

STATE OF NEW YORK  
DEPARTMENT OF TAXATION AND FINANCE

Testimony of  
William J. Comiskey, Deputy Commissioner  
Office of Tax Enforcement

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On behalf of the Department of Taxation and Finance, I want to thank the Committee for inviting me here today to discuss one of the most difficult tax administration and enforcement tasks that we face in New York today, that of cigarette tax collection on the Native American reservations. As the Committee members all know, this vexing problem has produced volumes of judicial decisions, regulations, statutes, and legislation. It has challenged Governors for more than three decades, and, for each administration, no final resolution has been achieved.

*The Department's efforts to combat tax fraud and evasion.*

Before turning to the problem of cigarette tax collection from Native American merchants, I want to take a few minutes to provide you with some information regarding our overall efforts to combat tax evasion of all types.

In 2007, the Department publicly recognized that the State loses billions of dollars annually in taxes that are owed, but not paid. Since then, we have developed a comprehensive strategy to attack that tax gap. As part of the development of that strategy, we recognized that a significant portion of these annual revenue losses are directly attributable to deliberate acts of tax fraud and evasion. We are determined to expose and curtail this conduct.

The losses from deliberate tax evasion cut across the full spectrum of taxes and it is honest taxpayers who bear the cost of these crimes.<sup>1</sup> Honest taxpayers pick up the slack for those who

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<sup>1</sup> Each year, hundreds of thousands of taxpayers evade their obligations by simply choosing to not file. Huge numbers knowingly understate their income or exaggerate their expenses or deductions and each year we receive tens of thousands of income tax returns from taxpayers and tax preparers who fraudulently seek refunds or credits that the taxpayers are not entitled to receive. Our investigations have demonstrated that far too many tax preparers do not function as legitimate accountants, but instead serve as fraud coaches guiding taxpayers on how to cheat without getting caught. And, in some quarters of our economy, it is not an exaggeration to say that sales tax evasion is an epidemic. It is, for some, the way business is conducted.

do not pay their fair share. It is law-abiding businesses that suffer because they cannot compete with cheaters who enjoy a competitive advantage gained by tax evasion. And, as we are seeing today in these times of recession and fiscal austerity, it is the honest citizens and businesses who suffer the consequences when essential services are reduced or eliminated because government doesn't have the money to provide those services.

The good news is that the Department, under both Governors Paterson and Spitzer, has made great strides to increase tax compliance by strengthening and improving tax enforcement programs. The Legislature has also been a key partner in our efforts. With its support, we have substantially increased our fraud-fighting resources and created new, multi-disciplinary enforcement units across the state. We have never had more tax fraud cases under audit or investigation, or more cases referred to prosecutors as we do currently. Laws adopted last year for detecting, deterring, investigating, and prosecuting tax fraud are now some of the strongest in the Nation here in New York.<sup>2</sup>

This is the landscape in which I urge you to consider cigarette tax evasion. Cigarette tax evasion is unquestionably significant. It costs us hundreds of millions in lost tax revenues each year, but it is only one aspect of a much broader problem. When that evasion touches upon our relationships with Native American nations and implicates the host of complex issues relating to Indian sovereignty, tax enforcement becomes challenging and difficult.

#### *Evasion of cigarette taxes on Native American Reservations*

Any analysis of cigarette tax evasion on New York's Native American reservations requires an examination of the policy of "forbearance," which I know is something that this Committee is interested in discussing. Before turning to forbearance, however, let's take a look at the numbers.

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<sup>2</sup> In the last two and a-half years we have built the largest, most professional criminal and civil law enforcement agency in the nation devoted to the enforcement of state tax laws. Our efforts have received widespread coverage in the media and our message has unquestionably reached tax professionals.

Our cigarette tax enforcement efforts are a key component of our battle against tax evasion. For example, our investigators recently concluded the largest and most significant undercover investigation of cigarette tax evasion ever by the Department or by any state agency in the nation and this enforcement action is coupled with the hundreds of arrests and thousands of retail inspections we conduct every year. No state or local law enforcement agency in the country has more personnel devoted exclusively to cigarette tax enforcement and none has more success in making major cases against criminal enterprises engaged in cigarette tax evasion. Some of our recent cigarette tax enforcement cases are described in the Appendix at pages A1 and A2.

Key facts to know about the Native American cigarette transactions<sup>3</sup>

1. More than one in three cigarettes sold in New York by licensed stamping agents are sold to Native American merchants without a stamp and thus without the tax being paid.
2. The overwhelming majority of New York's licensed cigarette stamping agents do not sell unstamped cigarettes to Native American merchants. Since 2006, only ten licensed stamping agents have participated in Native American sales. Four of these agents only sell unstamped cigarettes to Native Americans. Since 2006, they have not sold a single stamped and taxed pack of cigarettes to anyone. Selling unstamped cigarettes to Native Americans is big business for the other seven agents as well. For three of them, it represents more than 95% of their cigarette sales and for the others, it represents between 57% and 71% of their business. *See* Chart 4 in the Appendix.
3. Agent sales to Native Americans grew rapidly from 1999 (15.5 million cartons) to 2005 (47.6million cartons). These sales have declined in every year since and, based on current data, the final sales for 2009 will reflect a continued decline. *See* Chart 5.
3. While the sale of tax stamps to licensed agents declined following the 2008 increase in the cigarette tax, the amount of money collected as a result of the increased cigarette taxes nonetheless increased.
4. If every pack of cigarettes sold to Native American merchants by licensed stamping agents in 2008 had been stamped and taxed, New York would have collected \$825 million in cigarette taxes. No one, however, should assume that we will collect this amount if we succeed in closing down the pipeline of unstamped cigarettes from licensed agents to Native Americans. Estimates that suggest the contrary fail to consider the following:
  - Virtually all of the Native American merchants in New York do not comply with the federal Jenkins Act which requires them to provide information regarding their out-of-state customers. Because of this, we do not know how much of the Native American cigarette business consists of sales over the internet or through mail order. But we do know that many of their internet or mail order customers are out-of-state smokers and would not otherwise buy cigarettes in New York. They will turn to other sources of cheap, untaxed cigarettes. We also know that some internet customers are New York residents and they too will likely turn to other internet sources of untaxed cigarettes. Until the federal government requires the United States Postal Service to stop mailing cigarettes, internet and mail order

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<sup>3</sup> Statistical information relating to cigarette sales generally and sales to Native American merchants is set out in the Appendix at pages A3 to A9.

businesses – whether they are operated by New York’s Native American tribal businesses or by businesses that are out-of-state -- will continue to flourish..

- While stopping licensed stamping agents from selling unstamped cigarettes to Native Americans that are re-sold to non-Indians will stop the major pipeline that currently supplies Native American businesses, it is likely that Native American merchants will turn to other sources, including Native American manufactured cigarettes. We know from our investigations that some Native American smoke shop operators are already buying cigarettes from sources in lower-tax states and from smugglers, and this behavior is likely to increase.
- Finally, we know that when it becomes more difficult for New York consumers to get cheap cigarettes (because the Native American pipeline has been diminished), some New York smokers will quit or cut back their consumption rather than pay higher prices for cigarettes.
- Those who fail to consider all of these factors erroneously inflate the revenues to be gained through a successful cigarette tax enforcement strategy in New York. The Department’s economists estimate that if all cigarette transactions conducted through Native American merchants with non-Indians were properly taxed (including those that are now occurring through mail and internet sales), New York would collect additional state revenue (using 2008 sales numbers) of approximately \$220 million. Because complete compliance is not likely, the actual number achievable would be less. In SFY 2007-08, the Division of the Budget estimated the collection of \$124 million from reservation sales. In SFY 2008-09, their estimate was \$93 million and in SFY 2009-10, it was \$85 million.

### 1994 to 2006

In 1994, the Supreme Court ruled that New York was entitled to impose and collect cigarette taxes on reservation sales of cigarettes to non-Indians.<sup>4</sup> As the Court of Appeals observed, not long after achieving this court victory following nearly a decade of litigation, then Governor Pataki “changed course and adopted a policy of forbearance.”<sup>5</sup> Governor Pataki adopted this non-enforcement policy after his efforts to start enforcing the cigarette tax laws on Indian reservations were resisted by Native Americans and sparked civil unrest that led to personal injuries and significant, organized interference with public transportation on State highways.

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<sup>4</sup> *Dept. of Taxation and Finance v. Milhelm Attea & Bros., Inc.*, 512 U.S. 61 (1994).

<sup>5</sup> *New York Association of Convenience Stores v. Urbach*, 92 N.Y.2d 204, 209 (1998).

Given these developments, the Appellate Division ultimately found that the Governor's "indefinite" policy of forbearance was rational.<sup>6</sup>

It is my understanding that during those years the policy was initially a strict and simple "hands-off" directive from the Governor's office to stay away from enforcement activity relating to sales of unstamped and untaxed cigarettes to Native American merchants or by those merchants. Later, as the policy evolved, it became clear that the policy was only intended to protect suppliers who were licensed agents and the Department began to take, and continues to take, enforcement action against cigarette suppliers who are not licensed cigarette stamping agents. In addition, although there is reason to believe that the policy was intended to apply only to reservation merchants selling at retail to non-Indians, in practice the policy shielded all reservation cigarette merchants selling any quantities of unstamped but otherwise legitimate cigarettes to non-Indians on the reservation, including those selling wholesale quantities to non-Indian cigarette smugglers.

Once Governor Pataki adopted forbearance and abandoned any enforcement strategy, sales by licensed agents to Native American tribes skyrocketed from approximately 15 million cartons in 1998 to more than 47 million cartons in 2005.

Multiple legislative remedies were attempted during the Pataki administration; none were successful.

In 2003, the Legislature overrode Governor Pataki's veto of legislation and passed former section 471-e of the Tax Law which directed the Department to promulgate regulations necessary to implement a system to collect taxes on reservation cigarette sales to non-Indians and to ensure a supply of non-taxed product for Native American consumption. The Department promulgated draft regulations that would have created the Indian tax exemption coupon system in September 2003, but, acting at the direction of the Governor's Office, never adopted those regulations.

Frustrated, in 2004, the Legislature passed legislation that incorporated the draft regulations into the statute. Governor Pataki vetoed this bill.

In 2005, the Legislature again passed a bill to enact the Indian tax exemption coupon system. The bill was signed by Governor Pataki in April 2005. By its terms, it was to take effect on March 1, 2006, "provided that any actions, rules and regulations necessary to implement [the statute] on its effective date are authorized and directed to be completed on or before such date."

On March 16, 2006, the Department, acting at the direction of the Governor's office, issued an Advisory Opinion that announced that it was going to continue its "longstanding" policy of

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<sup>6</sup> *New York Association of Convenience Stores v. Urbach*, 275 A.D.2d 520, 522-23 (3<sup>rd</sup> Dept. 2000).

forbearance and would not implement or enforce the Indian tax exemption coupon system set forth in the new law.<sup>7</sup>

2007 to March 2008

In January 2007, just after Governor Spitzer assumed office, Erie County Supreme Court Justice Rose Sconiers issued a decision in a lawsuit brought by a Native American merchant and a licensed agent which held Tax Law section 471-e was not “in effect” because the Department had not issued either the Indian tax exemption coupons contemplated by the statute or regulations to implement the statute. Based on that decision, on February 20, 2007, Justice Sconiers issued a preliminary injunction enjoining the State from enforcing the provisions of section 471-e until the Department adopted “the rules and regulations to implement the Indian tax exemption coupon system” and distributed Indian tax exemption coupons to governing bodies of the Native American nations.

Governor Spitzer appealed this decision and intensified efforts to secure an agreement with the Indian Nations in lieu of enforcement. I was not part of these negotiations nor was I privy to the details of the conversations but given the history, sensitivity and complexity of the issues involved, it seemed only responsible for Governor Spitzer to attempt to resolve these longstanding disputes with the Native Americans by negotiation and agreement. Indeed, I believe that the Legislature contemplated the same preference in section 471-e(5) which provides that a negotiated agreement with an Indian nation or tribe, if approved by the Legislature, “shall take precedence over the provisions of this article . . . “

As far as I know, negotiations were continuing at the time that Governor Spitzer left office.

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<sup>7</sup> A copy of the advisory opinion is included in the Appendix at page A10. In pertinent part, the advisory opinion stated:

“[The Department] has a long-standing policy of allowing untaxed cigarettes to be sold from licensed stamping agents to recognized Indian Nations and reservation-based retailers making sales from qualified Indian reservations....”

[T]he Department has no intention to alter its long-standing policy until [issues relating to its proposals to amend 471-e] are fully addressed and considered. However, if the Department decides to revise its policy in the future, it will provide adequate notice to all affected stamping agents. . . .

[T]he Department will not issue . . . assessments [against stamping agents for their sales of unstamped product to Indian nation merchants making sales from reservations] with respect to transactions occurring during the period of forbearance as that would be inconsistent with the State’s long-standing policy.”

March 2008 to the present

In May 2008, the 4<sup>th</sup> Department affirmed Justice Sconiers' preliminary injunction and ruled that section 471-e was not in effect because the Department had neither issued regulations to implement it nor issued tax exemption coupons to the Indian nations. In the months that followed, Governor Paterson's staff worked with the Department to examine its options, including whether there were steps that could be taken to limit the level of untaxed reservation sales without resorting to the coupon system. This examination was prompted by concerns about the potential intrusiveness of the coupon system on Native Americans and by the declarations of some Native Americans that issuance of the coupons would be viewed as an "act of war." As we were examining options with the Governor's staff, it is my understanding that Governor Paterson was actively and aggressively pursuing negotiations with the Native American nations. Indeed, he has repeatedly indicated his desire to secure a comprehensive negotiated settlement with all of New York's Indian Nations as an alternative to enforcement.

a. The certification statute – Tax Law section 471(4).

In December 2008, the Governor pursued one enforcement option by signing a bill sponsored by Senator Michael Nozzolio and Assemblyman William Magee, which was designed to curb the unlawful sale of untaxed cigarettes to Indian retailers by making licensed agents and cigarette manufacturers accountable for those sales [new Tax Law section 471(4)]. This bill was intended to provide the Department with a new tool, entirely separate from the Native American coupon system set forth in section 471-e, to stem the illegal flow of untaxed cigarettes to the Native American nations from licensed cigarette agents. The intended objective was to curtail illegal activity without intruding in any way on Native American sovereignty by focusing on the conduct of licensed agents and manufacturers and not directly on the conduct of the Native American merchants. Its terms were simple. It required licensed agents to provide the Department of Taxation and Finance and cigarette manufacturers with a certification under oath that they were selling and distributing the cigarettes they purchased from manufacturers in compliance with the law. While this certification would be no burden for most stamping agents, for the few that regularly sell huge quantities of untaxed cigarettes to Native American merchants, the certification would have proven challenging to say the least. And manufacturers who know the volume of cigarettes that a few licensed agents are selling to Native American merchants would have been hard-pressed to accept certifications from those agents or to continue to do business with those agents.

Governor Paterson made clear his intentions and objectives when he signed this bill. He emphasized his preference to achieve negotiated settlements with the Indian Nations but he also revealed his determination to close down the markets of cheap, untaxed cigarettes that had flourished on the reservations under the previous era of non-enforcement policies. In the press release that accompanied the new law, the Governor expressed his commitment to "enforcing the tax laws of New York in a fair and effective manner" and he recognized that our tax laws had "not been adequately applied for far too long giving non-Indians easy access to tax-free cigarettes both on the reservation and over the internet." He further acknowledged that reservation sales of untaxed, and thus cheap, cigarettes for non-Indians, which had flourished

under the policy of non-enforcement, had compromised efforts to protect the public health by curbing smoking through our high cigarette taxes.

*b. Recent judicial decisions.*

Unfortunately, Erie County Supreme Court Justice Sconiers did not recognize that the new certification provisions of Tax Law section 471(4) were intended to provide a separate vehicle for curbing illegal conduct that was entirely independent of the Indian tax exemption coupon system embodied in section 471-e. On January 27, 2009, Justice Sconiers issued another order in *Day Wholesale v. the State of New York*, in which she enjoined

“anyone charged with the enforcement of Article 20 of the New York Tax Law . . . from restricting New York State stamping agents from selling at wholesale unstamped cigarettes to reservation sellers or restricting reservation cigarette sellers from selling at retail unstamped cigarettes to tribal and non-tribal members”

Under the terms of the order, the injunction continues until the Department distributes the Indian tax exemption coupons to the governing bodies of the Native American nations and adopts regulations implementing the Indian tax-exemption coupon system. Because the coupon system has nothing to do with the certification statute, the Administration has asked the Attorney General to appeal this decision.

In addition to Justice Sconiers’ order, the Native American cigarette tax issue has steady and continuing attention from the courts. As set out below, at least some of the issues raised will reach the New York Court of Appeals this spring and it is hoped that our highest court will bring clarity to the laws. In addition, there have been a number of recent federal cases that have reached conclusions about the New York cigarette tax laws that are completely at odds with decisions rendered in the Fourth Department. The Tax Department believes that the federal decisions have reached the correct conclusions.

The Fourth Department, in a lawsuit challenging prosecutions by the District Attorneys of Cayuga and Seneca counties against Indian smoke shops for selling and possessing untaxed cigarettes overruled a State Supreme Court Justice who held that 471-e does not preclude other forms of enforcement and held that section 471(1), the primary statute imposing the cigarette tax on all cigarettes sold in the state, which has been on the books for decades, no longer governs cigarette sales on Native American lands to non-Indians.<sup>8</sup> Instead, the Court held – with one Justice dissenting -- that section 471-e, the 2005 statute creating the Indian coupon tax-exemption program, is the sole statute governing sales on tribal lands. Because the Fourth Department previously held that 471-e is not in effect as a result of the State’s failure to issue coupons or regulations, the Court precluded the District Attorneys from challenging the conduct

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<sup>8</sup> *Cayuga Indian Nation v. Gould*, 2009 WL 3161837, 2009 N.Y.Slip Op. 07122 (4<sup>th</sup> Dept. Oct. 22, 2009)

of the smoke shops. The Appellate Division, though ruling against the District Attorneys, granted them leave to appeal to the Court of Appeals.

Several federal courts have recently reached the opposite conclusion.<sup>9</sup> These courts have held that under state law, section 471-e merely provides a method for collecting the taxes imposed by 471(1) for reservation sales to non-Indians. These courts have interpreted New York law to mean that the tax imposed by 471(1) is owed regardless of whether 471-e coupon system is effective and regardless of whether the State chooses to follow the non-enforcement policy of forbearance. Several of these federal decisions have been rendered in unprecedented civil lawsuits brought by the City of New York against both the cigarette agents who supply Native American merchants with unstamped cigarettes and against some Native American smoke shops on the Poospatuck reservation in Long Island. Indeed, Federal District Court Judge Carol Bagley Amon, of the Eastern District of New York, has issued preliminary injunctions against certain Poospatuck smoke shops directing those shops to stop selling unstamped cigarettes to anyone other than members of the Unkechaug Nation for their personal use. Judge Amon's injunction has been upheld by the Second Circuit which has asked the parties to brief whether the case should be certified to the New York Court of Appeals to determine whether the tax imposed by 471(1) is in effect in connection with transactions on Native American reservations.

*c. The current state of "forbearance."*

Given the Fourth Department cases, it is fair to say that forbearance under Governor Paterson is primarily manifested by the determination to comply with the stays issued by Justice Sconiers and to refrain from implementing the coupon system by promulgating regulations and tax exemption coupons to the Native American nations. In that regard, as recently reported in the press, the Governor is currently seeking updated information from state and federal law enforcement agencies regarding their assessments of the likelihood of civil unrest should the Department begin the process implementation of section 471-e. At this point, however, the Governor has not authorized the Department to take steps to begin this process as he continues negotiations and awaits resolution of the judicial decisions arising in the Fourth Department.

Even though we have not issued coupons or promulgated regulations to implement 471-e, there is no question that the "hands-off" forbearance policy of the Pataki administration is no longer the governing rule for the Department. While the Department's investigators are not directly enforcing sections 471(1) or 471-e against the cigarette agents or Native American merchants involved in this cigarette trade, they are conducting investigations and taking administrative actions against licensed cigarette agents for engaging in fraudulent conduct in their transactions with Native American merchants that goes far beyond merely supplying them with unstamped

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<sup>9</sup> *U.S. v. Morrison*, 596 F.Supp. 2d 661 (EDNY 2009); *City of New York v. Milhelm Attea & Bros.*, 2009 WL 701005 (EDNY Mar. 11, 2009); *City of New York v. Golden Feather Smoke Shop*, 2009 WL 2612345 (EDNY Aug. 25, 2009).

cigarettes. Moreover, Department investigators are actively providing assistance to other agencies in ways that would not have been permitted under the Pataki forbearance policies.

For example, to learn about the Native American trade and the identity of their non-Indian wholesale customers we have conducted (and continue to conduct) surveillances, developed informants and conducted undercover operations in which our agents have posed as cigarette smugglers from New York City and purchased wholesale quantities of unstamped cigarettes from Indian merchants at various reservation smoke shops.

Most significantly, we shared the evidence we gathered with agencies that are pursuing remedies under federal law and we have collaborated (and continue to collaborate) with federal law enforcement and with the New York City Corporation Counsel to produce essential evidence for federal prosecutions and lawsuits. I am confident that if you ask Assistant Corporation Counsel Eric Proshansky about our assistance, he will tell you -- as he told me -- that the City cases would not have been successful without our help. To this day, we continue to provide the City with assistance.

The willingness of this Administration to find ways to curtail unlawful conduct by stamping agents who sell unlimited quantities of untaxed cigarettes to Native American merchants was also manifested by our recent licensing action against cigarette stamping agent and wholesaler Gutlove & Shirvint, Inc., a major supplier to Native American merchants. Following an aggressive investigation which included obtaining secretly recorded conversations, the Department initiated proceedings to cancel Gutlove's licenses on the ground that Gutlove had engaged in fraudulent conduct in connection with its transactions with those Native American merchants. In a lengthy ruling issued on May 28, 2009, which described in detail the evidence our investigation uncovered, Administrative Law Judge Frank Barrie sustained our action against the Gutlove licenses. In a strongly worded opinion, Judge Barrie concluded that Gutlove's president, Joseph Ruda, "knowingly aided and abetted Peace Pipe Smoke Shop, which operated in blatant disregard of the legalities of selling non-tax paid cigarettes."<sup>10</sup>

#### Conclusion.

The Department stands ready to enforce the cigarette tax laws as they apply to illegal sales to Native American merchants selling to non-Indians. We are ready to proceed in a manner that recognizes Native American rights and sovereignty by focusing primarily on the conduct of licensed stamping agents and manufacturers. Once Justice Sconier's stay is lifted or overturned,

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<sup>10</sup> Judge Barrie further found that the Department had established Ruda's "distain for the public good by its sale of cigarettes, motivated completely by the goal of maximizing profit..." and he further observed that the Department had proven that through its fraudulent conduct Gutlove "aided and abetted the illegal sale of non-tax paid cigarettes by Peace Pipe Smoke Shop, a notorious on-reservation vendor, which was a major provider of non-tax paid cigarettes to a vast bootlegging operation."

we are prepared to implement the requirements of the newly enacted certification statute set out in section 471(4) which we believe will sharply reduce the amount of unstamped product being sold to Native American merchants. We are also prepared to implement section 471-e, once the Governor determines that implementation of that statute is appropriate. Regulations to implement that statute have been drafted and are ready to be promulgated. Similarly, tax exemption coupons for distribution to Native Americans are printed and are ready for distribution.

I am heartened by the serious steps that Governor Paterson has taken to close down the illegal cigarette trade in New York and by his determination to bring a fair resolution to these difficult issues. I am encouraged by the steps we have been able to take to help others tackle these problems through the enforcement of federal law. While I am clearly no expert in issues relating to Native American relations, I understand that the issues that the Governor faces are broader and more complex than tax enforcement. I accept that the full range of these are far greater and carry more serious consequences for the State than the fairly discrete and limited tax issues which we are discussing today. Nonetheless, I remain hopeful and confident that Governor Paterson will find the path that has eluded his predecessors – a path that will lead to resolution of this difficult and sensitive issue and that results in the fair and even-handed application of our tax laws.