

## Closing the Excise Tax Revenue Gap on Cigarette Smuggling



Automate the alerting of taxpayer identities and relationships to surface potential high risk candidates to investigate.

---

### Highlights

---

- **Implement a robust relationship resolution capability across registration, filing, collections, payments and audit**
- **Connect the dots to external fraudulent individuals and networks**
- **Find multiple degrees of separation in relationships**
- **Enhance national security through improved data sharing of actionable intelligence**
- **Determine 'network' value of the suspect**
- **Build on existing investments to optimize investment in skills and infrastructure**
- **Create an innovative real time tax intelligence solution that aids in detecting potential non-compliance, revenue losses and to ensure tax compliance**
- **Use proven IBM technologies and techniques to implement**

### Strategic Issues

Today's tax agencies typically lose 15 per cent or more of total revenues to tax evasion and other types of non-compliance –known as the 'tax gap.' At a time when tax evasion techniques have grown more sophisticated, cigarette smuggling is a very real and significant example that national and state governments are dealing with.

Today, the World Bank estimates that 30 percent of all cigarette exports in the world end up on the black market. According to California's Board of Equalization (BOE), the ratio of total taxes to retail price is a measure of the incentive for smuggling. The US Bureau of Alcohol, Tobacco , and Firearms (ATF) supports BOE's assessment, maintaining that 'there is no doubt that there's a direct relationship between the increase in a state's tax to an increase in illegal trafficking'.

Cigarette smuggling generally falls into one of three categories:

- Individual bootlegging: driving across state borders to purchase cigarettes and pay the lower state excise taxes there, visiting Indian reservations or military bases for tax free cigarettes, or using the Internet to purchase cigarettes without paying any state tax

- Organized wholesale domestic smuggling: the bulk purchasing of cigarettes in low tax states and then trucking them across the United States or within other countries and selling them to cigarette retailers who would sell them to customers as fully tax-paid cigarettes
- International smuggling: the smuggling of cigarettes that were exported to or made in a foreign country, such as Mexico, or purchased at duty free shops and brought back across the borders. International smuggling can also include counterfeit cigarettes being manufactured in other countries and smuggled into the United States or other Countries

### **Loss of State Revenue Associated with Cigarette Smuggling**

ATF estimates that as the incentive to evade cigarette taxes rises with tax rates, states lose billions of dollars of lost revenue. In fact, just from smuggling operations alone, ATF predicts that states across the US have lost up to \$2 Billion in tobacco tax revenue.

According to policy analyst Patrick Fleenor, small-time crooks and organized crime have engaged in murder, kidnapping and armed robbery to earn and protect their profits. Targets of this crime have included independent bootleggers, truckers, wholesalers, distributors, and retailers. Current ATF investigations have identified instances

of terrorist groups forming alliances with tobaccos smugglers to generate monies to support their organizations and activities, such as the purchasing of firearms or explosives to use against the United States. In 2004, ATF had more than 300 open cases if illicit cigarette trafficking, several of which had ties to terrorism.

### **Cigarette Sales Tax Gap Scenarios**

- New York City, for example, has steadily increased taxes each decade and now has the highest cigarette taxes in the country when state and city taxes are combined. Various reports indicate that at least half of the cigarettes consumed there have evaded state and city excise taxes. The attorney general of New York estimated that the state was losing \$300 million in revenue each year due to cross-border sales and smuggled cigarettes.
- In California, a man was arrested in February 2006 in connection with an operation that smuggled cigarettes from North Carolina. Over a three year period, ATF believes this operation evaded California taxes on more than 495,000 cases of cigarettes, which equates to a loss of \$4.5 million in excise taxes.
- Trials in 2002 involving terrorism and smuggling include the following: a federal jury in North Carolina convicted Mohamad Hammoud of supporting terrorist groups by funneling profits from a multi-million

dollar cigarette-smuggling operation to the Hezbollah cell. Hammoud and his brother were accused of smuggling at least \$7.9 million worth of tax cigarettes.

- More recently, in March 2006, 18 people were indicted in Michigan for taking part in a multi-million dollar conspiracy to smuggle cigarettes and other goods to raise money for the Hezbollah cell. The federal government estimated that the State of Michigan lost \$20 million in taxes as a result of the smuggling. While based in Michigan, the enterprise reportedly had smuggling operations throughout the country, including in California.

### **Why Now?**

Today's intensifying tax agency challenges mandate a fresh approach to managing tax compliance and fraud information.

- Multiplication of fraud types, frequency, complexity and interconnectedness of people and organizations
- Fraud is increasingly asymmetrical
- Explosion in complexity of fraud identification
- Frequency of transaction/interactions
- Transparency is clouding
- Regulatory pressures are increasing
- Intensifying budget and tax revenue pressures

- Customer centric approach

Current Approaches have become obsolete.

- SSN and/or EIN are no longer reliable as the sole means of identification and linkage to other taxpayers
- Information is compartmentalized – lack of full integration is obscuring visibility
- Query state limits ability to address complexity of fraud - you need to know the right question to ask
- Untimely – fraud identified ex-post facto.
- Inaccurate – broad scale false positives and false negatives
- Out of context – lack of decision support/guidance once fraud is identified

### **More Effective Taxpayer Compliance**

IBM Tax Compliance Intelligence is a powerful, sophisticated solution that can be configured to meet a given agency's particular compliance needs. It helps improve the compliance process in the following ways:

- Segment tax payers to detect who may be a higher risk to focus appropriate attention and resources where the taxpayer of interest suggests such attention
- Automate the real time alerting and insight into identities
- Detect and determine if tax payers are properly registered – eliminate duplicate registrations by up to 50%

- Automate previously manual steps to detect, verify taxpayer names, identities and relationships
- Provide full attribution with a complete history of a tax payer and never throw away data about them
- Real time updates, and self correcting to provide a current and a more accurate view
- Auditors require tools to know how noncompliance occurs and at the same time protect the privacy of tax payers.
- Improve tax/revenue department performance and effectiveness by using fact based taxpayer identity and relationship information for deep insight into who you are dealing with

### *Recognizes multi-cultural name variations*

- Kate, Cait, Catherine, Katherine, Kat
- Multiple name variations: name order, multiple titles, name variants, multiple prefixes, phonetic transpositions of nicknames

### *Recognizes identities*

- Provides the ability to identify who people, and organizations are

### *Recognizes relationships*

- Identities what relationships exist between a tax payer, and obvious, non-obvious people and organizations

### **Privacy Protection**

Information about tax payers is needed to successfully follow up on leads and process cases by the tax agency. The Information is usually provided by a tax payer themselves and does not itself represent privacy issue. Difficulty arises if elements of information are combined in ways that reveal more about a person's private life than intended. Different countries take different approaches to privacy. Many countries have legislated privacy into their tax systems. Sometimes privacy protections are an inhibitor to good tax compliance and service. Tax payers may be willing to allow privacy information to be shared if asked and to their benefit if they provide consent.

IBM Tax Compliance Intelligence provides tax agencies:

- Ability to share identity and relationship information with third parties without disclosing the identity of the person to whom the information relates
- Support tax agency services delivery model oriented around integrated service and tax payer consent and choice

### **Proven Tools and Techniques**

IBM has invested significant resources in Tax Compliance Intelligence to bring together a range of tools and techniques all specifically designed to enhance the implementation of

integrated tax case and risk management solutions for tax agencies.

**A solid foundation: World class technologies from IBM**

IBM is one of the largest providers of solutions to government agencies around the world. The IBM Tax Compliance Intelligence is built upon:

- IBM Global Name Recognition: recognizes names across multiple cultural variations
- IBM Identity Resolution: identities 'who is who'
- IBM Relationship Resolution: identifies 'who knows who' by detecting relationships across

multiple degrees of separation

- IBM Anonymous Resolution: allows multiple organizations to share identity and relationship data anonymously that never exposes the identity of an individual

**For more information**

To learn more about these solutions, please visit: [ibm.com/db2/eas](http://ibm.com/db2/eas) or contact your IBM sales representative.



© Copyright IBM Corporation 2006

IBM (United States of America)  
Entity Analytic Solutions  
6600 Bermuda Rd, Suite A  
Las Vegas, Nevada  
United States of America, 89119

Printed in the United States of America  
9/06  
All Rights Reserved.

DB2, IBM, the IBM logo, and the On Demand logo are trademarks of International Business Machines Corporation in the United States, other countries or both.

Other company, product and service names may be trademarks or service marks of others.

References in this publication to IBM products or services do not imply that IBM intends to make them available in all countries in which IBM operates.

♻️ Printed in the United States of America on recycled paper containing 10% recovered post-consumer fiber.

*Sources:*  
*Advisory Commission on Intergovernmental Relations (ACIR)*  
*Fleenor, Patrick. "New York's Deadly Cigarette Tax" New York Post, May 26, 2003*  
*Advisory Commission on Intergovernmental Relations (ACIR)*  
*US Bureau of Alcohol Tobacco and Firearms*  
*California Board of Equalization*  
*World Bank*