



Tax and Enforcement: Tackling Ontario's contraband tobacco problem

Discussion Paper

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How big is this issue?

Canada, and Ontario in particular, have a contraband tobacco problem, one of the biggest in the world, and one that defies a neat solution. Nonetheless, something can, and must be done. Indeed, there are already positive signs. In a recent fiscal update, the Ontario government has signalled that it intends to get serious about contraband issues, in hopes of recouping lost tax revenue. The Mohawk Council of Akwasasne, near the centre of smuggling in Ontario, has demonstrated its determination to be part of the solution, and an openness to working with other levels of government and law enforcement.

Tobacco, then, is not a third rail of provincial politics. If we reframe the issues and understand the ecology that gives rise to contraband in the first place, a comprehensive strategy is possible.

Illicit networks are necessarily difficult to study. However, estimates suggest that the Canadian contraband tobacco market is larger in proportion to its population than that of other Western countries. Estimates of the percentage of Canadian tobacco sold illegally range from 15% to 33%, with peaks as high as 50% in Ontario. Tax losses number in the billions of dollars. The general pattern suggests that contraband levels peaked around 2009, at a rate that almost rivalled the boom of the early 1990s. It seems the trend has atrophied since, but the overall rate of federally and/or provincially untaxed tobacco across Canada appears to be markedly higher than the international average. In fact, Ontario is thought to have the highest rate of contraband tobacco of any jurisdiction in North America, and quite possibly in the developed world.

The Canada Border Services Agency (CBSA) and the Royal Canadian Mounted Police (RCMP) have made significant seizures of counterfeit cigarettes from China being shipped though the East and West coasts. At the same time, open source data from seizures and investigations point to the reserves of Akwesasne (near Cornwall), Oshweken/Six Nations (near Brantford) and to a lesser extent Tyendinaga (near Belleville) as hotspots for cigarette manufacturing and smuggling. A report by the Canadian Taxpayers' Federation estimated that as little as 21% of allocation cigarettes sold on Ontario reserves in 2011 were properly taxed. For complex historical and political reasons, enforcement of the Ontario *Tobacco Tax Act*, the federal *Excise Act* and now the *Criminal Code* provisions relating to contraband tobacco are not diligently enforced in Ontario: off reserve it is not a high priority, especially for local and provincial police, and tobacco enforcement on reserve can be a red herring.

Since 2005, the RCMP, in conjunction with provincial, municipal and First Nations police forces, have apprehended associates of at least 10 distinct criminal networks peddling contraband in Ontario. However, this tally includes only publicized arrests and excludes at least four large networks that operated primarily out of nearby Kahnawake during this time, at least three of which involved members of the Hells Angels biker gang. These 10 networks yielded over 170 arrests, including known members of the Mafia. Illegal migrants, ecstasy, and marijuana tend to be smuggled from Canada to the U.S., while weapons and cocaine dominate

the non-tobacco illicit goods smuggled into Canada along with cigarettes from the U.S. side of Akwesasne and tobacco from North Carolina.

The consequences of Canada's booming illicit tobacco trade go well beyond lost tax revenue and extend to threats to public health, corruption of communities and legitimate businesses, and most dismayingly, funding of organized crime and potentially terrorism. Criminal organizations are attracted to the ease of tobacco smuggling, partially due to its benign image, but tobacco smuggling routes also carry hard drugs and weapons. This is an issue that should concern everyone.

Policy Background and Initiatives

By convention, section 87 of the *Indian Act* exempts status Indians from tax on the purchase of tobacco products. Even so, federal excise tax paid by cigarette manufacturers is generally applied to cigarettes sold to status Indians on reserves. Off-reserve, provincial and federal sales taxes, a provincial excise tax and the federal excise tax apply.

Cigarettes and tobacco are governed by Ontario's *Tobacco Tax Act*, the federal *Excise Act*, and now the *Criminal Code* with the recent enactment of Bill C-10. Because contraband tobacco offences are now explicitly mentioned in the *Criminal Code*, they can be enforced by municipal, provincial and federal police alike.

The *Excise Act* also governs the federal licensing of tobacco manufacturers and collection of the federal excise tax, but it is federal jurisdiction that, by convention, tends to be enforced domestically by the RCMP.

Ontario's *Tobacco Tax Act* was last amended in 2011 by Bill 186. Even before this legislation, the *Tobacco Tax Act* mandated the payment of the provincial excise tax by non-Native consumers. It sets an allocation quota for the number of cigarettes for tax-exempt sale on each reserve. Section 25 of Bill 186 empowers the provincial government to "enter into such arrangements and agreements with a council of the band as the Minister considers necessary for the purposes of the administration and enforcement of this Act on a reserve". While this section was perhaps included in an effort to enhance the jurisdiction and capabilities of First Nations governments, it is seen by some as a means of jurisdictional intrusion by the province.

Enforcement powers were also enhanced by the bill, which allows for the seizure of raw leaf by Ministry-approved officials, including police, if there are reasonable and probable grounds to think it is being handled by unlicensed persons. It also allows provincial and municipal police to seize tobacco products "in plain view" that are suspected of being contraband.

The most important amendment made by Bill 186 expanded the scope of Ontario's *Tobacco Tax Act* by requiring the registration of all those who "produce, process, sell or

distribute” raw leaf tobacco in Ontario. Bill 186 became law in 2011 and the Ministry of Finance was slated to assume regulatory oversight of tobacco agriculture in Ontario from the Ontario Flue-Cured Tobacco Marketing Board in 2012, but this transition was delayed until January 1, 2015. The transition from the Market Board to the Ministry of Finance has been accompanied by some restrictions in the monitoring and enforcement regime associated with tobacco growing licenses: the required frequency of reports was reduced; identifications for the tracking and tracing of harvested tobacco were eliminated. This is especially discouraging since enforcement of licensing conditions was already intermittent before these changes. Unregulated tobacco farming in Southwestern Ontario will likely remain a source for illegal manufacturers as long as it goes unchecked.

Policy options for discussion

First Nations Excise Tax

A major hurdle to progress on this issue is disagreement over the definition of “contraband” by federal and provincial governments on the one hand and First Nations groups on the other. These differences centre around the taxes that are perceived sufficient to render a tobacco product “legal”. Some First Nations people refuse to collect the provincial excise tax, while others believe that the federal excise tax is an infringement of their treaties with the federal government. First Nations and other levels of government will need to work together to establish a policy framework that balances the interests of First Nations in maintaining their cultural ties to tobacco and economic ties to the fledgling and profitable business with the interests of public health initiatives, other cigarette manufacturers, and government revenue during fiscally austere times.

A First Nations Excise Tax on cigarettes sold on-reserve holds out considerable promise in this regard. These cigarettes could be sold with an excise tax – or “fee”, as some Native communities prefer to call it — that is equal to or slightly less than the provincial excise tax to non-Native customers.

The most immediate benefit to this is potential tax revenue for band councils to spend on community projects and/or split into dividends for band members, essentially re-distributing some of the wealth that can be generated by the tobacco trade. These tax dollars can also bolster on-reserve police forces to deter organized crime groups from the tobacco industry.

Directing tax dollars back to First Nations communities for sales made on that reserve provides a strong incentive for compliance and enforcement. The Cowichan Tribe in B.C. uses tax revenue for community projects, economic development, or remittances to band members.

The Akwesasne Tobacco Pilot Project, undertaken by the Mohawk Council of Akwesasne, has generated draft legislation concerning the licensing of tobacco manufacturers,

wholesalers, and retailers on-reserve. This project not only marks an important recognition of the capacity for self-government in Akwesasne, but is also indicative of improved relations between the province of Ontario and Akwesasne's leadership. As of November 2014, the Akwesasne Tobacco Manufacturing and Products Law was being put before the public in a series of meetings.

Legislation in Kahnawake sets out a form of taxation, requiring a "Contribution Stamp" for tobacco products with proceeds going to a newly-established Kahnawake Community Contribution Fund. Similarly, in Ontario the band council of Tyendinaga near Belleville has introduced a \$2 per carton fee on cigarettes within the allocation that is used for community development projects.

A contraband ombudsman

The contraband tobacco problem in Canada extends across provincial boundaries, involves First Nations territories and has longstanding links to activities on American soil. What is more, Canada, and Ontario in particular, play host to the entire contraband tobacco supply chain from raw leaf growth and diversion to illicit manufacture, distribution, sale and laundering. The result is a complex regulative framework enforced by a patchwork of different bodies at various levels of government.

This context calls for central co-ordination to harmonize oversight, enforcement and feedback across jurisdictions and up and down the contraband supply chain. An Ombudsman for Contraband Tobacco could be established under the purview of the Minister of Public Safety to intensify communication and co-ordination between different law enforcement agencies, and with these law enforcement agencies and other regulatory bodies, such as the Canada Revenue Agency, which is in the habit of making unilateral decisions that have deleterious effects for Ontario.

The Ombudsman's office — self-funded entirely through the proceeds of crime its investigations recover — could bridge the administration, regulations and enforcement through criminal investigations. Its remit would be in line with the nature of contraband tobacco itself, a supply chain that relies on both regulatory evasion and overt criminal activity, such as smuggling.

Reductions in quota allocation

The supply chain of tobacco for reserves that is for sale to status Indians should also undergo some changes, from 2.5-2.7 cartons per member per month to 1-1.5 cartons per member per month, and individual purchases should be capped at 8 cartons per adult member per month. Furthermore, a refund system akin to Alberta's — where provincial excise taxes are paid by the wholesaler and refunded to the retailer after proof of legitimate tax-exempt purchase is provided

— should be instituted for sales of cigarettes to status Indians on reserves to prevent the sale of “blackstock” tax-exempt cigarettes to non-Natives. In return for a reduction in personal quota allocation, the federal government may consider loosening some of the provisions of Bill C-10 so as not to criminalize small-scale activity.

Better raw leaf licensing enforcement

Enforcement of Ontario’s tobacco agriculture also stands to be enhanced: the Ministry of Finance should retighten regulations loosened in the transition of oversight from the Ontario Flue-Cured Marketing Board, and should partner more systematically with provincial and federal police forces to ensure diligent enforcement of the raw leaf tobacco licensing regulations. The Ontario Provincial Police could also make a greater contribution to enforcing tobacco laws in Ontario if the problem were framed as one of criminality and not merely fiscal evasion. The Sûreté du Québec, in conjunction with local police forces, has made a significant contribution to reducing the supply of contraband in that province. The proposed office of the Ombudsman would go a long way in fostering the sort of multilevel, horizontal and vertical collaboration and information sharing among federal, provincial, local, and Aboriginal partners that is indispensable in implementing and administering an effective and comprehensive strategy to counter contraband.

Lessons Learned: Quebec’s Bill 59

Quebec exemplifies the impact that a comprehensive interagency contraband strategy can have. Project ACCES was initiated in 2001 as a partnership between a broad array of federal and provincial agencies including RCMP, the CBSA, the CRA, the SQ, Service de police de la Ville de Montréal, the Association des directeurs de police du Québec, and a number of municipal police forces, as well as Quebec’s Ministère de la Sécurité publique, Régie des alcools, des courses et des jeux, Ministère de la Justice, Ministère du Revenu, Ministère de la Santé et des Services Sociaux and Ministère des Finances. It is made up of a strategic committee of Associate Deputy Ministers, operational groups from various agencies as well as a tactical committee to connect operational groups, oversee and optimize projects and communicate with the strategic committee.

This province-wide initiative focuses on an array of contraband activity, including but not limited to tobacco. Investigations led by Project ACCES confiscated more than 1.2 million cartons (240 million sticks) in Quebec between 2005 and 2011 including “Project Blulette” in 2007 which netted over 4 million cigarettes, 9 guns, 37 vehicles used for smuggling and 26 arrests.

Like Ontario, Quebec has also amended its *Tobacco Tax Act*. In 2009 Bill 59 sought to limit the growth of the licensed tobacco industry in that province by putting a moratorium on new manufacturers’ licenses, instituting a shorter validity period for existing certifications, and

stiffening regulations around tobacco manufacturing equipment. It also increased fines, imposed maximum penalties of two years' imprisonment for their infraction, and enables certain offences to be punished with the revocation of the offender's driver's license.

Ontario might entertain the revocation of driver's licenses as a potentially efficient, effective and proportional punishment for those convicted of select smuggling offences, considering the importance of automobiles in smuggling tobacco. Bill 59 also enhances the powers of police in Quebec to enforce the Act by allowing them to stop and search vehicles if they have "reasonable grounds" to suspect it to be carrying contraband tobacco and to prevent the vehicle from moving until a search warrant can be secured. In a move that Ontario might mimic, Bill 59 explicitly permits members of the SQ and local police forces to enforce the key sections of the *Tobacco Tax Act* on regulation and taxation. Fines from convictions accrue to municipalities if the proceedings take place in their court.

Input controls

Another option for controlling cigarette production, albeit one that is not in the purview of the Ontario government, is to control the sale of certain materials necessary in their manufacture, primarily cigarette papers and cellulose acetate tow. These controls would compel manufacturers of these substances to make and sell only enough to supply the legal market, or otherwise ensure that all of their buyers are manufacturing cigarettes legally. Around 80 percent of all acetate tow worldwide is used for cigarettes, and there is currently no viable alternative to the use of acetate tow in cigarettes. Enforcement at this crucial point in the manufacturing process might be especially efficient because both acetate tow and cigarette paper production are highly specialized processes with a high barrier of entry and consequently few manufacturers; there are about two for each substance in North America, and only seven major producers of acetate tow worldwide. The Global Acetate Manufacturer's Association (GAMA) has encouraged all of its members to implement "Know Your Customer" protocols to ensure sale to only legal manufacturers, but these are not legally binding, and their effectiveness is unclear.