

STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE

Testimony of
William J. Comiskey, Deputy Commissioner
Office of Tax Enforcement

Before the Senate Standing Committee on Investigations and Government Operations

Tuesday, October 27, 2009

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Highlights of recent DTF Cigarette Tax Enforcement activities

While our cigarette tax enforcement efforts include thousands of retail inspections and hundreds of arrests each year, our primary investigative strategy in recent years is to infiltrate the cigarette smuggling underworld by conducting long-term undercover investigations. To catch smugglers, our agents go deep undercover, sometimes for months and even years, posing as smugglers. The work is unquestionably dangerous and difficult and often involves out-of-state operations. But the technique has been extraordinarily successful.

Here are some highlights.

Operation Keystone

In September 2009, Department investigators concluded the largest and most successful undercover bootleg cigarette investigation ever conducted by any state or local law enforcement agency in the nation. Working with Westchester District Attorney Janet DiFiori and other law enforcement agencies, our investigators posed as cigarette smugglers willing to supply other smugglers with untaxed cigarettes. Starting from a humble warehouse in Westchester, this undercover business grew until more than 60 major New York smugglers were our customers. In September, investigators executed search warrants at 13 New York locations and arrested 27 individuals on felony evasion charges, including one individual who was involved in illegal weapons sales and bomb making. We seized over 3,900 cartons of untaxed cigarettes, \$841,000 in cash, 33,700 untaxed cigars, 800,000 counterfeit tax stamps and 16 vehicles. Over the course of the investigation, the targets purchased over 466,000 cartons of cigarettes for over \$16 million and evaded more than \$21 million in state and city cigarette excise taxes.

Brooklyn counterfeit tax stamp case

A nine month undercover cigarette investigation we conducted with the Brooklyn District Attorney's office and other state and federal law enforcement agencies resulted in the February 2008 arrest of an individual following the largest seizure ever of counterfeit cigarette tax stamps. Our investigators seized 2,178,307 stamps, valued at over \$6 million, as well as 1320 cartons of untaxed cigarettes and \$264,000 in cash.

Operation KG

This two-year multi-agency undercover operation, which culminated in 2008, was spearheaded by Department investigators who operated a Virginia cigarette warehouse that supplied untaxed cigarettes to major New York smugglers. During the course of this investigation, these smugglers not only purchased thousands of cartons of untaxed cigarettes from our undercover agents but some sold us weapons. Altogether these smugglers evaded approximately \$10 million in New York cigarette taxes. In 2008, 23 bootleggers were arrested and our agents seized more than \$360,000 and 5 vehicles. Those arrested have been prosecuted in federal court and have each received federal prison sentences.

Operation Phoenix

Before Operation KG, we had conducted an earlier and also successful undercover operation in Virginia in which we posed as criminals and operated a Virginia warehouse that supplied major New York cigarette smugglers. The investigation, conducted in collaboration with several other law enforcement agencies, resulted in the arrest of 20 major cigarette bootleggers who were prosecuted in federal court and received federal prison sentences.

Operation Stamp Out

In May 2009, Department investigators, working with the Nassau District Attorney's office and the Nassau Police Department, concluded undercover investigations into the illegal contraband cigarette trade in Nassau County. 18 business owners, including some operating national chain stores, were arrested on felony evasion charges after they had collectively evaded more than \$2.1 million in cigarette taxes. Nine vehicles, over 2,700 cartons of cigarettes, 4,500 untaxed cigars and \$1,000,000 in cash were seized.

Operation Avon

In October 2008, we concluded a six month undercover investigation with the Rockland County District Attorney's Office. The investigation resulted in felony arrests of four businessmen, including a New York State registered cigarette wholesaler, for unlawfully purchasing 17,368 cartons of untaxed cigarettes, with a tax loss to NYS of \$541,881. During the execution of search warrants, our investigators recovered over 300 cartons of untaxed cigarettes, 4,000 counterfeit tax stamps, four vehicles, and two stun guns.

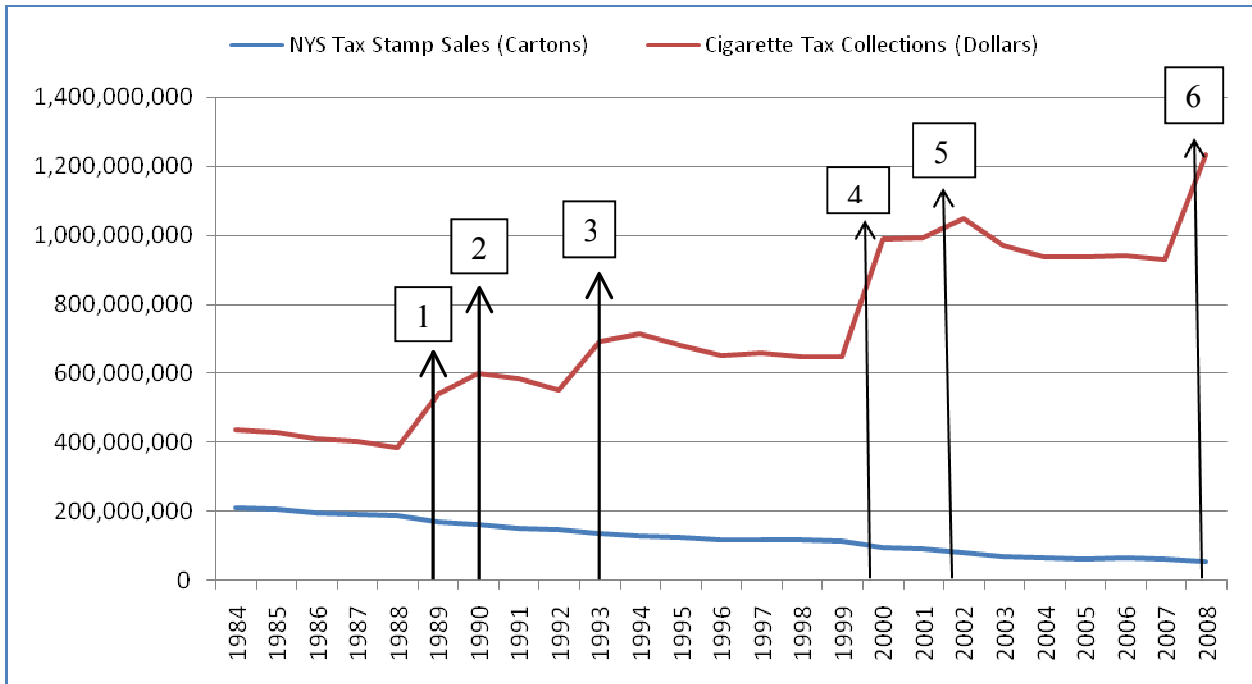
Tri State Counterfeit Stamp Case

Department investigators and federal agents conducted this three year undercover investigation into the smuggling of untaxed contraband cigarettes and the sale of counterfeit tax stamps. During the investigation our undercover investigator purchased over 20 illegal firearms from the criminals with whom he was dealing. The investigation also revealed a counterfeit stamp making operation in the Bronx which was dismantled in March 2007 with the arrest of two individuals and the seizure of counterfeiting equipment and over 260,000 counterfeit stamps. Five search warrants in Delaware in February 2008 led to the arrest of a target and the seizure of over 17,000 cartons of contraband cigarettes, over \$360,000 cash, and more than 30,000 counterfeit stamps.

Five Fingers Counterfeit cigarette case

Following a five month joint investigation with the Nassau Police Department, our investigators helped execute search warrants in August 2007 at a warehouse in Queens one of the largest seizures of counterfeit cigarettes ever in New York State, over 21,000 cartons, as well as an additional 46,000 cartons of untaxed cigarettes, 250,000 counterfeit tax stamps, stamping equipment, two vans, boxes of counterfeit "Nike" sneakers and over \$350,000.00 in cash. Three individuals were arrested.

**Chart 1:
A Comparison of NYS Tax Stamp Sales and Cigarette Tax Collections: (1984-2008)**



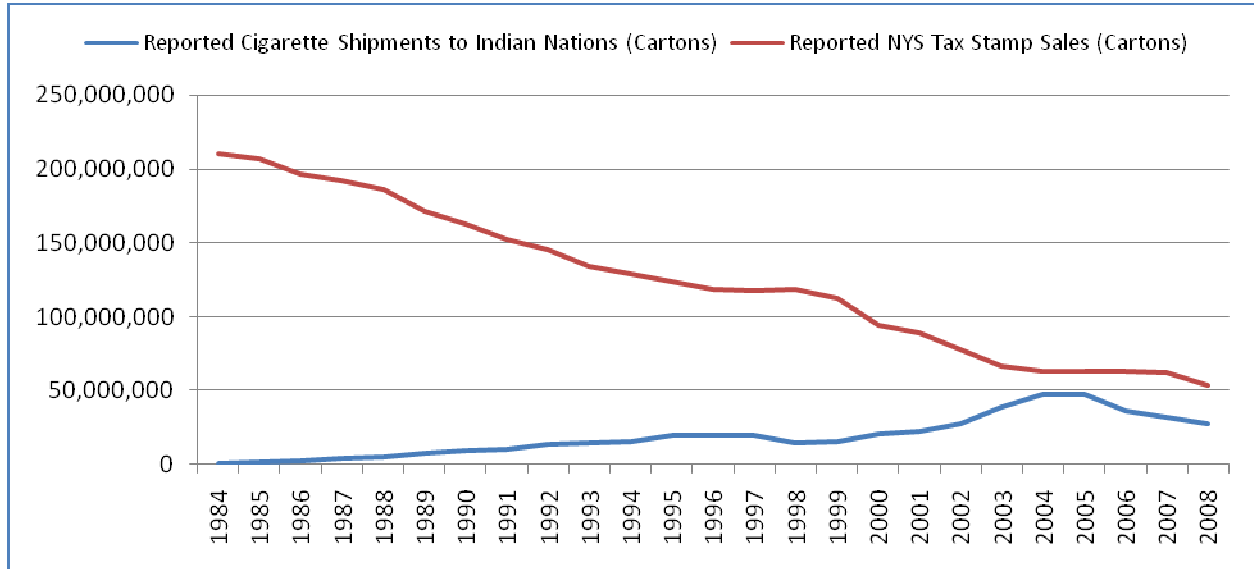
Source: NYS Department of Taxation

- (1) Cigarette tax rate increased from 21 cents to 33 cents per pack on 5/1/89
- (2) Cigarette tax rate increased from 33 cents to 39 cents per pack on 6/1/90
- (3) Cigarette tax rate increased from 39 cents to 56 cents per pack on 6/1/93
- (4) Cigarette tax rate increased from 56 cents to \$1.11 per pack on 3/1/00
- (5) Cigarette tax rate increased from \$1.11 to \$1.50 per pack on 4/2/02
- (6) Cigarette tax rate increased from \$1.50 to \$2.75 per pack on 6/3/08

In SFY 2008-09, the cigarette excise tax generated over \$1.2 billion in excise tax revenues and another \$220 million in prepaid sales taxes.

In the 25 year period from 1984 to 2008, stamp sales have declined a total of 75 percent, from 210 million cartons in 1984 to 53 million cartons in 2008. The decline in consumption reflects the impact of increased public awareness of the adverse health effects of smoking, smoking restrictions imposed by governments, anti-smoking education programs, changes in consumer preferences toward other types of tobacco, and State and local cigarette taxes. During the period 1984-2008, the State excise tax on cigarettes was increased on six different occasions. While each tax rate increase further contributed to a drop in taxable consumption, it also successfully generated increased revenues.

Chart 2: A Comparison of Reported Cigarette Sales to Indian Nations and NYS Tax Stamp Sales: (1984-2008)



Source: NYS Department of Taxation

While cigarette consumption (as measured by cigarette stamp sales) declined by 75 percent from 1984 to 2008, shipments of cigarettes to Indian reservations increased by 2,500 percent (at the high point in 2005). The volume of reported shipments began to increase significantly in the late 1990s. The increase in reported shipments correlates closely with the rise of the Internet as a medium to purchase cigarettes¹ and the proclivity of states to use their cigarette tax as a source of revenue to close state budget gaps. From 1995 to 1999, states increased their cigarette excise tax rates a total of 20 times. From 2000 to 2005, states increased their cigarette excise tax rates a total of 62 times (New York increased its rate two times during this period). Thus, it is not unreasonable to assume that a significant portion of the cigarettes shipped to New York Indian reservations during this period were making their way beyond New York borders into the national market via the Internet.

¹ The Internet in its current form has been around since the early 1990s. However, it wasn't until 1995 that the Internet's commercial and individual consumer use began to skyrocket. By the fourth quarter of 1999, the first period which the Census Bureau began tracking on-line sales, Internet sales totaled \$5.3 billion (or 0.64% of total retail sales).

Sales of cigarettes over the Internet also began to expand during this period. In 1999, researchers at the University of North Carolina identified 88 Internet cigarette vendors located in 23 states. The researchers identified roughly half (43) of these vendors as being located in New York, most of which were on Native American reservations in western New York. By 2001, OTPA identified 82 websites with geographic addresses in western New York. The last estimate of the number of domestic Internet cigarette vendors by the federal government put the number of vendors to over 400 (reservation and Non-Indian sellers).

Chart 3:

Comparison of Sales to Indian Reservations and New York State Tax Stamp Sales: 1984 to 2009 (August)				
	Reported Cigarette Sales to Indian Nations (Cartons)	NYS Tax Stamp Sales (Cartons)	Total Reported Volume of Cigarettes Shipped into NYS (Cartons)	Indian Share of Total Reported NYS Volume
1984	1,043,959	210,432,600	211,476,559	0.5%
1985	1,843,690	206,580,100	208,423,790	0.9%
1986	3,075,176	196,443,600	199,518,776	1.5%
1987	4,217,536	191,960,600	196,178,136	2.1%
1988	5,650,368	186,357,900	192,008,268	2.9%
1989 (1)	7,645,096	170,987,100	178,632,196	4.3%
1990 (2)	9,957,994	162,874,100	172,832,094	5.8%
1991	10,623,684	151,839,100	162,462,784	6.5%
1992	14,249,497	145,385,000	159,634,497	8.9%
1993 (3)	14,478,467	134,387,615	148,866,082	9.7%
1994	15,688,785	128,339,900	144,028,685	10.9%
1995	19,800,720	123,140,460	142,941,180	13.9%
1996	20,088,425	118,136,090	138,224,515	14.5%
1997	20,061,414	117,459,480	137,520,894	14.6%
1998	15,213,878	118,190,080	133,403,958	11.4%
1999	15,558,379	112,308,880	127,867,259	12.2%
2000 (4)	20,746,460	93,899,080	114,645,540	18.1%
2001	22,462,975	88,953,360	111,416,335	20.2%
2002 (5)	28,006,531	77,591,520	105,598,051	26.5%
2003	39,343,397	66,441,480	105,784,877	37.2%
2004	47,363,097	62,991,240	110,354,337	42.9%
2005	47,605,054	62,533,200	110,138,254	43.2%
2006	36,014,537	62,588,760	98,603,297	36.5%
2007	31,940,366	62,184,984	94,125,350	33.9%
2008 (6)	27,513,045	53,191,080	80,704,125	34.1%
2009 (Jan-August)	16,468,680	31,455,000	47,923,680	34.4%
(1) Cigarette tax rate increased from 21 cents to 33 cents per pack on 5/1/89				
(2) Cigarette tax rate increased from 33 cents to 39 cents per pack on 6/1/90				
(3) Cigarette tax rate increased from 39 cents to 56 cents per pack on 6/1/93				
(4) Cigarette tax rate increased from 56 cents to \$1.11 per pack on 3/1/00				
(5) Cigarette tax rate increased from \$1.11 to \$1.50 per pack on 4/2/02				
(6) Cigarette tax rate increased from \$1.50 to \$2.75 per pack on 6/3/08				

**Chart 4: Reported Sales 2006-August 2009
by Licensed Agents that Sell to Indian Merchants**

Agent Name	Unstamped Sales To Indians (cartons)	Stamped Sales (cartons)	Unstamped Sales as Percentage of Business	Indian Customers	
				Primary Nation	Secondary Nation
Jacob Kern & Son	80,085,521	0	100	Seneca, Onondaga	
Milhelm Attea	11,993,705	198,891	98	Tonawanda, Seneca, Tuscarora	Oneida, Onondaga
Day Wholesale	8,044,969	311,083	96	Mohawk, Tuscarora	Onondaga, Tonawanda
Mauro Pennisi	7,687,283	3,352,476	70	Poospatuck	
Gutlove & Shirvint	7,231,504	5,455,712	57	Shinnecock, Poospatuck	
Valvo Candy	3,236,619	0	100	Seneca, Mohawk	
Windward Tobacco	1,697,560	0	100	Seneca, Tonawanda	Tuscarora, Oneida, Onondaga
Capital Candy	1,149,329	459,453	71	Mohawk	Seneca
Alternative Cigarettes	704,608	1,125	99	Seneca, Tonawanda	
General Tobacco	499,765	0	100	Seneca, Oneida, Onondaga	
Total above agents	122,330,864	9,778,740			

In 1994, approximately one in ten cigarettes sold in New York were sold to Native American merchants, without any tax being imposed. In 2005, more than four in every ten cigarettes were sold without tax to Native American merchants. Today, approximately one in three cigarettes sold by licensed stamping agents are sold, without stamps, to Native American merchants.

Currently, New York has approximately 80 licensed stamping agents. Only 10 of these agents sell untaxed cigarettes to Native American merchants but, as reflected in Chart 3, those sales represent more than one-third of all the cigarettes sold by licensed agents in New York.

Under New York law, licensed stamping agents serve one purpose: They are licensed as “agents to buy and affix stamps to be used for paying” the cigarette tax. 20 NYCRR section 71.1(a). To carry out this purpose, licensed agents are permitted to engage in conduct that would be unlawful for others -- they are permitted to possess quantities of unstamped cigarettes.

As Chart 4 above reflects, these 10 agents do not “affix stamps” to the bulk of the cigarettes they sell. Four agents, including the agent with the greatest reservation sales, had no reported sales of stamped cigarettes. Their cigarette sales activity consists entirely of sales of unstamped cigarettes to reservation merchants. For three other agents, sales of unstamped cigarettes to Native American merchants represented nearly all of their cigarette sales activity and for the other three, it represented from between 57% to 71% of their cigarette business.

**Chart 5: Sales to Indian Nations as Reported by NYS Licensed Cigarette Agents
Ranked by Total Sales Volume (cartons) 1996 – June 2009**

Total <u>1996-June 09</u>	
<u>Indian Nation</u>	
Seneca	189,283,783
Poospatuck	49,270,180
Tonawanda	44,015,129
Tuscarora	35,449,784
Oneida	20,686,218
Shinnecock	15,768,196
Onondaga	16,723,126
Mohawk	11,333,812
Total	382,530,228

Sales by year 1996 – 2002

<u>Indian Nation</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
Seneca	7,243,495	10,093,605	6,580,620	5,717,238	6,265,565	9,428,926	14,563,668
Poospatuck	406,148	362,804	611,430	1,047,140	444,643	680,035	952,340
Tonawanda	3,239,717	2,783,814	2,662,340	2,700,097	3,595,878	3,972,924	4,522,550
Tuscarora	3,503,075	2,850,618	2,306,733	2,040,078	4,835,751	3,331,270	2,480,306
Oneida	1,149,565	792,803	789,923	1,330,283	1,332,637	1,294,383	1,259,108
Shinnecock	1,021,473	771,969	750,072	696,971	2,129,653	1,832,502	2,066,428
Onondaga	2,053,982	1,422,350	703,250	1,156,728	1,499,974	1,370,508	1,337,782
Mohawk	1,443,959	979,125	802,589	852,344	639,865	526,825	601,544
Total	20,061,414	20,057,088	15,206,957	15,540,879	20,743,966	22,437,373	27,783,726

Sales by year 2003 – June 2009

<u>Indian Nation</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u> (thru June)
Seneca	23,963,563	29,813,680	27,505,847	17,677,150	12,559,554	11,811,732	6,059,140
Poospatuck	811,899	4,978,931	7,886,663	8,888,129	11,316,773	8,425,202	2,458,043
Tonawanda	4,496,889	4,174,047	4,080,130	2,453,889	2,000,376	2,028,773	1,303,705
Tuscarora	2,704,786	3,028,342	2,761,818	1,863,831	1,635,751	1,500,597	606,828
Oneida	1,085,060	1,856,768	2,106,062	2,777,496	2,642,851	1,608,076	661,203
Shinnecock	2,595,677	1,388,666	1,454,928	362,871	330,316	281,247	85,423
Onondaga	1,364,602	1,265,274	1,131,415	917,646	789,434	1,067,585	642,596
Mohawk	777,090	861,884	715,742	1,073,529	665,311	789,833	604,172

Total	37,799,566	47,367,592	47,642,605	36,014,541	31,940,366	27,513,045	12,421,110
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Chart 6: Numbers of Native Americans living on reservations (2000 census) compared to number of reported cartons sold by licensed stamping agents to Native American merchants in 2008.

Native American Residing on Reservations in NYS			
Tribe	NYS Population (2000 census)**		2008 Sales (cartons)
Seneca	7,967		11,811,732
-Allegany			
-Cattaraugus			
-Oil Springs			
Tonawanda Band of Senecas	256		2,028,773
St. Regis Mohawk	13,784		789,833
Tuscarora	1,025		1,500,597
Onondaga	2,866		1,067,585
Oneida	1,473		1,608,076
Shinnecock	1,915		281,247
Poospatuck	376		8,425,202
Cayuga	947		
TOTAL	31,557		
<p>**Based on Census 2000 Special tabulation for American Indian tribal members residing in NYS Census estimate is inflated by 10% to allow for undercounting in census enumeration</p> <p>SOURCE: U.S. Census Bureau, Census 2000, special tabulation (PHC-T-18, table 47)</p>			

New York State Department of Taxation and Finance
Office of Tax Policy Analysis Technical Services
Division

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. M060316A

On March 16, 2006, the Department of Taxation and Finance received a Petition for Advisory Opinion from Milhem Attea & Bros., Inc., 1509 Clinton Street, Buffalo, New York 14206.

The issues raised by Petitioner, Milhem Attea & Bros., Inc., are:

1. What is the Department of Taxation and Finance's current policy with respect to the sale of cigarettes from stamping agents to Indian Nations and Indian retailers making sales from reservations?
2. Has the Department of Taxation and Finance altered its long-standing policy as a result of the enactment of section 471-e of the Tax Law?
3. **In** light of section 471-e of the Tax Law, does the Department of Taxation and Finance have any plans to issue assessments to stamping agents regarding the sale of unstamped cigarettes to Indian Nations and Indian retailers making sales from reservations after March 1, 2006?

Petitioner submitted the following facts as the basis for this Advisory Opinion.

Petitioner is a licensed stamping agent which sells cigarettes and other tobacco products at wholesale to Indian Nations and Indian retailers on reservations for resale to the public.

Applicable law

Section 471-e of the Tax Law provides, in part:

1. General. (a) Notwithstanding any provision of this article to the contrary qualified Indians may purchase cigarettes for such qualified Indians' own use or consumption exempt from cigarette tax on their nations' or tribes' qualified reservations. However, such qualified Indians purchasing cigarettes off their reservations or on another nation's or tribe's reservation, and non-Indians 'making cigarette purchases on an Indian reservation shall not be exempt from paying the cigarette tax when purchasing cigarettes within this state. Accordingly, all cigarettes sold on an Indian reservation to nonmembers

of the nation or tribe or to non-Indians shall be taxed, and evidence of such tax will be by means of an affixed cigarette tax stamp.

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(b) In order to ensure an adequate quantity of cigarettes on Indian reservations which may be purchased by qualified Indians exempt from the cigarette tax, the department shall provide Indian nations and tribes within this state with Indian tax exemption coupons as set forth in this section. A reservation cigarette seller shall be able to present such Indian tax exemption coupons to a wholesale dealer licensed pursuant to this article in order to purchase stamped cigarettes exempt from the imposition of the cigarette tax. Qualified Indians may purchase cigarettes from a reservation cigarette seller exempt from the cigarette tax even though such cigarettes will have an affixed cigarette tax stamp.

2. Indian tax exemption coupons.

(a) Indian tax exemption coupons shall be provided to the recognized governing body of each Indian nation or tribe to ensure that each Indian nation or tribe can obtain cigarettes upon which the tax will not be collected that are for the use or consumption by the nation or tribe or by the members of such nation or tribe. The Indian tax exemption coupons shall be provided to the Indian nations or tribes on a quarterly basis for each of the four quarters beginning with the first day of December, March, June, and September. It is intended that the Indian nations or tribes will retain the amount of Indian tax exemption coupons they will need each quarter to purchase cigarettes for official nation or tribal use, and will distribute the remaining Indian tax exemption coupons to reservation cigarette sellers on such nations' or tribes' qualified reservations. Only Indian nations or tribes or reservation cigarette sellers on their qualified reservations may redeem such Indian tax exemption coupons pursuant to this section.

3. Tax exempt purchaser. (a) An Indian nation or tribe may purchase cigarettes for its own official use or consumption from a wholesale dealer licensed pursuant to this article without payment of the cigarette tax to the extent that the Indian nation or tribe provides such wholesale dealer with Indian tax exemption coupons entitling the Indian nation or tribe to purchase such quantities of cigarettes as allowed for on each Indian tax exemption coupon without paying the cigarette tax.

(b) A qualified Indian may purchase cigarettes for his or her own use or consumption without payment of the cigarette tax, provided that the qualified Indian makes such purchase on a qualified reservation.

(e) A reservation cigarette seller may purchase cigarettes for resale without payment of the cigarette tax from a wholesale dealer licensed pursuant to this article:

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(i) provided that such reservation cigarette seller brings such cigarettes or causes them to be delivered onto a qualified reservation for resale on such reservation;

(ii) to the extent that such reservation cigarette seller provides such wholesale dealer with Indian tax exemption coupons entitling the reservation cigarette seller to purchase such quantities of cigarettes as allowed for on each Indian tax exemption coupon without paying the cigarette tax; and

(iii) provided that such cigarettes are affixed with a cigarette tax stamp.

(d) A wholesale dealer shall not collect the cigarette tax from any purchaser to the extent the purchaser gives such wholesale dealer Indian tax exemption coupons entitling the purchaser to purchase such quantities of cigarettes as allowed for on each such Indian tax exemption coupon without paying the cigarette tax.

Opinion

As Petitioner is probably aware, the New York State Department of Taxation and Finance (the Department) has a long-standing policy of allowing untaxed cigarettes to be sold from licensed stamping agents to recognized Indian Nations and reservation-based retailers making sales from qualified Indian reservations. In a challenge to the State's policy (*New York State Association of Convenience Stores v. Urbach*), the Court held that the policy of indefinite forbearance was rationally based, and therefore, the petitioners' Article 78 proceeding attempting to compel the State to enforce the collection of excise and sales taxes pertaining to onreservation sales of cigarettes and motor fuel to non-Indian consumers was dismissed. This policy has been reiterated on several occasions by the Department over the years since the decision *in NYACS*.¹

The Petition specifically asks whether the enactment of section 471-e of the Tax Law has resulted in a change in policy. The Commissioner indicated in his testimony to a joint session of the Legislature's fiscal committees on February 15, 2006 that the Department would not begin enforcement on March 1, 2006 (the effective date of section 471-e). In the Executive Budget, several amendments were proposed to correct deficiencies in the law. Specifically, the amendments include the creation of an Indian export decal system relating to out-of-state sales, a provision to allow qualified Indians to purchase tax exempt products from any qualified reservation and changes to facilitate the negotiation of tax agreements with the various Nations.

These amendments will respect Indian sovereignty and avoid excessive State entanglement in Indian commerce. Pending resolution of these issues, it would be premature to

See, for example, Department affidavit dated February 10, 2006 in *Milhelm Attea & Brothers, Inc v. Spitzer*; Department affidavit in *Ward v. Spitzer* dated July 7, 2003; Department Office of Counsel letter dated June 12, 2003; and Department TSB-M-00(4)M dated October 20, 2000 (superseded by TSB-M-03(I)M)

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begin enforcement. Moreover, it is likely that a party will commence a lawsuit or otherwise challenge the new law, which could have the effect of invalidating or postponing the new statutory scheme.² Therefore, the Department has no intention to alter its long-standing policy until such issues are fully addressed and considered. However, if the Department decides to revise its policy in the future, it will provide adequate notice to all affected stamping agents.

Addressing Petitioner's last question with respect to the possibility of issuing assessments in light of the enactment of section 471-e, the Department will not issue such assessments with respect to transactions occurring during the period of forbearance as that would be inconsistent with the State's long-standing policy.

DATED: March 16, 2006

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.

² A lawsuit was, in fact, recently commenced against Department and Attorney General Spitzer challenging section 471 and the entire cigarette taxing scheme, but was withdrawn on the eve of a Temporary Restraining Order hearing.