Behind the Cigarette Tax Evasion Crackdown

By David Cay Johnston

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In this article, Johnston examines the motives behind increased enforcement of cigarette excise taxes and how tax policy can be used to stop price gouging by manufacturers.

Guess who has become a driving force for tax law enforcement, and in particular excise tax enforcement? Big tobacco companies.

Of course, as with almost everything that Altria Group’s Philip Morris USA, R.J. Reynolds, Brown & Williamson, and Lorillard Tobacco have done, this is not about sound tax policy or vigorous enforcement for its own sake, but to enhance the lucrative enterprise of selling a drug delivery system that kills an American every 80 seconds.

From California to Massachusetts, tax authorities have been making a show for some months now of enforcing cigarette excise taxes. There have been raids on individual merchants trumpeted by prosecutors, the prosecution of off-reservation smoke shops owned by Native American nations, and even arrests of some distributors with counterfeit tax stamps.

California has adopted radio frequency tags to combat smuggling of untaxed smokes, although it took counterfeiters less than five weeks to create fake tags. New Jersey has a request for vendors to develop similar technology. But high tech has not won favor with the Indiana Department of Revenue, which has rejected the electronic tags as a costly and ineffective way to catch bootleggers.

New York state revenue officials estimate that one in three packs of cigarettes is sold untaxed to non-Native Americans, costing the state $220 million in 2008. Since then the state has raised the tax per pack 83 percent—from $1.50 to $2.75. In New York City there is an added municipal tax that brings the levy to $4.50 per pack. With the federal tax of just over a buck added, the total tax in New York City comes to $5.50 per pack—or more than 27 cents per cigarette.

The New York Association of Convenience Stores says its economist calculated the lost New York state and city tax revenues at $1 billion a year, more than four times the state tax authority’s estimate.

Last week the arrests of four men on felony cigarette tax evasion charges were announced by the New York State Department of Taxation and Finance. The case qualifies as a felony, but the sums involved are penny ante compared with the size of the problem. Authorities seized 1,925 cartons of untaxed cigarettes, representing $173,250 of lost state and city tax revenue, assuming all the packs were to be sold in the city.

For this, two of the men face 15 years. Now that suggests what vigorous law enforcement could be doing here. Instead of going after small-time tax evaders like these, tax agents and prosecutors could start looking at the big money. Who are the kingpins here? And why aren’t they being prosecuted?

Lots of other states have been raising cigarette taxes, too, with plenty of Republican support, showing the diminishing power of Grover Norquist’s antitax pledges, which began smoldering after George W. Bush broke his pledge. “If elected president, I will oppose and veto any increase in individual or corporate marginal income tax rates or individual or corporate income tax hikes,” Bush wrote to Norquist in June 1999, seven years before he signed a law raising taxes on teenagers who work or have college funds.

In the most revealing action to date, the South Carolina Legislature voted in early May to raise the lowest cigarette tax in the country from 57 cents a pack to $1.07. Gov. Mark Sanford (R) vetoed the tax increase before rushing off to Florida to reignite the fire with his Argentine mistress. While Sanford was cavorting, his fellow Republicans in the Palmetto State overrode his veto.

What is going on?

The usual beneficiary of increased tax enforcement is the honest taxpayer, who is assured after the handcuffs are slapped on some suspect that the government is not letting the other guy or gal get away without paying their taxes. But that is not what is going on here. These tax law enforcement actions are designed to protect a price-gouging oligopoly.

If the largest tobacco companies can show that they have lost market share to small manufacturers and new entrants to the business of selling cigarettes, then they can reduce the amount of money they must pay the states under what is formally known as the Master Settlement Agreement (MSA). That 1998 deal was portrayed at the time as a way to encourage addicts to break free of nicotine’s powerful hold, to reduce adoption of the nicotine habit among the young, and to limit advertising and promotion to lure the young into burning tobacco, chewing it, or stuffing it up their noses.

So why the flurry of enforcement actions and tax hikes now? In a word, profits.

Buried deep in the more than 300-page-long agreement are provisions that require the use of tax law enforcement to protect market share. If market share, as
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determined by a PricewaterhouseCoopers annual auditor, falls by 2 percentage points, then the tobacco companies can hold back part of their annual payments.

In April the original signers paid almost $6.4 billion to a fund to mitigate the damages caused in 2009 by their products. But they held back another $843 million because their market share fell as cheaper cigarettes gained in popularity with consumers. The good news is that the tobacco firms held back less than 12 percent of the total, down from the almost 18 percent they held back for 2004 and 2005.

State courts around the country have upheld the tobacco companies’ right to go to arbitration if their market share drops more than 2 percentage points in any year.

The MSA results in some bizarre, anticompetitive economics. As the Maryland Court of Special Appeals put it, the “adjustment attempts to level the marketplace by reducing the annual payment obligation of the participating manufacturers if, as a collective group, it is proven that they lost market share to the non-participating manufacturers” (State of Maryland v. Phillip Morris Incorporated et al., 179 Md. App. 140, 944 A.2d 1167 (2008)).

The court noted that the provision applies if a lack of diligent enforcement of cigarette excise tax laws is a “significant factor” in the loss of market share. Otherwise the tobacco companies could stop doing all they can to push nicotine and reduce their payments under the MSA.

“The MSA provides that the ‘significant factor’ determination is not subject to appeal,” the Maryland court noted. “Maryland and the other settling states, however, urged the auditor to deny the [market share loss provision] on the ground that the settling states ‘diligently enforced’ their qualifying statutes.”

The first nationwide arbitration to determine whether the tobacco companies get to keep the money they have been holding back each year is about to start. Each side has chosen an arbiter, and as soon as those two agree on a third arbiter, the private litigation will begin. But preparation for that litigation has been underway for years. The tobacco company lawyers have been papering the states with requests for enforcement records, training manuals for tax agents, and collection records — a sort of prearbitration discovery process.

At stake is $5.2 billion, plus interest, of withheld payments made over eight years. That is the amount the tobacco companies say they should not have to pay because they are losing market share to new entrants and small manufacturers that did not participate in the 1998 agreement.

In this matter, we see yet another way to use tax law not to raise revenue, but to achieve some ulterior objective, in this case to help earn unwarranted profits. Just as some utility holding companies have found ways to permanently capture the corporate income taxes embedded in the rates customers pay, and the drug companies have found ways to funnel profits out of the country under the guise of royalties (to themselves), the tobacco companies have found a way to use tax enforcement to fatten their bottom lines.

Too bad that former Sen. John Sherman, the Ohio Republican and Senate Finance Committee chair who sponsored the antitrust law bearing his name, is so long in the grave. Competition remains the eternal fear of business, especially inefficient business. Sherman’s 1890 law remains remarkable for its simplicity, lack of caveats, and brevity at just three sections in length. The first two sections state simply:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal.

> Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony.

All 50 states and the District of Columbia agreed under the 1998 contract to help the biggest tobacco companies maintain their market share. That raises one of those emperor-has-no-clothes questions: What part of “every” did the courts miss in allowing this blatant corporate-government conspiracy to restrain trade?

The tobacco companies have done a masterful job of promoting the idea that cigarettes are costly because of taxes. That is partly true, which is a big step forward for these merchants of death, who used to run magazine ads touting imaginary health benefits from smoking. They also bullied, lied, and denied the truth they knew: Smoking sickens and kills.

The companies actually jacked up prices after the agreement by more than twice the amount needed to cover the payments to mitigate the harm done by smoking, according to antitobacco advocates such as the Campaign for Tobacco-Free Kids. So those who remain addicted, not the owners of the tobacco companies, bear the burden of the MSA. The taxes are just an add-on that raises the price even more and gives the states an incentive to support this conspiracy in restraint of trade that generates oligopolistic profits.

Raising the price of cigarettes is, in my view, good since the stuff kills people. Raise prices and fewer people will die prematurely from heart attacks or cancer, or from slowly drowning in the pus filling their lungs from emphysema, an especially cruel way to go. Americans die from products sold by big tobacco companies at 10 times the rate people die in automobile crashes. However, automobiles serve a useful function, and they can and have been made safer.

The tobacco companies sold 17.4 billion packs of cigarettes to Americans in 2007, about equal to the early 1950s, when giveaways to soldiers and glamorizing of cigarettes in films (which continues) created widespread addiction among a much smaller population.

High prices play a big role in falling sales, as Adam Smith taught us 234 years ago. But tobacco company profits have not collapsed, because demand for an addictive drug tends to be highly inelastic. Wall Street continues to tout tobacco stocks, especially now that government has become the partner of these merchants of death in protecting their profits while adding to its own coffers through cigarette taxes and the tax-like settlement payments.
Uncle Sam benefits, too. This year the federal tobacco tax will bring in an estimated $17 billion, not counting whatever contribution cigarette smoking makes to collection of the estate tax.

This whole affair is not sound tax policy or serious enforcement to protect the fisc. It is a deadly game of using tax to protect an oligopoly from the rigors of the market — an oligopoly that should be allowed, like its customers, to die an early death.

Your thoughts? E-mail me at Johnstonstake@tax.org.