypted-stamp program. Nor can it justify the estimated \$12.5 million to \$15 million an encrypted-stamp program would cost Indiana’s cigarette distributors.”ⁱⁱⁱ

Conclusion. PM USA supports efforts to combat contraband cigarettes and believes that state tax stamps are necessary. PM USA believes states should require wax-based tax stamps that (i) use a serialization feature that can assist law enforcement and regulatory authorities with tracking and tracing, (ii) incorporate an authentication / anti-counterfeit feature and (iii) can be applied with existing stamping equipment. Encrypted tax stamps, which are easily counterfeited and much more costly to the state and the distribution system however, would not provide additional help with cigarette excise tax collection issues.

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