

"I'd like to believe this is a serious first step, but the fact is I have serious questions," Kessler said. "Would you agree to regulating nicotine as a drug? Will you agree to regulation of marketing practices? Will you agree to the removal of harmful ingredients if that is technically possible?"

Parrish acknowledged that nicotine is a drug but stopped short of agreeing that the FDA should regulate nicotine as a drug and cigarettes as drug-delivery devices.

Industry analysts said Philip Morris' concessions may be aimed at improving the company's image among judges and juries presiding over lawsuits filed on behalf of dead or dying smokers.

Meantime, the U.S. Supreme Court is expected to rule soon on whether Congress has given the FDA authority over the tobacco industry.

Philip Morris accounts for one of every two cigarettes sold in the United States.

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### **Tax Probe Targets Cigarette Makers**

By Sharon Walsh and David B. Ottaway  
Washington Post Staff Writers  
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NEW YORK — City authorities intent on recovering millions of dollars in lost cigarette taxes are investigating Philip Morris Inc. and Lorillard Tobacco Co., makers of the cigarettes most frequently smuggled up the Interstate 95 corridor from Virginia into New York.

Investigators believe the companies are aware that cigarettes by the truckload are being smuggled from Virginia, where the cigarette tax is 2.5 cents a pack, the nation's lowest, into the city of New York, where a state increase last week brought the tax to \$1.19 a pack, the nation's highest. Bootleggers sell the contraband cigarettes to small retailers, bodegas and newsstands here and the tax is never collected.

The smuggling system seems to thrive for several reasons. Companies can increase their market share and make use of the smuggling pipeline without any legal responsibility. Big discount stores in Virginia can legally sell tons of cigarettes. Bootleggers see only light penalties and heavy profits.

Meanwhile, tax authorities say they are woefully short-staffed in their ability to crackdown on vendors who sell out-of-state cigarettes. And the companies say it is not their job to act as police. "We do not have either the resources or the authority to substitute ourselves for federal, state and local law enforcement," Philip Morris spokesman Tom Ryan said.

Marjorie Landa, assistant corporation counsel for the city of New York, said her office is exploring whether the city can recover lost cigarette taxes through civil litigation. The investigation includes "everybody involved--from the manufacturer to the bootleggers and everyone in between," she said.

New York authorities believe companies track sales of their cigarettes and knowingly oversupply Virginia stores to get their excess products to New York.

"The cigarette makers and distributors know exactly what brand is going where," said Thomas Stanton, director of the New York City Department of Finance. "And you'd think a good corporate citizen wouldn't want to sell in a way that avoids taxes."

Officials do not know precisely how much New York has lost in unpaid taxes, but one distributor estimates the amount to be hundreds of millions of dollars a year. The lower prices of smuggled cigarettes are rarely passed on to the consumer and mostly benefit the smugglers and the retailers who buy from the bootleggers.

Philip Morris officials deny that the company has any role in creating or encouraging a black market. "I hope it doesn't happen," Ryan said of the possible civil lawsuit that may result from the investigation. "I can assure you that Philip Morris in no way encourages misuse of the distribution of the product, such as smuggling."

An assistant to the spokesman for Lorillard, a subsidiary of Loews Corp., said the company would have no comment.

Last week's tax increase in New York raised fears of increased smuggling. Maryland, which nearly doubled its cigarette tax to 66 cents last July, already has witnessed a sharp upsurge in smuggling, and tax authorities there have arrested more than 20 runners shuttling minivans full of cigarettes up I-95.

"This is no small potatoes game," said Larry M. Tolliver, director of the Maryland tax enforcement office. "It's going to become a whole East Coast problem."

The New York investigation is not the first to focus on cigarette companies and smuggling. In December the Canadian government sued R.J. Reynolds Tobacco Co. for \$1 billion over a scheme to avoid Canadian taxes by funneling cigarettes through an Indian reservation on the U.S. border.

R.J. Reynolds pleaded guilty to federal criminal charges stemming from that activity in Syracuse in December 1998 and was ordered to pay penalties of \$15 million.

The stakes are high. In fiscal 1998, New York state collected \$667 million in tobacco taxes. The new cigarette taxes are expected to bring in an additional \$270 million in the first year. The money is earmarked for health care for the uninsured.

The litigation the city of New York is considering mimics legal action that cities brought last year against gun manufacturers. But just as gun companies deny that they are responsible for persons who buy guns from distributors, cigarette companies say they have no control over bootlegged cigarettes.

Yet investigators and some wholesalers contend there is ample evidence that the cigarette companies and discount stores are aware of the smuggling and do nothing about it. Sophisticated marketing programs that track cigarette sales in different areas establish this, investigators say.

Tobacco manufacturers send representatives to visit cigarette retailers, where they can see which state stamp is on each package sold. Even tiny grocery stores and newsstands--all of which must have a license to sell cigarettes--are visited, wholesalers said.

The smuggling chain begins when cigarettes come off the assembly line and are distributed either directly or through wholesalers to large Virginia discount stores, including Sam's Club and Costco, according to smugglers and industry sources. In turn, the "gas and go" operations along the I-95 corridor buy from big wholesalers or from Costco and Sam's Club. Some smugglers buy directly from wholesalers. A typical smuggler loads up with thousands of packs per trip to New York.

The financial incentives are enormous. "It's twice as profitable as running guns or drugs," said David Schiller, a Virginia assistant attorney general who prosecuted a major cigarette smuggling case in 1997.

In that case, a Fredericksburg, Va., distributor was doing a \$1 million-a month business in cigarettes at his two gas-and-go stations along I-95. His profit margin: 50 percent.

With the rise in New York cigarette taxes, profit margins for smugglers have risen as well. In New York city, a carton of cigarettes will soon carry \$11.65 more in tax than a similar carton in Virginia. A van will hold about 4,500 cartons, reaping a minimum profit of more than \$52,425 per trip. That's more than \$150,000 for three days of work a week.

"This business is gonna go sky high," a former smuggler said in an interview with *The Washington Post*.

The leading cigarette smugglers are generally from Middle Eastern, Russian and Chinese ethnic groups, according to tax investigators. Many have sophisticated operations: traffic managers overseeing numerous drivers; secure storage warehouses; countersurveillance equipment; and decoy vans to divert investigators.

The Russians, in particular, with their beepers and home-delivery service, have brought a new level of customer service to the business, authorities said. And their customers are the only consumers to benefit from lower prices than at retail.

Catching smugglers is time-consuming and costly. Many states lack investigators to police the practice. Once caught, smugglers face minor penalties. Many runners pay a fine, get probation and go right back to their lucrative specialty.

Last week Gov. George E. Pataki (R) announced legislation that would make transporting cigarettes without a state tax stamp a felony, rather than a misdemeanor. Investigators would desperately like to cut off the smuggling at the source: the manufacturers. But the companies have no incentive to help.

"They love it," said Joe Koenigsberger, one of six New York wholesalers who filed suit against Philip Morris in 1998 for allegedly turning a blind eye to the smuggling. "It increases their market share and costs them nothing."

Investigators and informants alike say the cigarette companies stock wholesalers, discount stores and gas-and-go stations along I-95 with an oversupply of Newport Menthols and Marlboros in hard boxes. New Yorkers in the ethnic communities served by smugglers buy only cigarettes in boxes, never in soft packs, while most Virginia buyers prefer soft packs, according to distributors.

"They sell exponentially more hard packs along the I-95 corridor than they do 10 miles away," Stanton said.

Legitimate distributors who say they are losing sales to bootleggers point to Philip Morris's sophisticated marketing programs that track cigarette sales with great precision.

Under the "Wholesale and Retail Leaders's" programs, the company offers wholesalers payment for weekly lists showing exactly which stores bought cigarettes and in what amounts. The programs show the disparity in cigarettes shipped and sold in New York and Virginia, distributors say.

Philip Morris spokesman Ryan confirmed that the company has such a program, but he denied that it is used to foster smuggling.

Koenigsberger said he met many times with Philip Morris representatives about the problem before filing suit. "They listen, but do nothing," said the cigar-chewing Bronx wholesaler, whose family has been in the cigarette wholesale business since 1918. "They could stop it overnight."

Philip Morris also sends "missionary men" to check on every New York bodega, newsstand and corner convenience store that sell its brands, Koenigsberger and tax authorities said. The company representatives provide promotional materials, make sure their products get the best display, check the age and freshness of cigarettes and the volume of sales.

At the same time, they can't help noticing that many of the packs and cartons sold in New York stores have Virginia tax stamps.

Philip Morris has warned wholesalers and retailers enrolled in its Leaders program that they will lose their rewards and privileges if any are caught selling gray-market cigarettes--those marked for export. Companies lose money on gray-market cigarettes, which are sold for about \$10 a carton to duty-free shops and often are bootlegged back to normal retailers. If the company can take such a step to stem the sale of gray cigarettes, it could do the same to staunch domestic smuggling, experts said.

But Philip Morris has not issued a warning to distributors who deal in smuggled domestic cigarettes, Ryan said.

"They should take a more pro-active role in helping police make arrests," said Nick D. Dourian, head of Empire Pacific Group, which does investigations for tobacco companies and law enforcement agencies. Dourian said he had found that 80 percent of the smuggled cigarettes he had uncovered in more than 50 cases belonged to Philip Morris.

A prominent New York smuggler who became a government informant described the run to Virginia for cigarettes on what smugglers call "Newport Day." The day that Newport Menthols in a box are delivered, the parking lots at discount stores in Glenn Allen, Dale City, Woodbridge and other exits along I-95 are dotted with cars and vans with New York plates. A line of customers forms early, waiting for the stores to open at 7 a.m.

Each customer loads shopping carts with as many cigarettes as he can buy for under \$10,000, the cash limit that triggers a report to federal authorities. Fist fights have occurred when there aren't enough cigarettes to go around. After one such incident, a store manager calmed the crowd by rationing cigarettes among the smugglers.

A spokesman for Wal-Mart Stores Inc., which owns Sam's Club, declined to comment.

Roger Campbell, a spokesman for the southeastern operations of Costco Wholesale Corp., which owns what was previously called Price Club, denied that the company's stores in the Richmond area were selling cigarettes to out-of-state buyers.

Costco sells only to local convenience stores or those with retailing licenses issued by the counties they're in, he said. But smugglers said they use phony drivers' licenses and bogus business licenses to get the club cards. No effort is made to check the names of the businesses for which they allegedly work, a former smuggler said.

"You can make up whatever name you like," he said. "They can see that you're in there everyday buying 25,000 cartons of cigarettes. . . . Of course they know."

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## **New York City Tax Probes Eyes Cigarette Cos - WP**

*Dow Jones International News Service via Dow Jones*

NEW YORK (Dow Jones)--New York City authorities are investigating possible connections between cigarette smugglers and two U.S. tobacco companies, the Washington Post reports in its Monday edition.

Lorillard Tobacco Co. (LTR) and Phillip Morris Inc. (MO) are being probed by tax investigators, who believe the two companies are aware that truckloads of cigarettes are being smuggled from Virginia, where the cigarette tax is 2.5 cents per pack, to New York, a state with a \$1.19 tax per pack, the Post reported. New York City is planning to recover the lost tax through civil litigation, and plans to include the cigarette manufacturers in the lawsuits.

Investigators believe tobacco companies have been overstocking Virginia stores, which enables smugglers to move excess products to New York, the Post said.

Philip Morris officials denied any role in the black market, the Post said. Lorillard, a subsidiary of Loews Corp., had no comment.

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