

# STATE OF ARIZONA

Department of Revenue



Janet Napolitano  
Governor

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Director

May 23, 2007

Attached please find copies of a proposed Arizona Luxury Tax Procedure discussing the affixation of cigarette tax stamps and issues relating to the post-affixation handling and inspection of stamped cigarette packages. In an ongoing effort to interact with and inform the public regarding issues relating to taxation, the Department would appreciate your written comments on these drafts.

Please be advised that the deadline for comments is **Wednesday, June 20, 2007**. Any request for an extension of time for review must also be made by this date. This office will review all comments that are received through this date and make any appropriate revisions before the Department issues the final procedure.

Please address your comments to:

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Thank you for your continuing efforts to establish an ongoing line of communication with the Arizona Department of Revenue.

Sincerely,

/s/ Hsin Pai  
Tax Analyst  
Tax Research & Analysis

Attachment

ARIZONA LUXURY TAX PROCEDURE  
LTP 07-\_\_

**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."

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

50  
51 A.R.S. § 42-3202.01 states,

52  
53 Except as otherwise provided in section 42-1127, subsection F, section 42-  
54 3202, subsection B and section 42-3203, subsection C, for the purpose of  
55 proper administration and to prevent evasion of the taxes imposed by this  
56 chapter, until the contrary is established, it is presumed that cigarettes that  
57 are sold, distributed, used or consumed by a person in this state, but not  
58 placed in packages or containers on which official tax stamps are affixed, are  
59 intended for first sale by the person and are subject to the taxes imposed by  
60 this chapter.

61  
62 A.R.S. § 42-3202.03(B) states, “Only licensed cigarette distributors may purchase, obtain  
63 or affix cigarette stamps.” The statute also provides that, “[w]hen affixing cigarette stamps  
64 to cigarettes, cigarette distributors shall ensure that the affixation method that is used  
65 maintains the legibility of the serial numbers on the stamps.”

66  
67 A.R.S. § 42-3210 provides Department-enforced prohibitions of the stamping and  
68 importation of cigarette packages that are not intended for sale in the United States or are  
69 otherwise counterfeit in nature.

70  
71 A.R.S. § 44-7111(6)(d) provides the Department-enforced prohibition of the sale,  
72 distribution, acquisition, possession, transportation, or importation of cigarette packages  
73 that are not listed in the directory of approved tobacco products maintained by the Office of  
74 the Arizona Attorney General.

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76  
77 **DISCUSSION:**

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

83  
84 Every cigarette package sold at retail in the state must be affixed with an Arizona tax stamp  
85 or tax-free stamp to demonstrate that tobacco taxes have been paid on the cigarettes or  
86 that the cigarettes are otherwise not subject to the taxes. Under A.R.S. § 42-3202.03(B),  
87 the duty to affix tax stamps on these cigarettes lies with licensed cigarette distributors. This  
88 statutory provision also states that cigarette distributors must ensure that “the affixation  
89 method that is used maintains the legibility of the serial numbers on the stamps.”

90

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

100  
101 Different factors contribute to the legibility of tax stamps from the time that licensed  
102 cigarette distributors affix the stamps to cigarette packages to when retailers sell the  
103 cigarettes to final consumers, including the quality of the tax stamps, the affixation method  
104 used, the quality and maintenance of stamping equipment, the related quality control  
105 procedures of the licensed cigarette distributors when they affix the tax stamps, and the  
106 wear and tear encountered in the handling of cigarette packages subsequent to licensed  
107 cigarette distributors' affixation of tax stamps. All cigarette distributors are required both to  
108 affix tax stamps by firmly adhering them to cigarette packages and to maintain the legibility  
109 of each stamp's serial number, but tax stamps are required by statute to be destroyed if  
110 attempts are made to remove them after they have been affixed to the packages.  
111 Consequently, the many requirements and duties imposed upon the Department,  
112 distributors, and retailers can result in confusion among the different parties, and  
113 determining whether affixed tax stamps meet the statutory requirements that a stamp be  
114 firmly adhered to a package during possession by a consumer and that a cigarette  
115 distributor's affixation method maintains the legibility of the serial numbers is a highly fact-  
116 intensive process that does not reduce to a simple "checklist."

117  
118 The Department recognizes the importance of assuring cigarette distributors and retailers  
119 that the Department does not have a standard requiring "perfect affixation" of Arizona tax  
120 stamps on all cigarette packages. During compliance inspections, where there are  
121 instances of cigarette packages that, when viewed in isolation, do not bear tax stamps with  
122 fully legible serial numbers, the Department's tobacco agents will consider the totality of the  
123 circumstances in determining whether retailers may keep these cigarettes for sale.  
124 Retailers are encouraged to discuss any concerns related to stamp affixation with the  
125 Department before attempting to return product to their cigarette distributors.

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127

#### 128 **PROCEDURE:**

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

135

136 The following list provides several general criteria that the Department uses during its  
137 compliance inspections:<sup>\*</sup>

138

139 1. If individual cigarette packages do not bear tax stamps with fully legible serial  
140 numbers, but the legible numbers match corresponding digits of serial numbers from  
141 properly stamped cigarette packages that are packaged or shelved with them, the  
142 Department should consider the individual cigarette packages at issue to have been  
143 properly stamped.

144

145 2. If the validity of stamped cigarette packages cannot be confirmed as described in  
146 Paragraph 1, but the cigarette packages that individually appear to violate applicable  
147 statutes are part of the same pallet, master carton, or carton that contains properly  
148 stamped cigarette packages, the Department should consider the individual  
149 cigarette packages at issue to have been properly stamped. This criterion applies  
150 only to pallets, master cartons, or cartons that are unopened before the Department  
151 conducts compliance inspections.

152

153 3. If the validity of individual cigarette packages cannot be confirmed as described in  
154 Paragraphs 1 and 2, but the distributor or retailer can demonstrate through books,  
155 records, or other indicia to the satisfaction of the Department's tobacco agents that  
156 the cigarette packages were purchased as part of the same pallet, master carton, or  
157 carton that contains properly stamped cigarette packages, the Department should  
158 consider the individual cigarette packages at issue to have been properly stamped.

159

160  
161 3. If any cigarette packages bear authentic Arizona tax stamps that are inappropriate  
162 for sale from the location of the retailer (e.g., Indian Reservation Tobacco Tax "red"  
163 stamps on cigarettes being sold by a retailer that is not located on an Indian  
164 reservation, or tax stamps of another state or jurisdiction), the packages are  
165 considered contraband and subject to seizure and forfeiture.

166

167 4. If any cigarette packages bear counterfeit tax stamps, or if the packages are  
168 counterfeit products but bear authentic tax stamps, the packages are considered  
169 contraband and subject to seizure and forfeiture.

170

171 5. If any cigarette packages bear no visible Arizona tax stamps, the packages are  
172 ineligible for retail sale; retailers will be advised to return the packages to the issuing  
173 cigarette distributor for restamping or, with the presence of extenuating  
174 circumstances, the packages may be subject to seizure and forfeiture.

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<sup>\*</sup> 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.

176 6. If any cigarette packages demonstrate affirmative attempts by a cigarette distributor  
177 or retailer to “split” or “half-stamp” packages and thereby fraudulently use the tax  
178 stamps, the packages are considered contraband and subject to seizure and  
179 forfeiture.  
180

181  
182 Because inspections are highly fact-intensive processes, it is impossible to provide an  
183 exhaustive list of factors under which the Department’s tobacco agents will definitely allow  
184 product to remain in the custody of a distributor or retailer or will definitely seize product.  
185 Nevertheless, as can be inferred from the examples provided below, retailers can greatly  
186 assist tobacco agents by storing and maintaining cigarette inventories by shipment and  
187 keeping any relevant books, records, invoices, and documentation easily accessible for  
188 inspection.  
189

190 Retailers are encouraged to discuss any concerns related to stamp affixation with the  
191 Department before attempting to return product to their cigarette distributors.  
192

193  
194 **EXAMPLES:**

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196 The Department provides the following illustrative examples of how a tobacco agent will  
197 respond under different facts and circumstances during compliance inspections of retail  
198 locations.  
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200 **Example 1:**

201  
202 During a compliance inspection of a retailer location, a tobacco agent  
203 encounters a retail display containing packages of Brand X cigarettes of the  
204 same blend and style. Some of the Brand X packages fail to bear fully legible  
205 serial numbers, although none of the stamps appears to be counterfeit or  
206 otherwise invalid. None of the packages completely lacks an Arizona tax  
207 stamp. Upon further inspection, however, the agent finds that the legible  
208 digits of the serial numbers from the packages lacking the complete tax stamp  
209 serial numbers match the corresponding digits of the serial numbers from the  
210 properly stamped packages in the display.  
211

212 Assuming that the retailer has otherwise demonstrated compliance with state  
213 tobacco laws, and the serial numbers from the properly stamped packages  
214 correspond with Arizona tax stamps sold to the licensed cigarette distributor  
215 from whom the retailer purchased the cigarettes, the agent should deem all of  
216 the cigarette packages in the retail display properly stamped.  
217

218 **Example 2:**  
219

220 Assume the same facts as in Example 1, except that, on a previous  
221 compliance inspection, the tobacco agent had determined that the retailer had  
222 actively concealed the fact that it had obtained several Brand X packages that  
223 failed to bear fully legible serial numbers from an unlicensed cigarette  
224 distributor and had presented a false sales invoice from a licensed cigarette  
225 distributor when asked for the identity of the distributor from whom it had  
226 purchased the cigarettes.

227  
228 Due to the differing factual circumstances and background, the agents may  
229 request further inspection of the retailer's inventory, books, records, invoices,  
230 and documentation.

231  
232 Example 3:

233  
234 During a compliance inspection of a retail location, a tobacco agent finds that in a  
235 randomly selected, unopened carton of cigarettes, several of the packages fail to  
236 bear tax stamps with fully legible serial numbers, although no stamp appears to be  
237 counterfeit or otherwise invalid. None of the packages completely lacks an Arizona  
238 tax stamp. The tobacco agent can see, however, that the packages are improperly  
239 stamped merely due to the quality of the tax stamp or a mechanical or operator-  
240 based stamping error and that all the packages are part of the same original carton.

241  
242 Assuming that the retailer has otherwise demonstrated compliance with state  
243 tobacco laws, and the serial numbers from the properly stamped packages  
244 correspond with Arizona tax stamps sold to the licensed cigarette distributor from  
245 whom the retailer purchased the cigarettes, the agent should deem all of the  
246 packages properly stamped.

247  
248 Example 4:

249  
250 During a compliance inspection of a retail location, a tobacco agent finds that a retail  
251 display of cigarette packages contains multiple packages that fail to bear fully legible  
252 serial numbers, although no stamp appears to be counterfeit or otherwise invalid.  
253 None of the packages completely lacks an Arizona tax stamp. The retailer produces  
254 documentation showing that it purchases cigarettes from two different licensed  
255 cigarette distributors. Upon closer inspection, the tobacco agent finds that the  
256 cigarettes appear to have been purchased from these two sources.

257  
258 Assuming that the retailer has otherwise demonstrated compliance with state  
259 tobacco laws, the agent should deem all of the packages in the display properly  
260 stamped.

261  
262 Example 5:  
263

264 Assume the same facts as in Example 4, except that on a *previous* compliance  
265 inspection, the tobacco agent had determined that, in addition to the cigarette  
266 packages on retail display that were purchased from the two different licensed  
267 distributors, the retailer maintained a cache of export-only cigarettes behind the  
268 sales counter. The retailer had been unable to produce any invoices or  
269 documentation to show the origin or purpose for holding these cigarettes in the  
270 store. The tobacco agent subsequently seized the export-only cigarettes.

271  
272 Due to the differing factual circumstances and background when compared to  
273 Example 4, the agents may, on the present compliance inspection of the retailer in  
274 this example, request further inspection of the retailer's inventory, books, records,  
275 invoices, and documentation.

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