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TESTIMONY BEFORE THE NEVADA ASSEMBLY JUDICIARY COMMITTEE
IN SUPPORT OF AB 460
April 3, 2003

Mr. Chairman, members of the committee, good morning. My name is Jack Holleran, and I am the Vice President of Brand Integrity at Philip Morris USA. Thank you for giving me this opportunity to present our views in support of Assembly Bill 460.

This legislation offers the State of Nevada an important opportunity to take a leadership role in helping to disrupt, reduce and eventually eliminate illegal activity related to cigarette sales. In addition, this legislation would help further Nevada's efforts to prevent youth smoking, in part by establishing tough controls that will reduce youth access to cigarettes over the Internet.

A weak economy, heightened consumer frugality, and dramatic increases across the country in state cigarette excise taxes and other costs have caused smokers across the nation to seek avenues for purchasing cigarettes at a lower price. While there is nothing wrong with looking for a bargain, unfortunately this purchasing behavior has led to a growing number of unintended consequences. These include an increase in illegally sold or "contraband" cigarettes, as well as an increase in Internet sales that often occur without the proper payment of excise taxes or mandatory escrow payments, without effective age verification, and in violation of trademark and other laws.

This illegal activity hurts everyone, whether or not they are adult smokers or engaged in the tobacco trade. Like any illegal activity, contraband cigarette trafficking negatively affects our society. Illegal cigarette sales also deprive governments of tax revenue and can result in stolen products, hijacked cigarette trucks, tarnished trademarks and brand reputations, and distortions in the

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legitimate market. Illegal sales are currently posing a threat not only to Philip Morris USA, which makes about half of the cigarettes sold in the U.S., but also to the State of Nevada in the form of increased crime and lost revenue that, if collected, could provide some welcome relief toward the current budget deficit. It is currently estimated that billions of dollars in federal and state tax revenue are lost each year due to illegal activity related to cigarette sales. (See e.g. GAO Report: Internet Cigarette Sales: Giving ATF Investigative Authority May Improve Reporting and Enforcement (August 2002); Opening Statement of Director Bradley A. Buckles to the International Conference on Illicit Tobacco Trade, United Nations (July 2002).)

Illegal cigarette sales also hurt law-abiding businesses including wholesalers, retailers and manufacturers who are competing against those that have unfair economic advantages due to illegal activity – for example, Internet sites that don't collect State excise taxes.

Moreover, illegal sales negatively impact our brands, including Marlboro, if adult smokers unknowingly purchase substandard, counterfeit cigarettes that they believe are authentic. Finally, Internet sites often mislead consumers into violating State excise tax laws and the laws against importing versions of domestic brands that are not intended to be sold in the United States.

Philip Morris USA takes the issue of illegal cigarette sales very seriously, and we are pleased to support Assembly Bill 460. We commend Chairman Anderson and this Committee for its leadership in putting forth comprehensive legislation that, if enacted and enforced, would help disrupt, reduce and ultimately eliminate illegal cigarette sales. By passing Assembly Bill 460, Nevada can be a leader in helping to prevent contraband cigarettes from infiltrating the market. As such, Assembly Bill 460 could serve as a model for other states who recognize the need to give their law enforcement

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officials the tools they need to stop similar illegal activity, better collect tax revenues currently owed to the state, strengthen penalties for those who break the law, and help protect legitimate businesses engaged in the legal tobacco trade.

Let me tell you how, starting with the issue of contraband. There are three types of contraband cigarettes that this bill would help address:

- Counterfeit cigarettes, which are of poor quality when smoked, but are difficult to identify before consumption because the external packaging is very similar to legitimate product.
- Illegally imported or illegally re-imported cigarettes, formerly known as "gray market" cigarettes, which are intended for sale outside the United States. These cigarette sales are illegal under federal law and under Nevada law.
- Untaxed and under-taxed cigarettes, which are genuine cigarettes that are sold typically in a low tax state, but are illegally sold often over the Internet or through direct mail, in states and localities with higher excise taxes.

According to the U.S. Customs Service, the number of seizures of counterfeit cigarettes jumped significantly in 2002, with the seized product representing a domestic value of \$37.6 million versus \$4.5 million in 2001. During fiscal year 2002 (October 2001 – September 2002), 34 containers of counterfeit cigarettes were seized – representing close to 300 million cigarettes. During the last three months of 2002, 16 containers of counterfeit cigarettes were seized – representing over 115 million cigarettes. Philip Morris USA has already identified more than 80 counterfeit product codes and confirmed the existence of counterfeit cigarettes at retail in 8 states, with suspected counterfeit cigarettes in 20 more. Nearly all counterfeit cigarette packs also carry counterfeit tax stamps.

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Contraband sales are a significant issue for Nevada. Not only does illegal trafficking hurt those legitimately engaged in the trade by infiltrating the legal channels through which cigarettes are currently sold, causing lost sales and damage to valuable brand reputations, this illegal activity also occurs without full or any payment of taxes to the State and with disregard for the state and federal laws. The activity also supplants sales of genuine product by manufacturers such as Philip Morris USA.

Assembly Bill 460 would help address these serious issues by providing better tools for law enforcement officials here in Nevada to eliminate contraband cigarettes, and help ensure that all industry participants comply with the requirements governing the legitimate distribution and sale of cigarettes. This bill would, among other things:

- Require cigarette manufacturers to obtain licenses, so that illegitimate industry participants can be identified and dealt with. Licenses can only be held by industry participants who are in compliance with all applicable laws.
- Impose stronger penalties for trafficking in contraband, including the revocation of licenses under certain prescribed conditions.
- Require wholesalers to stamp tobacco products within a reasonable time period and to keep unstamped product separate from stamped product, as well as prohibit wholesalers from transferring unstamped product within the state.
- Limit transactions to those occurring between licensed entities.
- Require the seizure and destruction of contraband cigarettes, counterfeit tax stamps and machinery used to manufacture contraband cigarettes.

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- Impose additional recordkeeping and reporting requirements that would help enforcement agencies to track the distribution of tobacco products.

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Delivery Sales

Another threat to the State addressed by this legislation stems from smokers purchasing cigarettes over the Internet where taxes may be evaded, again illegally. This activity puts Nevada retailers at risk.

While online sales currently represent a small percentage of total cigarette sales, a recent report estimated that within the next ten years, at least one-fifth of annual U.S. cigarette sales will occur over the Internet alone. There are currently more than 500 web sites selling tobacco products. According to the U.S. General Accounting Office, three-quarters of all Internet tobacco sellers explicitly say that they will not report cigarette sales to tax collection officials. Moreover, Internet sites often mislead consumers into violating State excise tax laws and the laws against importing versions of domestic brands that are not intended to be sold in the United States.

An increase in alternative cigarette distribution channels, such as the Internet, telephone or direct mail, also could run counter to efforts to prevent youth access to cigarettes. Many of these transactions occur in a way where age cannot be verified effectively, which presents a potential opportunity for minors to purchase cigarettes.

Assembly Bill 460 addresses this issue by imposing requirements that will help ensure Internet and mail order sales of cigarettes occur in compliance with all Nevada tax and other laws, and by imposing more effective age verification procedures at both the point of sale and the point of delivery in order to help prevent minors from obtaining access to cigarettes.

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Non-Participating Manufacturers

Finally, Assembly Bill 460 takes further steps that the Attorney General supports to ensure that all cigarette manufacturers have either signed the Master Settlement Agreement (MSA) or have made all escrow payments required by the Model Escrow Statute adopted into law by Nevada and all other states participating in the MSA. These steps include requiring NPMs to provide a list of all brand families and the number of cigarettes sold in the State, as well as requiring NPMs to certify that they have established and continue to maintain individual qualified escrow funds.

In addition, this legislation, with some technical amendments, would close a loophole in the current law identified by the National Association of Attorneys General (NAAG). According to the attorneys general, this loophole has "permitted some companies that refused to join the MSA to avoid any significant responsibility under the Model Escrow Statute."

The NAAG has endorsed model legislation, which Philip Morris USA supports, to address both the NPM escrow payment and "allocable share" issues discussed above. We hope to work with the Nevada Attorney General and the legislature to make some technical amendments to Assembly Bill 460 in order to conform with the NAAG model legislation. With these amendments, Assembly Bill 460 will enable the State to better enforce the letter and spirit of the MSA and the Model Escrow Statutes.

Conclusion

Contraband products and related activities continue to present challenges for the domestic cigarette industry, and, as states raise excise taxes, the incidence of this problem likely will increase.

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Nevada is in a unique position to continue to keep its excise tax at a reasonable level, while taking a leadership role in addressing an issue that negatively impacts not only compliant cigarette manufacturers, their trade partners and consumers, but also the government and its revenue collection efforts.

The issue of illegal cigarette sales is one that Philip Morris USA takes very seriously, and we are committed to working with you to help stop this growing problem. While Philip Morris USA will continue to work with law enforcement in Nevada and elsewhere in order to provide intelligence information and cooperate with their investigations, there is a clear need for the existing laws to be strengthened so that law enforcement has the tools it needs to address this issue. Assembly Bill 460 is a significant step toward solving this issue and can serve as a strong model for other states to do the same. We urge you to support it. Thank you.

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