Treasury - permits to retail level
- Fed'l permit to wholesale / retail.
- Clean record.

PROPOSAL RELATING TO TOBACCO LICENSING

I. Scope

This paper provides ideas to combat the anticipated growth in the "black market" distribution of cigarettes and smokeless tobacco in the event the provisions of the tobacco settlement are enacted into law. As explained below, preventing the black market distribution of tobacco products may have the effect of reducing youth smoking. These proposals appear to complement the Department of Health and Human Services' (HHS) proposals relating to licensing entities which sell tobacco products directly to the consuming public.

II. Background

The Secretary of the Treasury, through the Bureau of Alcohol, Tobacco and Firearms (ATF), is responsible for the administration of Chapter 52 of the Internal Revenue Code of 1986 (IRC), which imposes Federal excise taxes on the manufacture of tobacco products. In connection with the collection of these taxes, ATF enforces the permit and record keeping requirements imposed upon manufacturers of tobacco products. These requirements are primarily concerned with protection and collection of the revenue, not the regulation of the distribution of tobacco. Additionally, ATF is responsible for enforcing the Contraband Cigarette Trafficking Act (18 U.S.C. §§ 2341 *et seq.*) which prohibits the shipment, transportation, or possession of more than five cases of cigarettes (60,000 cigarettes) into a State without required evidence of payment of that State's taxes. ATF also has ancillary jurisdiction to enforce the reporting requirements of the Jenkins Act (15 U.S.C. §§ 375 *et seq.*), which requires tobacco distributors to report on a monthly basis to State tobacco tax administrators information about every shipment of cigarettes into a State in which the distributor is not licensed. Finally, ATF works closely with officials from foreign governments, *e.g.*, Canada, to assist in the investigation and prevention of unlawful trafficking in cigarettes from the United States to those countries.

Domestic commerce in cigarettes, which accounts for the largest portion of commerce in tobacco products, is generally conducted through a multi-tiered chain of distribution that can involve a manufacturer or importer, multiple wholesale distributors (including jobbers and stamping agents), and retail dealers. Generally, tax-paid cigarettes are shipped after production to one of several remote manufacturer's warehouses located throughout the country. Most cigarettes are then shipped to one or more wholesale distributors for further distribution to retail dealers. However, some retail dealers purchase cigarettes directly from producers. With respect to exportation, tobacco products can lawfully be exported through either an export warehouse proprietor or a Customs bonded warehouse.

The proposed tobacco settlement requires the tobacco industry to make "payments" on the cigarettes and smokeless tobacco produced in the United States for domestic consumption. The settlement contemplates that these industry payments will be passed on to consumers through increased retail prices for cigarettes. Analysts believe this could result in an increase of up to $1.50 in the retail price of a pack of cigarettes.[1] If youth smoking levels are not reduced to certain established levels, the settlement requires the industry to pay penalties, which could increase the retail price of cigarettes even further.

The proposed settlement does not appear to reach products produced abroad and imported into the United States, nor does it reach products exported from the United States. In other words, the industry payments contemplated by the settlement would not be made on cigarettes imported into, or exported from the United States. This "loophole" in the settlement could provide a means for cigarette manufacturers to avoid the industry payments required by the settlement simply by moving operations outside the United States. Moreover, this "loophole" would make the importation and exportation of cigarettes particularly vulnerable to unlawful diversion to the black market.

Based on ATF's experiences gained from investigating the unlawful trafficking of cigarettes and alcohol, it has learned that any action that artificially increases the market price of a commodity (*i.e.*, a tax increase, industry payments or prohibition) tends to give rise to the "black market" distribution of that commodity. At the current level of regulation, the increases contemplated by the settlement would assuredly result in a significant diversion of cigarettes into the black market. Such distribution could grow to a point where the illicit products will be sold at a price significantly lower than the retail price of legitimate products.

Studies show that price is a primary factor young people consider when deciding whether to smoke. These studies support the proposition that the increase in retail price for cigarettes as a result of settlement payments will reduce youth smoking. If this proposition is true, then young people will be a significant market for black market distributors and, if black market distribution grows to a point where the illicit products are widely available, youth smoking could remain static or actually increase. Canada experienced a similar phenomenon after it significantly increased its excise taxes on tobacco in the early 1990s. Ironically, if this were to occur, the legitimate domestic consumption of cigarettes could appear to decrease. Consequently, under the settlement, the industry would appear to be attaining reduced levels of overall consumption and, under the original settlement would have faced lower payments. This would occur despite the fact that youth smoking remained static or actually increased as a result of black market distribution.

III. Regulation of the Tobacco Distribution System on the Alcohol Model

One way to help prevent the unlawful diversion of tobacco products to the black market would be to regulate commerce in tobacco products on a model similar to that in place for

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[1]While other proposals advocate actual per pack increases of this nature, the effect of the original settlement as written is $0.58 to $0.67 per pack in real terms (*i.e.*, controlling for inflation), depending on the size of the youth look back surcharge.

alcohol beverages for over sixty years. This model includes Federal regulation of all levels of the distribution chain for tobacco products -- from manufacturer to retail dealer.

As we understand it, HHS' proposal for the licensing aspects of the tobacco settlement envisions a Federal/State partnership in which the State would enforce the Federal standards relating to the advertising, labeling, promotional schemes, and distribution of cigarettes and smokeless tobacco through a State retail dealer licensing scheme. These State licensing schemes would be funded primarily by the Federal government. The following model complements HHS' proposal in that it imposes controls on the distribution of tobacco products from manufacture or importation up to the retail dealer -- even providing the Federal government a means to put retail dealers who violate Federal laws relating to the regulation of tobacco out of business. Regulation of the sale to the actual consumer would be picked up by HHS' proposal.

Because a licensing/permit system is the most practical way to control the distribution of a commodity, a permit system (similar to that imposed on the alcohol industry by the Federal Alcohol Administration Act (27 U.S.C. §§ 201 *et seq.*)) should be proposed. This system should require all manufacturers, importers, exporters, and wholesale distributors (including brokers) of tobacco products to obtain a permit. Additionally, all retail dealers in tobacco products should be required to register with the Federal agency designated to administer the program.[2] The system should include the authority for the designated Federal agency to suspend or revoke any permit or registration, and/or levy fines if the entity holding the permit or registration violates any Federal law relating to the regulation or distribution of tobacco products. Sales of tobacco products to consumers should only be allowed in "non-commercial" quantities. In whole or in part, the funding for this proposal could be derived from a special (occupational) tax/ or registration fee imposed on each level of the distribution chain.

This system should allow manufacturers, importers, or wholesale dealers to deliver, sell, ship, or transfer tobacco products only to permitted or registered entities. Exporters should be allowed to deliver, sell, ship, or transfer tobacco products only to permitted manufacturers, other exporters, or to foreign purchasers. In that regard, all tobacco products intended for export should be marked "FOR EXPORT FROM THE UNITED STATES ONLY." Re-importation of exported cigarettes should not be permitted, except for re-exportation, or for direct return to a manufacturer for repackaging. It should be unlawful to distribute or possess for domestic resale tobacco products in packages marked for export only in the United States.

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[2]Retail dealers would register by filing a "Notice of Registration" with the designated Federal agency. Unless there is evidence that the retail dealer had previously violated Federal laws relating to tobacco, the Notice would be approved. An application for a permit would be investigated much more thoroughly.

Manufacturers, importers, exporters, and wholesale distributors should be required to keep records of production, importation, acquisition, and distribution. Retailers should be required to keep records only of acquisition, since such records are sufficient for enforcement purposes. The designated Federal agency should have adequate inspection authority for both the permitted or registered premises and required records.

Adequate criminal penalties should be imposed for any violations of these provisions. Additionally, the designated Federal agency should be given the authority to impose civil monetary penalties for violation of the proposed system, and the ability to compromise said violations. The designated Federal agency should also be given the authority to seize and forfeit tobacco products, conveyances, and proceeds associated with and derived from any violation of the proposed system.

Finally, the Contraband Cigarette Trafficking Act currently contains loopholes which make enforcement difficult in certain jurisdictions. For example, that Act currently applies only to cigarettes not bearing a tax stamp demonstrating payment of the State tobacco tax. However, five states do not require tax stamps for cigarettes. By closing this loophole, the entire system would have greater integrity, which would generally make it more difficult to divert tobacco products from the lawful distribution chain.

IV. Costs to Implement and Maintain a Comprehensive Tobacco Program

Given the nature of the settlement as outlined, provisions in this proposal could change based on the scope of the legislation resulting from the settlement. However, failure to enact a comprehensive scheme to regulate the distribution of tobacco products will have a substantial impact on the ability of the designated Federal agency to ensure compliance with the proposals. In any event, no proposals will succeed without adequate funding for administration and enforcement.

Assuming a regulatory model similar to the Federal Alcohol Administration Act is adopted, and applying existing workload and cost data for Federal regulation of the alcohol industry, a period of three years would be required to phase-in all aspects of the program. We estimate that costs would exceed $88 million during each of the first three years of the program. This amount includes processing permit applications, issuing those permits, collecting a special (occupational) tax or registration fee from permitted entities and retailers and necessary enforcement actions. This also assumes a floor stocks tax program (payment of tax on existing tobacco products inventory) would be required.

After the phase-in period, annual costs of $38 million would be required to collect annual special tax or registration fees, to conduct industry audits to ensure compliance with the law and for necessary enforcement actions.

An annual fee of $75 for each permittee and retail registrant would cover these costs. This fee could be enhanced to allow flexibility for reimbursement to State/local enforcement authorities in a Federal/State partnership at the retail level. Also, this fee schedule could be significantly impacted by changes in a proposed regulatory system and would need to be reconsidered in light of those changes.

tobacco lisensing – GW

ATF, HHS, Treasury, OMB

2/6/98

GW

tobacco
Liscensing

→ Hatch

Issues
~~complete~~

not fed'l administered

- States would meet fed'l stnds

- Some fees to have liscenses
  to cover cost of progm

1. state – fed stnds.
2. tough penalties
3. ↓ liscensing fees

→ wholesale vs. retail
↓ fed'l ↓ state

→ comparable to alcohol

Wholesale –
liscensing / tax
- qualifications w/ permit
- cr. term – not a felon

liscensing

liscen –

Issues

Criminal - vs. permit

FDA reg'l vs. & ATF

ATF already regulates

- black mkt. → strong distribution system

- ads, youth, vending
purchase

- occupational tax
  - to identify sellers
  - shrinks # of sellers

Synar

Sampsa

18 minimum age
→ need to
show your
are enforcing
→ w/ks block
grant
→ 80% compliance
by yr-X

paper —

- Treasury — how it would like to reg'l w/ wholesale level
  - special emphasis on black mkt.
- FDA — How best to deal w/ pt. of sale, stmts for states, how to keep kids
- Current structure as well
- 34 states have licensing scheme in place.
- Surgeon report

→ Friday paper due

Bruce N. Reed
01/12/98 04:49:54 PM

Record Type: Record

To: Thomas L. Freedman/OPD/EOP

cc: Elena Kagan/OPD/EOP, Mary L. Smith/OPD/EOP, Jerold R. Mande/OSTP/EOP

Subject: Re: Liscensing/Tobacco meetings

Yes

Tom -

Don't call a meeting on licensing. We're waiting for the Counsel language before we proceed on this subject.

Elena