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ARIZONA LUXURY TAX PROCEDURE LTP 07-1

ISSUE:

Affixation of Arizona tax stamps to cigarette packages for retail sale and various issues of cigarette distributors and retailers related to the nature and handling of tax stamps after affixation.

APPLICABLE LAW:

Arizona Revised Statutes ("A.R.S.") §§ 42-1125 and 42-1127 provide various civil and criminal penalties for the use or distribution of counterfeit tax stamps.

A.R.S. § 42-3001(5) states,

"Cigarette distributor" means a distributor of cigarettes without stamps affixed as required by this article who is required to be licensed under section 42-3201. Cigarette distributor does not include a retailer or any person who holds a permit as a cigarette manufacturer, export warehouse proprietor or importer under 26 United States Code section 5712 if the person sells or distributes cigarettes in this state only to licensed cigarette distributors or to another person who holds a permit under 26 United States Code section 5712 as an export warehouse proprietor or manufacturer.

A.R.S. § 42-3001(16) states, "'Retailer' means any person who comes into possession of any luxury subject to the taxes imposed by this chapter for the purpose of selling it for consumption and not for resale."

A.R.S. § 42-3004(3)(b) provides that the Department may prescribe the manner in which official tax stamps or labels are to be affixed.

A.R.S. § 42-3006(A) provides for the Department to prepare and have available official adhesive stamps for cigarettes.

A.R.S. § 42-3006(B) provides that tax stamps "shall be of a character so that they cannot be removed when once attached to an article without destroying them."

A.R.S. § 42-3006(E) provides that the Department "shall prescribe by rule or procedure the method and manner in which stamps are to be affixed to cigarettes and may provide for the cancellation of stamps."

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A.R.S. § 42-3007 provides that a tax stamp “shall be securely affixed to some visible part” of a cigarette package “to which it will firmly adhere during possession by the consumer, except as otherwise provided.”

A.R.S. § 42-3202.01 states,

Except as otherwise provided in section 42-1127, subsection F, section 42-3202, subsection B and section 42-3203, subsection C, for the purpose of proper administration and to prevent evasion of the taxes imposed by this chapter, until the contrary is established, it is presumed that cigarettes that are sold, distributed, used or consumed by a person in this state, but not placed in packages or containers on which official tax stamps are affixed, are intended for first sale by the person and are subject to the taxes imposed by this chapter.

A.R.S. § 42-3202.03(B) states, “Only licensed cigarette distributors may purchase, obtain or affix cigarette stamps.” The statute also provides that, “[w]hen affixing cigarette stamps to cigarettes, cigarette distributors shall ensure that the affixation method that is used maintains the legibility of the serial numbers on the stamps.”

A.R.S. § 42-3210 provides Department-enforced prohibitions of the stamping and importation of cigarette packages that are not intended for sale in the United States or are otherwise counterfeit in nature.

A.R.S. § 44-7111(6)(d) provides the Department-enforced prohibition of the sale, distribution, acquisition, possession, transportation, or importation of cigarette packages that are not listed in the directory of approved tobacco products maintained by the Office of the Arizona Attorney General.

DISCUSSION:

To effectively enforce Arizona tobacco tax laws for cigarettes, this procedure provides cigarette distributors and retailers with an explanation of the general principles and considerations that the Department uses in ensuring that tobacco taxes have been paid on cigarettes offered for sale in the state through proper affixation of Arizona tax stamps.

Every cigarette package sold at retail in the state must be affixed with an Arizona tax stamp or tax-free stamp to demonstrate that tobacco taxes have been paid on the cigarettes or that the cigarettes are otherwise not subject to the taxes. Under A.R.S. § 42-3202.03(B), the duty to affix tax stamps on these cigarettes lies with licensed cigarette distributors. This statutory provision also states that cigarette distributors must ensure that “the affixation method that is used maintains the legibility of the serial numbers on the stamps.”

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The Department conducts compliance inspections of cigarette distributors and retailers as part of its duties to enforce various laws regarding cigarettes that are sold, used, or held in Arizona. Aside from inspecting cigarette inventories held in the state to ensure that Arizona taxes have been paid on cigarettes, the Department also is charged with ensuring that counterfeit stamps are not being circulated and that contraband and counterfeit products are not being stamped, distributed, or offered for sale. Because it is a violation of state statute to affix tax stamps to these products, the ability of the Department to review legible serial numbers on affixed stamps is a critical component in ascertaining the validity and origin of tax stamps.

Different factors contribute to the legibility of tax stamps from the time that licensed cigarette distributors affix the stamps to cigarette packages to when retailers sell the cigarettes to final consumers, including the quality of the tax stamps, the affixation method used, the quality and maintenance of stamping equipment, the related quality control procedures of the licensed cigarette distributors when they affix the tax stamps, and the wear and tear encountered in the handling of cigarette packages subsequent to licensed cigarette distributors' affixation of tax stamps. All cigarette distributors are required both to affix tax stamps by firmly adhering them to cigarette packages and to maintain the legibility of each stamp's serial number, but tax stamps are required by statute to be destroyed if attempts are made to remove them after they have been affixed to the packages. Consequently, the many requirements and duties imposed upon the Department, distributors, and retailers can result in confusion among the different parties, and determining whether affixed tax stamps meet the statutory requirements that a stamp be firmly adhered to a package during possession by a consumer and that a cigarette distributor's affixation method maintains the legibility of the serial numbers is a highly fact-intensive process that does not reduce to a simple "checklist."

The Department recognizes the importance of assuring cigarette distributors and retailers that the Department does not have a standard requiring "perfect affixation" of Arizona tax stamps on all cigarette packages. During compliance inspections, where there are instances of cigarette packages that, when viewed in isolation, do not bear tax stamps with fully legible serial numbers, the Department's tobacco agents will consider the totality of the circumstances in determining whether retailers may keep these cigarettes for sale. Retailers are encouraged to discuss any concerns related to stamp affixation with the Department before attempting to return product to their cigarette distributors.

PROCEDURE:

While licensed cigarette distributors are responsible for methods and quality control procedures that ensure that they affix tax stamps in a manner that preserves the legibility of the serial numbers printed on the stamps, the cigarette packages will not be required in every instance to appear "perfectly stamped" at the point that they are reviewed during compliance inspections conducted by the Department.

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The following list provides several general criteria that the Department uses during its compliance inspections:

1. If individual cigarette packages do not bear tax stamps with fully legible serial numbers, but the legible numbers match corresponding digits of serial numbers from properly stamped cigarette packages that are packaged or shelved with them, the Department should consider the individual cigarette packages at issue to have been properly stamped.
2. If the validity of stamped cigarette packages cannot be confirmed as described in Paragraph 1, but the cigarette packages that individually appear to violate applicable statutes are part of the same pallet, master carton, or carton that contains properly stamped cigarette packages, the Department should consider the individual cigarette packages at issue to have been properly stamped. This criterion applies only to pallets, master cartons, or cartons that are unopened before the Department conducts compliance inspections.
3. If the validity of individual cigarette packages cannot be confirmed as described in Paragraphs 1 and 2, but the distributor or retailer can demonstrate through books, records, or other indicia to the satisfaction of the Department's tobacco agents that the cigarette packages were purchased as part of the same pallet, master carton, or carton that contains properly stamped cigarette packages, the Department should consider the individual cigarette packages at issue to have been properly stamped.
4. If any cigarette packages bear authentic Arizona tax stamps that are inappropriate for sale from the location of the retailer (e.g., Indian Reservation Tobacco Tax "red" stamps on cigarettes being sold by a retailer that is not located on an Indian reservation, or tax stamps of another state or jurisdiction), the packages are considered contraband and subject to seizure and forfeiture.
5. If any cigarette packages bear counterfeit tax stamps, or if the packages are counterfeit products but bear authentic tax stamps, the packages are considered contraband and subject to seizure and forfeiture.
6. If any cigarette packages bear no visible Arizona tax stamps, the packages are ineligible for retail sale; retailers will be advised to return the packages to the issuing cigarette distributor for restamping or, with the presence of extenuating circumstances, the packages may be subject to seizure and forfeiture.

* These principles presume that a distributor or retailer has otherwise demonstrated compliance with state tobacco laws. Depending on the nature of compliance issues, circumstances may necessitate further inspection by the tobacco agent.

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7. If any cigarette packages demonstrate affirmative attempts by a cigarette distributor or retailer to “split” or “half-stamp” packages and thereby fraudulently use the tax stamps, the packages are considered contraband and subject to seizure and forfeiture.

Because inspections are highly fact-intensive processes, it is impossible to provide an exhaustive list of factors under which the Department’s tobacco agents will definitely allow product to remain in the custody of a distributor or retailer or will definitely seize product. Nevertheless, as can be inferred from the examples provided below, retailers can greatly assist tobacco agents by storing and maintaining cigarette inventories by shipment and keeping any relevant books, records, invoices, and documentation easily accessible for inspection.

Retailers are encouraged to discuss any concerns related to stamp affixation with the Department before attempting to return product to their cigarette distributors.

EXAMPLES:

The Department provides the following illustrative examples of how a tobacco agent will respond under different facts and circumstances during compliance inspections of retail locations.

Example 1:

During a compliance inspection of a retailer location, a tobacco agent encounters a retail display containing packages of Brand X cigarettes of the same blend and style. Some of the Brand X packages fail to bear fully legible serial numbers, although none of the stamps appears to be counterfeit or otherwise invalid. None of the packages completely lacks an Arizona tax stamp. Upon further inspection, however, the agent finds that the legible digits of the serial numbers from the packages lacking the complete tax stamp serial numbers match the corresponding digits of the serial numbers from the properly stamped packages in the display.

Assuming that the retailer has otherwise demonstrated compliance with state tobacco laws, and the serial numbers from the properly stamped packages correspond with Arizona tax stamps sold to the licensed cigarette distributor from whom the retailer purchased the cigarettes, the agent should deem all of the cigarette packages in the retail display properly stamped.

Example 2:

Assume the same facts as in Example 1, except that, on a previous compliance inspection, the tobacco agent had determined that the retailer had actively concealed the fact that it had obtained several Brand X packages that failed to

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bear fully legible serial numbers from an unlicensed cigarette distributor and had presented a false sales invoice from a licensed cigarette distributor when asked for the identity of the distributor from whom it had purchased the cigarettes.

Due to the differing factual circumstances and background, the agents may request further inspection of the retailer's inventory, books, records, invoices, and documentation.

Example 3:

During a compliance inspection of a retail location, a tobacco agent finds that in a randomly selected, unopened carton of cigarettes, several of the packages fail to bear tax stamps with fully legible serial numbers, although no stamp appears to be counterfeit or otherwise invalid. None of the packages completely lacks an Arizona tax stamp. The tobacco agent can see, however, that the packages are improperly stamped merely due to the quality of the tax stamp or a mechanical or operator-based stamping error and that all the packages are part of the same original carton.

Assuming that the retailer has otherwise demonstrated compliance with state tobacco laws, and the serial numbers from the properly stamped packages correspond with Arizona tax stamps sold to the licensed cigarette distributor from whom the retailer purchased the cigarettes, the agent should deem all of the packages properly stamped.

Example 4:

During a compliance inspection of a retail location, a tobacco agent finds that a retail display of cigarette packages contains multiple packages that fail to bear fully legible serial numbers, although no stamp appears to be counterfeit or otherwise invalid. None of the packages completely lacks an Arizona tax stamp. The retailer produces documentation showing that it purchases cigarettes from two different licensed cigarette distributors. Upon closer inspection, the tobacco agent finds that the cigarettes appear to have been purchased from these two sources.

Assuming that the retailer has otherwise demonstrated compliance with state tobacco laws, the agent should deem all of the packages in the display properly stamped.

Example 5:

Assume the same facts as in Example 4, except that on a *previous* compliance inspection, the tobacco agent had determined that, in addition to the cigarette

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packages on retail display that were purchased from the two different licensed distributors, the retailer maintained a cache of export-only cigarettes behind the sales counter. The retailer had been unable to produce any invoices or documentation to show the origin or purpose for holding these cigarettes in the store. The tobacco agent subsequently seized the export-only cigarettes.

Due to the differing factual circumstances and background when compared to Example 4, the agents may, on the present compliance inspection of the retailer in this example, request further inspection of the retailer's inventory, books, records, invoices, and documentation.

Gale Garriott, Director

Signed: June 29, 2007

Explanatory Notice

The purpose of a tax procedure is to provide procedural guidance to the general public and to Department personnel. A tax procedure is a written statement issued by the Department to assist in the implementation of tax laws, administrative rules, and tax rulings by delineating procedures to be followed in order to achieve compliance with the law. Relevant statute, case law, or administrative rules, as well as a subsequent procedure, may modify or negate any or all of the provisions of any tax procedure. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.