



# Anti-Contraband Tobacco Working Group

## Discussion Paper

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## **Introduction: The Global Contraband Trade**

Annual global tax losses from the sale of contraband cigarettes are in the area of US\$40–\$50 billion.<sup>1</sup> Canada’s market, however, is disproportionately large. Canada’s illicit tobacco market is estimated at 15–33 percent of all cigarettes consumed, compared to between 10.7 percent and 11.6 percent of cigarettes consumed worldwide.<sup>2</sup>

Contraband tobacco generally comes in one of four forms: 1) large-scale smuggling (usually export diversion); 2) small-scale smuggling (from low- to high-tax jurisdictions); 3) counterfeits; and 4) “illicit whites” (illegally manufactured, non-counterfeit cigarettes). The Canadian contraband tobacco market consists mainly of illicit whites originating in China and cigarettes manufactured on Canadian Aboriginal territories and US Native American reservations from diverted raw leaf tobacco.

The comparatively large illicit market in Canada is a function of both history and path-dependence, as well as the current policy landscape governing the Canadian cigarette industry. But the relatively smaller portion that contraband cigarettes comprise in other markets suggests that there is room in Canada to curtail the contraband portion of the cigarette market.

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. The scope of organized crime threatens Canada’s very institutions, as we have seen with the Charbonneau Commission hearings in Quebec. This threats should concern every Canadian.

### **Contraband and organized crime**

RCMP figures suggest that between 18 and 105 distinct organized crime groups are involved in smuggling cigarettes. At least four major RCMP investigations since 2009 have resulted in the arrest of members of organized criminal groups, including the Hell’s Angels and the Italian Mafia. These networks sought to distribute cigarettes manufactured on Native reserves across Ontario, Quebec, and New Brunswick. Owners of cigarette manufacturing and distributing companies located on Aboriginal territories have also been arrested in these busts, and in one case a Hells Angels member was the vice president of such a distribution company.

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<sup>1</sup> International Tax and Investment Center and Oxford Economics, “Asia-11 Contraband Tobacco Indicator 2012,” (Asia-11, 2013): 27; Ramos, “Illegal trade in tobacco in MERCOSUR countries,” 270; Tobacco Manufacturers’ Association, “Tax Revenue Losses”, available at <http://www.the-tma.org.uk/tma-publications-research/facts-figures/tax-revenue-losses/>.

<sup>2</sup> Jean Daudelin, Stephanie Soiffer and Jeff Willows, *Border Integrity, Illicit Tobacco and Canada’s Security*, Macdonald-Laurier Institute (March 2013): 7; Luk Joossens, “Deliverable 5.2: Illicit tobacco trade in Europe: issues and solutions,” *Pricing Policies and Control of Tobacco in Europe* (August 2011): 4; Robert Schwartz and Teela Johnson, “Problems, policies and politics: A comparative case study of contraband tobacco from the 1990s to the present in the Canadian context,” *Journal of Public Health Policy* 31 (2010): 342.

These investigations have resulted in the seizure of over 7.3 million cigarettes and 50,000 kg of loose tobacco. Unregistered firearms, marijuana, cocaine, ecstasy, and other drugs were also seized in these operations, demonstrating that contraband cigarettes can be a lucrative and relatively low-risk way to make and/or launder profits that can be channelled through pre-existing, multi-purpose illicit networks.

There have also been demonstrated links between contraband cigarettes and terrorist activity in the United States. Smuggling networks with links to Hezbollah or Al-Qaeda were found to purchase cigarettes in low- or no-tax jurisdictions, such as West Virginia, North Carolina, and Native American reservations, and apply counterfeit tax stamps only to resell them to retailers in high-tax jurisdictions, especially New York City. While there have been no confirmed cases of terror groups in Canada financing their activities with contraband tobacco, it remains a high-profit, low-risk activity that does not necessitate collusion with Aboriginal groups.

It would also be a mistake to lay sole blame for the contraband cigarette trade in Ontario and Quebec with Aboriginal groups. The scope of the distribution of Aboriginal-made cigarettes necessitates the involvement of many non-Aboriginals. For example, terror-related networks in the US demonstrate that criminal groups of any affiliation can acquire large amounts of cigarettes by making many small tax-free purchases.

### **The scale of the problem**

The federal excise rate currently amounts to \$21.03/carton, and the average cost of a legal carton of cigarettes is over \$81 in Quebec, the most lightly-taxed province. This level of taxation creates a market for less expensive untaxed cigarettes that sell for as little as \$8–10 per “baggie” of 200. The large market, relatively easy retail, low enforcement priority, and outsized profit margins make contraband cigarettes lucrative and attractive.

Illicit networks are necessarily difficult to study; precision in regard to the amount of tobacco currently smuggled and the actual costs to the Canadian taxpayer are thus difficult to come by. However, all available estimates suggest that the Canadian contraband tobacco market is larger in proportion to its population than that of any other Western state. The share of illegal tobacco in the cigarette market is reportedly as high as 50 percent in Ontario and 40 percent in Quebec.<sup>3</sup> It is equally difficult to estimate the annual tax loss from these sales. 2001 estimates range from \$689 million to \$1.1 billion to \$2.4 billion.<sup>4</sup>

Contraband cigarettes are purchased overwhelmingly by youth, the poor, and some minority groups whose disposable income is highly constrained and to whom cost savings in the order of 90 percent are thus inherently attractive.

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<sup>3</sup> Daudelin, Soiffer and Willows, *Border Integrity, Illicit Tobacco and Canada's Security*, 7.

<sup>4</sup> Canadian Taxpayers' Federation, *How Much Is Contraband Tobacco Costing Taxpayers In Ontario?* (December 2001): 3

## **The Aboriginal Cigarette Industry in Canada**

Aboriginal bands have the right to sell tobacco legally to Status Indians without federal and provincial excise taxes, as enshrined in s. 87 of the *Indian Act*. While it is illegal for these same groups to sell tobacco to non-Aboriginals without also charging all applicable excise taxes, some individuals and bands insist that they are perfectly within their right to sell to whoever they choose on their territory. Up to 79 percent of all tax-exempt tobacco sold on reserves is estimated to be sold to non-Aboriginals. However, such sales are a relatively minor part of the problem. Beginning in the late 1990s Aboriginal bands in Ontario and then Quebec began manufacturing their own cigarettes for sale on reserve as part of the fulfillment of legal cigarette allocation systems. This has since grown into a thriving industry across several reserves in Ontario and Quebec. Although some Aboriginal manufacturers are federally licensed by the Canada Revenue Agency to produce cigarettes, the RCMP estimates that over 50 illegal manufacturers exist on Aboriginal territory.

### **Illicit tobacco and legitimate farmers**

Both legal and illegal cigarettes manufactured on Aboriginal territories rely at least partially on tobacco grown in Southwestern Ontario. By law, all commercial tobacco grown in Ontario must be grown with a licence and done so under contract from a licensed wholesaler. The raw leaf tobacco used in illegal manufacture is sometimes knowingly sold by a farmer to an illicit wholesaler for about four times the legal rate. This activity is obscured by reporting it as stolen or under-reporting crop yields to the licensing body, the Ontario Flue-Cured Tobacco Marketing Board. Proving the complicity of farmers in supplying illegal raw leaf tobacco is difficult, but patterns in crop yields can be highly suggestive as in when crop yields fall precipitously between seasons, especially when nearby farmers (sometimes licensed to a different wholesaler) report stable or rising yields. Although some farmers have consistently reported yields low enough to warrant the revocation of their licence by the licensing body's standards, these standards are rarely enforced and, for all intents and purposes, tobacco farms and wholesalers in Southwestern Ontario operate in a virtually unregulated manner.

### **Steps to combating an illicit trade**

#### **Legislative changes**

Bill C-10, an amendment to Canada's *Criminal Code* that received Royal Assent earlier this month, introduces prison sentences for repeat offenders of contraband tobacco. Offences under the *Excise Act* (2001) remain largely the purview of the RCMP (see the appendix, RCMP Enforcement and the Connections between Organized Crime and the Contraband Cigarette Trade in Canada); data on charges suggest that enforcing it is not a priority for provincial and municipal police forces. By contrast, *Criminal Code* enforcement is a provincial and municipal priority; C-10 is a bit of a game changer insofar as the *Criminal Code* now explicitly references contraband tobacco – and in potentially antagonizing some Aboriginal bands.

The criminalization of contraband tobacco may increase cooperation in anti-contraband operations among law enforcement agencies. Bills 186 and 59, amendments to the *Tobacco Tax*

*Act* of Ontario and Quebec respectively, expanded provincial law enforcement powers to seize contraband tobacco.

On the one hand, Aboriginal leaders fear that with the Canadian government's current definition of "contraband" – which includes all Aboriginal cigarettes sold without some or all taxes to non-Aboriginals – Aboriginal people will be criminalized and imprisoned, encouraging recidivism and more serious crime among a subgroup that is already plagued disproportionately by delinquency. On the other hand, there is concern that penalties are not harsh enough because they are not equivalent to penalties for trafficking narcotics, thus encouraging organized crime to deal in contraband tobacco. Given this complexity, the federal government would be well advised to launch a public awareness campaign around C-10 and ensure enforcement officers are fully aware of its content and the ramifications for Aboriginal relations.

Ontario's 2011 amendment to the *Tobacco Tax Act* puts Ontario's Ministry of Finance in charge of licensing tobacco growers as of January 1, 2015. However, it is still unclear how the Ministry of Finance will enforce the licensing scheme more effectively than the Ontario Flue-Cured Tobacco Marketing Board.

### **Input controls**

Another option for controlling cigarette production 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.

### **Enforcement efforts**

When targeting the illegal smuggling of cigarettes made on Aboriginal territories, Canadian and US law enforcement officials have typically concentrated their efforts on the stretch of the Canada-US border between Cornwall, Ontario and Valleyfield, Quebec, along which the Aboriginal territories of Akwesasne, St. Regis, and Kahnawake are located. Indeed, this particular site has recently been the target of \$100 million of enforcement and surveillance spending. These sites are still key conduits of the Canadian contraband market and should, therefore, remain focal points of enforcement, but production of cigarettes has spread to Tyendinaga near Belleville and especially Six Nations near Brantford where Grand River Enterprises, the third-largest cigarette manufacturer in Canada, is located. Furthermore, these cigarettes are finding their way east to the Maritimes and as far west as Alberta. Growing

geographic dispersion may require enforcement to be complemented by innovative approaches to federal-Aboriginal relations, including Aboriginal-administered taxation schemes.

### **Aboriginal-Administered Taxation Schemes**

Tobacco is commonly seen as central to Aboriginal economic development and Aboriginal sovereignty. Scholars and law enforcement widely acknowledge that some form of regulation and enforcement by a band government of its own tobacco industry is essential to stopping this form of contraband. It is also clear, if slightly uncomfortable, that the lucrativeness of the Aboriginal tobacco industry relies to a significant extent on (currently illegal) sales to non-Aboriginal customers, a practice that many bands will likely be keen to continue within a legal framework. There is precedent for such a scheme in Canada and the US. The Cowichan tribe located near Duncan, BC, charges non-Aboriginal customers the equivalent to the provincial excise tax, which is collected by the province and then remitted to the Band Council for government expenditure or distribution to band members. Unlike current taxes which are already supposed to be paid in such sales, Aboriginal retailers have an incentive to enforce the taxation scheme if taxes collected are remitted to their community.

### **A federal ombudsman**

A crucial component of Aboriginal governance and enforcement partnerships between provincial, federal, and Aboriginal authorities will be to ensure that organized crime groups do not exploit the unique jurisdictional situation of Aboriginal territories for trafficking activity in general and contraband tobacco activity in particular. To this end, another policy option is the creation of a federal ombudsman to oversee contraband tobacco enforcement in Canada. This office would facilitate communication and cooperation among law enforcement and revenue agencies in Canada tasked with regulating and policing the tobacco industry. This office could be paid for entirely by liquidating the seizures of tobacco-related investigations, similar to the *PACT Act* in the US.

### **Conclusion**

With the passing of Bill C-10, the Ontario government's recently stated commitment to tackling lost revenues from contraband tobacco, and increasing concerns about organized crime, the time is ripe for a more systematic approach to curbing Canada's booming trade in illicit tobacco.

## **Appendix**

### **RCMP Enforcement and the Connections Between Organized Crime and the Contraband Cigarette Trade in Canada**

The RCMP allege that an unspecified organized crime group was involved in a scheme that saw contraband cigarettes produced on the US side of the Akwesasne territory, smuggled into Canada, distributed, and sold, with the proceeds used to purchase marijuana for sale in the US. Project Crawler arrested 10 people in November 2006.

In July 2007 the RCMP arrested 26 people in the Ottawa/Gatineau area who allegedly made up a network focused on distributing contraband cigarettes in that region. RCMP indicated the involvement of an unspecified organized crime group, and seized 435 cases of contraband cigarettes, 37 vehicles used to distribute the cigarettes, real estate worth \$600,000, approximately \$700,000 in cash, and nine firearms.

Project Chateau was executed by the RCMP in March 2009 and resulted in the arrests of 22 people and the seizure of 298 cases of contraband tobacco, 20,000 methamphetamine pills, cocaine, marijuana, nine guns, and about \$75,000 in cash. Police suspect that the Hell's Angels were involved in this network, which distributed contraband tobacco in Quebec City.

The RCMP busted a large cigarette-smuggling ring that included the notorious Hells Angels member Salvatore Cazzetta in June 2009 as part of Project Machine. Hells Angels members established contacts on Kahnawake territory, renting out a warehouse on the reserve to store contraband and money. Contraband was distributed in Quebec, especially Montreal. Forty-six people in total were arrested, and one kilogram of cocaine, 860 rocks of crack cocaine, 900 grams of marijuana, 4000 methamphetamine tablets, 80 ecstasy tablets, 139 boxes of tobacco, 34,800 pounds of tobacco, more than \$161,500, and 12 weapons were seized.

In 2011 the RCMP-led Project Jacoby seized 50 cartons of contraband cigarettes, as well as marijuana, cocaine, ecstasy, steroids, a cocaine press, and several restricted firearms. In this case an unknown number of people, including some allegedly tied to the Hells Angels, distributed contraband tobacco throughout Quebec and New Brunswick.

In April 2014 the RCMP in conjunction with provincial and Aboriginal police raided various locations in Montreal and on the Akwesasne and Kahnawake territories, revealing a network that smuggled raw leaf tobacco from North Carolina through Akwesasne and then Kahnawake for manufacture near Montreal. The arrested include at least one member of the Italian Mafia as well as an Akwesasne resident who owns an unlicensed cigarette manufacturing plant on the US side. Forty thousand kilograms of tobacco, \$45,000 in cash, and 1300 marijuana plants were seized in the raids.