TESTIMONY

Of

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before the

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Subcommittee on Federal Workforce, Postal Service, and the District of Columbia

Hearing on

Nonmailable Tobacco

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Chairman Davis and Ranking Member Marchant, my name is Eric Proshansky. I am an Assistant Corporation Counsel in the New York City Law Department. Thank you for the opportunity to testify before this Subcommittee on the issue of tobacco product mailability, which has been a thorn in the side of New York City's health and fiscal initiatives for quite some time. I would also like to say thanks to our own Congressman McHugh, our partner in upstate New York, for all of his work and leadership on this particular issue. We are fortunate to have you with us today Congressman.

New York City agencies that run up against obstacles in carrying out their government role will often approach the City's Law Department seeking a legal solution. It is relatively rare however for two such agencies independently to approach the Law Department at the same time, with the same concern, as was the case in early 2002, when both the New York City Department of Finance and the City Department of Health came to us when bedeviled with cigarettes sales over the Internet.

Reducing tobacco use is one of the top priorities of New York City's Mayor Michael Bloomberg, for the simple reason that diseases caused by tobacco kill more New York City residents than any other preventable cause of death -- more than one every hour. As you know, New York City has a very comprehensive tobacco control program, which includes laws restricting smoking in public places, hard hitting television ads and educational programs about the dangers of smoking, free and low cost tobacco cessation services, and tobacco tax increases. Tobacco taxes are not only a source of state and local revenue, but are also a proven public health measure because they reduce tobacco consumption.

When cigarette prices go up, smoking goes down – especially among youth. These measures, particularly the tax increase, contributed to a reduction by 20% in adult smoking and 50% in teen smoking – resulting in 250,000 fewer smokers in New York City over the past 6 years. Of all the public health measures available to us, economists and public health experts tell us that increasing the cost of tobacco products is the most effective

Congress recognized as early as 1949 through the passage of the Jenkins Act (15 U.S.C. § 375 *et seq.*) that so long as cigarette taxes differ in amount across State borders, consumers will cross those borders in search of a cheaper cigarette. Worse yet, entrepreneurs in low tax locales will also exploit cross-border tax disparities via bulk shipments to high tax locales.[1] Before the advent of the Internet, the process of marketing and of ordering cheap cigarettes from another state was mediated by newspapers, flyers and telephone. *See United States v. DeFiore*, 720 F.2d 757 (2d Cir. 1983), *cert. denied*, 467 U.S. 1241 1984); *United States v. Brewer*, 528 F.2d 492, 496 (4th Cir. 1975). Those now quaint methods, combined with the relatively modest difference in taxes, kept the problem in comparatively reasonable check. By the 21st Century, the Internet and the very steep tax disparities across state borders – approaching $50 a carton – have created a nearly perfect setting for the cross-border purchase of what are commonly advertised as "tax-free" cigarettes. With cigarettes costing, for example, $70 for a carton of premium cigarettes in New York City, it is an easy matter to log on to a computer, run a search for "tax-free cigarettes," type a credit card number into one of the hundreds of foreign and domestic websites that will appear in response to that search, and then sit back as the United States Postal Service delivers the cigarettes to your door, perhaps as early as the next morning, at

[1] *See*, for example, *United States v. Brewer*, 528 F.2d 492, 496 (4th Cir. 1975): "The [Jenkins Act] was enacted for three major reasons: '(1) The large and increasing loss of revenue to the States caused by the evasion of sales and use taxes on cigarettes shipped in interstate commerce to consumers'; '(2) The discrimination caused by this evasion against sellers of cigarettes in States having a higher tax than the tax of the seller States'; and '(3) *The fact that this evasion was accomplished through the use of the United States mail.*'" (citing S. Rep. No. 1147, 84th Cong., 1st Sess., *U.S. Code Cong. and Admin. News* 2883 (1955)) (emphasis added)

a cost of only \$30 per carton, a \$40 per carton "discount." The purchase is not only convenient, but for many consumers guilt-free, because Internet cigarette sellers frequently misrepresent to their customers that the cigarettes are "tax-free," when in fact in virtually all States a buyer of cigarettes on which excise taxes have not been paid by the seller must remit the taxes to the State, and, in New York, also to the City. The cigarettes may be "tax-free" to the seller – sellers need not remit them to the out of state buyer's jurisdiction – but they are certainly not tax-free to the buyer. What many of the Internet cigarette sites also represent to their customers – and in this they are absolutely correct – is that it is perfectly legal for the cigarettes to be shipped by the U.S. mail.

Faced with this situation, both the New York City Department of Finance and the Department of Health voiced essentially the same complaint – by allowing consumers so easily to circumvent State and City tax laws, the City (as well as New York State) was losing untold millions of tax dollars annually; at the same time, the public benefit from the tobacco tax increase was not being fully realized, with the result being avoidable illness and death from smoking.

Let me offer a simple illustration of the tax avoidance. In approximately 2004, New York City obtained the sales records of an Internet cigarette seller located in the State of Virginia, a State whose cigarette tax is lower than most other States. The sales records were analyzed by epidemiologists in the New York City Department of Health, who compared the volume of sales made to residents of a given state with the amount of the tax that the buyer would have had to pay to his home State. The results are shown in the attached graph entitled "Shipments vs. State Tax." The Y-axis of the graph, "Per capita shipments (per million smokers)" shows the number of orders from each of the States for which there were orders, normalized for population. The X-axis, "State Tax ($ per carton)," shows the amount of the tax on a carton of cigarettes in the buyers' State. The graph shows with clarity that, as might be expected, the higher the cigarette tax, the greater the number of orders: residents of high-tax jurisdictions placed the greatest number of orders from this Internet seller, leading the Department of Health to conclude that the primary purpose of buyers of cigarettes over the Internet was tax evasion.

The Internet's dual threat to City tax revenue and to its very vigorous programs designed to encourage smoking cessation prompted New York City to bringing a series of civil lawsuits against Internet cigarette sellers, both domestic and overseas, alleging mail and wire fraud. The lawsuits, which are still working their way through the courts, have even prior to completion met with some success by persuading some Internet sellers to cease and desist from selling to New York residents, and by recovering several million dollars in lost tax revenue from City residents. Perhaps most encouraging, surveys by the Department of Health showed a decrease in the number of City smokers buying cigarettes over the Internet that followed on the heels of the lawsuits and the attendant publicity surrounding the tax collection.

Tax losses from evasion are by their nature notoriously difficult to determine. A 2002 analysis by Prudential Financial Research estimated that in that year alone, States lost $254.7 million in excise taxes as a result of Internet cigarette sales.[2] The table below provides a hint of the magnitude of tax losses to New York City. Based on customer lists received in settlements of the lawsuits, and in one instance as a result of a federal prosecution of an Internet seller, the New York City Department of Finance attempted to recover some of the taxes owed from several Internet sites. The number of customers billed should not be taken as the actual number of customers purchasing from the sites, as only customers with large numbers of

[2] Prudential Financial Research "Buying Cigarettes Over The Internet," September 24, 2002.

purchases were billed. Bear in mind that these five Internet sellers represent a tiny fraction of the estimated hundreds of Internet sites that sell cigarettes, that the figures include only approximately two years worth of sales, and that the State tax losses, equal in amount to the City's, are not shown. While some of these cigarettes may have been delivered by common carrier, the vast bulks were delivered by the Postal Service.

	COLLECTED	BILLED	# NYC CUSTOMERS BILLED
Affordablecigs.com	$574,854	$956,340	2,313
Cigoutlet.com	$35,355	$120,845	136
Smokes4less.com	$177,068	$277,695	1,331
Dirtcheap.com *	$1,427,868	$3,300,585	2,000
eSmokes.com *	$1,064,340	$2,504,789	2,000
Other	$2,195		
TOTAL	**$3,281,679**	**$7,160,254**	

* Still ongoing. Numbers reflect efforts from September 1, 2006 through September 1, 2007.

The City discovered early in the course of these lawsuits that we were playing a classic game of "Whack-A-Mole," and that as fast as we could sue an Internet seller, another one popped up. The barriers to entry to this business are negligible, and we learned from several defendants that the necessary Internet software could be purchased for a few hundred dollars, with the necessary inventory purchased on an as-needed basis from local convenience stores. Product delivery was of course equally low-cost, provided by the U.S. Postal Service. Several of the businesses encountered during the lawsuits were clearly operated from the sellers' garages.

It soon became clear that a solution to the problem of Internet sales required a more efficient "choke-point" than litigation and that the choke-point was at the level of the delivery mechanism. By its very nature, Internet cigarette sales depend entirely on fast, cheap, convenient delivery, all of which is offered by the U.S. Postal Service, and of course, by common carriers as well. If the supply lines are severed, the business model collapses.

The States have also recognized the efficiency of the choke-point approach and have been relentlessly and effectively addressing Internet cigarette sales. New York State, for example, passed legislation outlawing the mailing of cigarettes, although of course the law could seek to regulate only the persons mailing the cigarettes, not the Postal Service. *See N.Y. Pub. Hlth. L* § 1399-ll. That law has had no effect on Internet cigarette sales. The States, acting through the National Association of Attorneys General, and with the assistance of the Bureau of Alcohol, Tobacco, Firearms & Explosives, negotiated an unprecedented set of agreements with credit card processors and common carriers in which members of those industries have essentially pledged to end any assistance to the Internet cigarette business.

With common carriers out of the business, there is one remaining route for the delivery of cigarettes. The National Association of Attorneys General and the State of New York individually have repeatedly attempted to close that remaining route by enlisting the voluntary cooperation of the Postal Service in halting or curtailing the passage of cigarettes through the mail. The uniform response of the Postal Service has been that it was without the legal authority to take any action. The issue was one that the States must take up with Congress.

The City supports legislation that would prohibit the Postal Service from delivering tobacco products as the most efficient and effective way to eliminate tax evasion, contribute to public health and keep minors away from tobacco products. The common carriers who have already agreed not to accept tobacco shipments obviously believe they can implement such a prohibition and I believe the Postal Service can do so also. When Postal Service trucks back up to the Smokes.com warehouse to pick up thousands of identically-shaped packages, the detection problem is not substantial.

Congressman McHugh, from a slightly less urban part of New York, has recognized this and introduced H.R. 2932. In 2005, a group of upstate New York teenagers from his district, in collaboration with law enforcement, conducted an experiment to see if they could get cigarettes over the internet. Half of their orders were successfully delivered and 90 percent of those were delivered by the Postal Service. I want to commend those teenagers and thank Congressman McHugh.

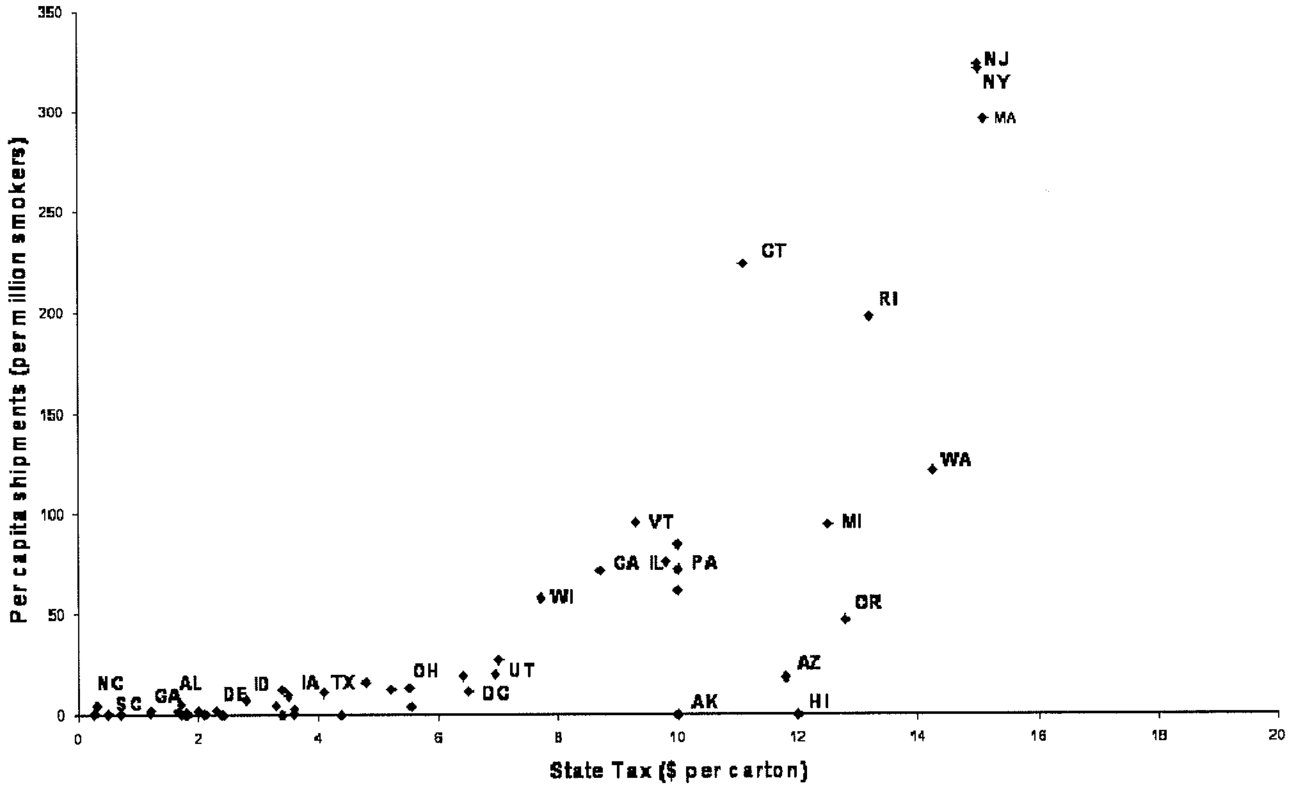
I understand that the Subcommittee may be discussing modifications to H.R. 2932, including giving state and local governments standing to enforce its provisions. I urge you to consider using the same rules of standing that were used in the recent amendments to the Contraband Cigarette Act, 18 U.S.C. 2341 *et seq*. Those amendments gave standing to state governments and also to local governments that impose tobacco taxes, of which there are many. The City has already put that new authority to good use in the courts.

This is the appropriate point to draw the Subcommittee's attention to some of Congress' own legislative history. The Jenkins Act was passed almost sixty years ago, to address precisely the same ills that Internet cigarette sales produces now: the "large and increasing loss of revenue to the States caused by the evasion of sales and use taxes on cigarettes shipped in interstate commerce to consumers," and the "discrimination caused by this evasion against sellers of cigarettes in States having a higher tax than the tax of the seller States. . . " *S. Rep. No. 1147, 84th Cong., 1st Sess.* (reprinted in *U.S. Code Cong. and Admin. News* p. 2883 (1955)). As Congress then observed -- "individuals and organizations are using the United States mails to circumvent State laws," and "[a]dvertisements of organizations specializing in this business cite the availability and use of the United States mails as proof of legality of their operations." Congress found that "respect for the laws of the sovereign States will be furthered

… and … the public interest will be served by [a] bill eliminating any inference that the Federal Government approves of the circumventing of State laws." *S. Rep. No. 644, 81st Cong., 1st Sess.,* (reprinted in *U.S. Code Cong. and Admin. News* 2158, 2159-60 (1949)).

Respectfully, the Jenkins Act, which requires merely the reporting of cross-border sales, but does nothing to bar them, is not viewed today as doing much to prevent the "large and increasing loss of revenue to the States caused by the evasion of sales and use taxes on cigarettes shipped in interstate commerce to consumers." The States need a bill that does more than merely eliminating "inferences that the Federal Government approves of the circumventing of State laws" – the States need a bill that eliminates the cheap, convenient method of circumventing State laws provided by the Postal Service.

Again, I thank you for the opportunity to testify today and I would be happy to answer any questions.



Number of Orders Received By An Internet Cigarette Seller Versus State Tax

"Shipments vs. State Tax"