

Excise Duty Notice

July 2005

Tobacco Stamping Regime – Review and Recommendations Discussion Paper

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La version française de ce document est intitulée
*Document de travail sur le régime d'estampillage du
tabac - Examen et recommandations*

Canada

Background

It has long been recognized that the significant taxation of tobacco products and the potential for profit act as powerful incentives for contraband activity. Such contraband activity results in substantial revenue losses at both the federal and provincial levels, and undermines government health initiatives, which form part of the basis for high excise duties and provincial taxes on tobacco products. These illegal sales are not reported, creating opportunities for non-payment and non-declaration of the applicable taxes.

Increasingly, there is a perception that purchasing illicit tobacco products is a victimless crime. Some studies have shown that if savings are sufficient, a majority of respondents are willing to purchase lower priced tobacco products, even though they know it is contraband. To compound the problem, as rates of duty and taxes climb, so too do the profits from contraband, and the risks that the criminal element is willing to take.

Since April 2001, when the federal government introduced a comprehensive strategy to improve the health of Canadians by discouraging tobacco consumption, a number of working groups and committees were formed. The Canada Revenue Agency (CRA) has been an active participant in these initiatives, some of which fall under the auspices of the Federal Tobacco Control Strategy, to identify, monitor, assess, and address tobacco issues.

In an effort to deal with the challenges, and to ensure that the tobacco tax system continues to support the Government's health goals, the CRA, in partnership with the Department of Finance, identified and analysed numerous possible initiatives to enhance compliance with Canada's tobacco legislation. As a result of that study, the Federal Budget 2005 provided funding over the next five years to enable the CRA to develop enhancements to tobacco tax compliance at three different stages of the production and distribution process:

- increased audit activity of tobacco manufacturers,
- increase monitoring of raw leaf tobacco and tobacco growers, including new raw leaf tobacco tracking mechanisms, and
- enhancements to the stamping and marking regime for manufactured tobacco products using new covert and overt identifiers that will clearly indicate whether excise duty has been paid.

Seizures of counterfeit and foreign produced tobacco products have drawn attention to the fact that Canada is clearly a target for offshore contraband tobacco products. It is also apparent that the existing stamping and marking regime of tobacco products can, and is, being copied with increasing degrees of success. This Discussion Paper proposes changes to enhance the tobacco stamping regime, by implementing new covert and overt identifiers to clearly indicate whether excise duty has been paid, and to strengthen the integrity of the stamping regime with new licensing provisions affecting tear tape/stamp manufacturers and security providers.

Consultation and Development Process

Since early 2003, the subject of tobacco stamping has been discussed at various levels and forums.

Provincial and Territorial Governments have been consulted via the semi-annual Tobacco Steering Committee and meetings of its Tobacco Working Group. Since January 2005, CRA has also been meeting with a cross-section of affected stakeholders. This issue has been discussed with a number of manufacturers along with a tear tape manufacturer and security provider. The main purpose of these discussions was to gather information on issues such as security of the distribution networks, processes, implementation times, and potential costs.

Meetings have also taken place with representatives from organizations such as Health Canada and the Royal Canadian Mounted Police (RCMP) to identify potential enforcement strategies and future cooperation. We have also conferred with non-government organizations including the Canadian Cancer Society, the Non-Smokers Right Association, the Ontario Convenience Stores Association and the National Association of Convenience Distributors (NACDA). Although all parties have their own specific concerns and views of the current tobacco situation, all agree that illicit tobacco issues must be addressed.

Following distribution of this Discussion Paper, there will be a 60-day representation period, during which submissions on the proposals are invited. CRA officials will continue to meet with affected stakeholders and address representations or concerns as needed. The representations received will be considered and addressed before moving forward with any amendments.

Throughout this process, a review of the *Excise Act, 2001* and its regulations is being performed to identify any potential legislative amendments that may be necessary. Timelines and deliverables will be adjusted accordingly.

In early 2006, CRA will develop the necessary enforcement strategies, verification programs, Service Level Agreements (SLA) and Memoranda of Understanding (MOUs) with affected enforcement partners and stakeholders.

It is anticipated that a new stamping and marking regime can be implemented by the end of November 2006.

Current Regime

Domestic Production

Under the current regime, a tobacco “stamp” indicates that Excise duty has been paid, and for cigarettes, this usually takes the form of an easy opening device (EOD), commonly known as a “tear tape”. For other tobacco products, a more traditional rectangular stamp can be used to seal the package. The process of stamping a tobacco product is linked to the calculation and payment of Excise duty. The wording, size and application of the stamps is specified by the *Stamping and Marking of Tobacco Products Regulations*, which also allow stamps to be modified to accommodate Provincial requirements, including specific provincial information and designated colour. For domestically produced tobacco products, the tobacco licensee applies the stamp at the time of packaging.

A tobacco “mark” indicates that Excise duty has not been paid and that the tobacco product is destined for the non-duty-paid market (e.g., exports). Wording is required to indicate that the products are not for sale in Canada, or that duty is not paid. This wording is generally found on the tear-tape. Marked tobacco products usually enter an excise warehouse prior to distribution to the non-duty-paid market.

Imports

Imported tobacco products must also be stamped in accordance with the *Stamping and Marking of Tobacco Products Regulations*. They may be stamped offshore or in a Customs Sufferance Warehouse. The validation of a stamp is accomplished by the payment of federal Excise duty prior to being released by Customs for domestic consumption.

At the Provincial level, a variety of procedures are allowed for importers/wholesalers to mark tobacco products. Provincial marking programs differ from province to province and any change to the federal stamping and marking program may, or may not, affect a Province’s marking program.

The high quality and increase in counterfeit tobacco products and stamps has weakened the integrity of the current stamping regime. Essentially, there are no means by which wholesalers, distributors or retailers can identify counterfeit or contraband tobacco products. This also applies to federal and provincial policing agencies. And, since possession of non-duty-paid tobacco products in the duty-paid market is an offence under the *Excise Act, 2001*, an enhanced stamping and marking regime would assist all legitimate levels of distribution in avoiding contraband, as well as policing agencies in detecting contraband.

Options and Technology

Federally, no guidelines or authority exists to regulate manufacturers of tear tape and stamps. Counterfeiters can quickly adapt to reproduce the specifications outlined in the publicly available federal *Stamping and Marking of Tobacco Products Regulations*. The resulting tear tapes and stamps applied to counterfeit and contraband tobacco products can make these illegal products indistinguishable from legitimate products and compromise enforcement efforts.

Although it is an indictable offence under the *Excise Act, 2001* to possess, purchase or sell tobacco products that are not stamped in accordance with the Act or that are fraudulently stamped, the increasing prevalence of counterfeit products and incidents of undeclared production will eventually render the current stamping regime ineffectual.

The current regime offers limited controls that no longer effectively support detection and enforcement activity, and therefore threatens revenues. A range of options have been identified and analyzed for the purposes of this paper, including similar initiatives being pursued by foreign jurisdictions. With few exceptions, stamping initiatives fall into one of three models, such as:

- Incorporating new covert and overt identifiers on enhanced tear tapes;
- Incorporating new covert and overt identifiers on new prescribed stamps; or
- Merging the two options to establish a stamping and marking regime that allows for either an enhanced tear tape and/or a prescribed stamp.

Security that features ink-shifting technologies can be applied by a variety of ink and printing technologies and offers the option to layer and rapidly change overt and covert features. A first layer of security can be achieved by overt color-shifting technology displaying a distinctive color-shift, and allowing for a simple and rapid yes/no authentication by the naked eye. This overt feature is based on optical interference and selective reflection, with sophisticated manufacturing technology making it both difficult and costly to duplicate.

Semi-covert security inks could offer a second security layer as they can be detected using simple viewing devices and are usually targeted for use at the point of sale or by law enforcement officers.

Covert machine-readable inks offer a higher level of security but remain detectable by easy-to-use, but sophisticated dedicated devices. These features offer a third line of defence.

Colour shifting ink technology is quickly replacing holographic imaging, increasingly seen as compromised and dated. This is further supported by the fact that, after years of circulation on bank notes and other security items, no simulation or counterfeit items with colour shift inks have been found in the marketplace. In addition, security features such as visible sequencing numbers, unique codes/serialization, code encryptions and electronic signatures are also available and can be incorporated in the future, if needed.

In addition to adopting new stamping features, CRA will propose amendments to implement a licensing program that will require all manufacturers of tear tapes or tobacco stamps to obtain a licence, maintain adequate books and records, and sell only to tobacco manufacturers licensed under the *Excise Act, 2001*. Amendments will also be proposed that will require tobacco licensees to purchase tear tape or stamps from licensed tear tape or stamp manufacturers.

CRA will also propose amendments to provide for similar requirements and controls for the security company that is successful in the procurement process to become the ‘approved’ security provider. The security provider would develop and supply the security inks for use by tear tape/stamp manufacturers and would also develop the required detection technology.

Option 1 - Covert and Overt Identifiers – Enhanced Tear Tapes

This option would consist of enhancing the security of the tear tape system currently in use by incorporating new overt and covert identifiers. The security inks would be supplied by an ‘approved’ security supplier and incorporated in the tear tape manufacturing process. Tear tape manufacturers would be required to be licensed under the *Excise Act, 2001* and possession, sale, and purchase of tear tape would be governed by the same Act. Development of the instruments capable of detecting specific levels of security would be the responsibility of the security provider, with responsibility for allocation of such instruments falling to the CRA.

Considerations

Currently, under the *Excise Act, 2001* and its *Stamping and Marking of Tobacco Products Regulations*, tear tapes or stamps must be applied to tobacco products to identify their duty paid status. However, provincial legislation and regulations require that tear tapes, with a minimum width of at least 4.5 mm, be used on all packages of cigarettes.

This option may require the use of a wider tear tape to allow a visible security feature onto a section of the tear tape. This would allow retailers and the general public to identify legitimate products based on a visible feature. Additionally, a covert feature would be added via a machine-readable taggant into another section of the tear tape. This would allow authentication of the tear tape by government and enforcement agencies and protect the integrity of the tear tape from counterfeiters.

Incorporating new features into the tear tape will likely lead to an increase in the cost of tear tape.

Strengths:

- For high volume production of cigarettes most Canadian tobacco manufacturers use tear tape. Therefore, equipment and production lines currently in place could, with minimal investment, be adapted to accommodate enhanced tear tapes.
- Could be implemented in a shorter time period than other options.
- Valuable experience and information could be gained from an industry/province led pilot project currently in place in British Columbia.
- With only the security provider and the CRA aware of specifics of the security features, there is a reduced opportunity for information to be leaked.

Weaknesses:

- Size restrictions limit the number of features that can be incorporated (maximum 3 or 4 levels of security features) on a tear tape, and as such, reduces the difficulty to reproduce and counterfeit tear tape.
- Option becomes difficult to administer or ineffective once the 3 levels of security have been compromised and security features will need to be continually updated or replaced.
- As tear tape is produced in a continuous roll form, it is impossible to precisely control inputs of material used and accurately determine yields between rolls of tear tape and finished products packaged. Regular manufacturing losses are also difficult to control, which complicates the detection of undeclared production of tobacco products.
- Smaller manufacturers, who use non-automated production and packaging lines, could incur substantial capital investment to comply with enhanced tear tape requirements.
- Tear tapes are applied mostly to cigarettes and tobacco sticks. Other tobacco products, such as fine cut tobacco and packaged raw leaf, currently use stamps to indicate their duty paid status. The diversity in the size and form of the container used could make the application of tear tapes difficult and more costly.

Option 2 - Covert and Overt Identifiers – Prescribed Stamp

Similar to option 1 but uses a new “prescribed” stamp instead of tear tape. The security inks would be supplied by the approved security provider and incorporated in the stamp manufacturing process by licensed stamp manufacturers. The security provider would maintain the integrity of the security features in the inks provided to stamp manufacturers, and the distribution of the enhanced stamps to legitimate tobacco licensees could be administered by the stamp manufacturers, or the CRA. Possession, sale and purchase of prescribed stamps would be controlled under the *Excise Act, 2001*.

Development and allocation of the instruments capable of detecting specific levels of security would be the responsibility of the security provider and the CRA, respectively. CRA would determine distribution of the instruments capable of detecting specific levels of security based on the enforcement role of the partner.

Considerations:

The increased size allows for stamps to accommodate a more sophisticated menu of overt and covert security features. This option can offer a large degree of control over production and importation of legitimate tobacco products and offers greater support for detection and prosecution of illegitimate products.

Strengths:

- Unlike a tear tape, a prescribed stamp could easily be applied to all packages of tobacco products, no matter the size, shape or material of the package.
- Stamps have the potential of being sequentially numbered to facilitate detection of undeclared production and complicate counterfeiting, and each stamp could be accounted for.
- Due to the larger size of a stamp compared to a tear tape, more levels of security features could be applied to increase the overall security of the stamp, protect the integrity of the stamping and marking regime, and greatly reduce the chance of undetectable counterfeiting.
- Future enhancements would also be an option such as increasing or combining security features and the possibility to attach security features for track and trace technology.
- With only the security provider and the CRA aware of specifics of the security features, there is a reduced opportunity for information to be leaked.

Weaknesses:

- Currently, larger automated tobacco licensees are equipped with production and packaging lines to apply tear tape to high volume products such as cigarettes and tobacco sticks. A change imposing the requirement for application of stamps would require major capital investment and a lengthy implementation period.
- Smaller manufacturers that currently produce their own stamps, or have them printed, will have to purchase stamps from a licensed stamp manufacturer at an increased cost.
- Most Provincial and Territorial jurisdictions require the use of tear tape on certain tobacco products. Adopting a prescribed stamp model without provincial adjustments would require tobacco licensees to maintain both a federal stamping and a provincial tear tape system.
- Complex and costly government administration would be required should CRA assume distribution of prescribed stamps, a practice previously in place and abandoned in the early 1970's.

Option 3 - Combination of Enhanced Tear Tapes and Prescribed Stamps

This option provides three alternatives for tobacco licensees:

- Enhanced tear tapes on all tobacco products;
- Prescribed stamps on all tobacco products, or
- Enhanced tear tapes on some tobacco products and prescribed stamps on others.

The tear tape or stamp contains security inks produced by an 'approved' security provider. The security provider supplies the inks to the licensed tear tape/stamp manufacturer who supplies the tobacco licence holder. Production, transactions, and internal controls are subject to audit by the CRA.

Development and allocation of the instruments capable of detecting specific levels of security would be the responsibility of the security provider and the CRA, respectively. CRA would determine distribution of the instruments capable of detecting specific levels of security based on the enforcement role of the partner.

Considerations:

This option combines the strengths of both the enhanced tear tape option and the prescribed stamp option while addressing the individual weaknesses of the two.

This option may be better suited for tobacco licensees of all sizes, as it minimizes the investment required for equipment modifications and the time required for implementation.

As mentioned in option 1, tear tape is produced in a continuous roll form and it is difficult to determine yields between rolls of tear tape and finished products packaged. However, tear tape is used mostly by lower risk manufacturers and with the additional controls proposed on the security provider and tear tape manufacturers, greater control can be expected.

With the limited security layers that can be applied to tear tape, and the advances made by counterfeiters, tear tape as a security feature may be short-lived. This option would allow for the CRA and industry to maintain current practices. It would also address immediate challenges while providing flexibility and future planning capability for longer term solutions that may require a switch from tear tape to stamps.

While tobacco licensees would still be required to monitor and control the use of tear tape/stamps, this option would place new controls and responsibilities on tear tape/stamp manufacturers and the CRA.

Strengths:

- Either an enhanced tear tape or a prescribed stamp would cover all tobacco products.
- Financial investment would be minimized. Non-automated production facilities could continue using stamps with hand-held stamp applicators, while larger automated manufacturers could continue using the high-speed tear tape packaging line currently in place.
- The security and detection features would facilitate identification of legitimate duty paid tobacco products. Tobacco licensees, distributors, retailers, enforcement agencies, and other stakeholders would be able to identify counterfeit non-duty-paid products.
- Flexibility would allow for quick amendments to address potential future challenges. For example, based on future monitoring and analysis, the tobacco stamping and marking regime could adapt and phase out tear tapes in favour of stamps in a timely manner, if required.
- More complex security features such as track and trace technology could be introduced quickly, as the infrastructure would be established.

Weaknesses:

- The development of the security features and detectors able to accommodate both tear tape and stamps would likely be reflected in the cost of the technology and the cost of tear tape/stamps.

Recommendation

Option 3 is the recommended option. To further support this option and the integrity of the stamping regime, CRA would also propose appropriate legislative and regulatory amendments to support a licensing or registration regime for tear tape and stamp manufacturers. As a licence holder, certain responsibilities and obligations would be imposed, and subject to audit. For example, sales to tobacco licensees would be verified and cross-referenced to records maintained by the tobacco licensees. Other amendments would be recommended that would include restricting the sale of tear tape/stamps to tobacco licensees.

Similarly, the security provider would be regulated and requirements established. The security provider could only supply licensed tear tape and stamp manufacturers, and Service Level Agreements would be established between CRA and the security provider to determine the controls necessary to protect the distribution of the security features to the tear tape and stamp manufacturers and the detection equipment.

Adopting these initiatives would provide a regime that offers greater control from the security ink, to application to the tobacco product, to retail.

Enforcement

One of the keys to this strategy's success will be cooperation with affected stakeholders and integrated monitoring and enforcement involving federal and provincial jurisdictions.

CRA will review the provisions of the *Excise Act 2001* to determine the required amendments to the administrative and enforcement provisions. New audit programs will be developed for field officers performing audits of the security provider, licensed tear tape and stamp manufacturers, as well as tobacco licensees.

Although the *Excise Act, 2001* does provide the authority for officers to inspect, audit or examine the records, processes, property or premises of a person in order to determine compliance with the Act, the Excise Duty program of the CRA concentrates on entities licensed under the Act. CRA auditors will continue with these responsibilities along with the audit responsibilities resulting from additions to the licensee base. The Royal Canadian Mounted Police (RCMP) will continue to be responsible for enforcement actions under the *Excise Act, 2001*.

In addition to examining its own resource requirements and direction for the new responsibilities that this strategy will require, the CRA will also be exploring the possibility of designating officials from other Departments and jurisdictions as officers under the *Excise Act, 2001*, for purposes of retail inspections. For example, Health Canada inspectors currently perform visits to retailers to verify compliance with the *Tobacco Act*, and provincial inspectors visit tobacco retailers under provincial legislation. The possibility of utilizing inspectors from other jurisdictions to inspect tobacco products for the new stamping requirements would provide further expertise and wider coverage, and should non-compliance be found, inspectors could act under the authority of the *Excise Act, 2001*, combine enforcement actions, or relay the information to the CRA or the RCMP. CRA could also seek inspector designation under the Health Act for its officials to share in the enforcement task at the distributor and retail levels.

The technology developed by the security provider to detect legal tobacco would be supplied to enforcement partners. Quantity and costs are still to be determined.

Next Steps

During the 60-day representation period, CRA officials will continue to meet with affected stakeholders to develop the options and address concerns. A final paper will then be prepared and distributed detailing the selected strategy, timelines and deliverables.

Following the 60-day representation period, and upon option approval, a Request For Proposal (RFP) will be prepared and posted on the Government Electronic Tendering System (GETS) for a minimum of 40 calendar days. Following the RFP closing date, all RFPs received will be evaluated as stated in the RFP with the objective of selecting a single supplier as the security provider for the new stamping and marking of tobacco products regime.

Although some preliminary discussions have taken place with the Provinces, Territories, and Health Canada on utilizing resources and designating inspectors under the *Excise Act 2001*, the feasibility of such an option will be explored more thoroughly throughout the 60-day representation period and beyond.

During the course of gathering information for this paper, other issues were raised in the context of compliance with tobacco tax legislation. Subjects such as controls on raw material (cigarette papers, filters, packaging material, etc), and on partially manufactured tobacco, fall outside the purview of this paper and will be studied independently.

Implementation of the new stamping and marking regime is planned for November 2006.

Submissions on this proposal should be submitted, in writing, no later than September 15th, 2005 to:

Tobacco Compliance Strategy Project

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