



October 2017

TOBACCO TRADE

Duty-Free Cigarettes Sold in Unlimited Quantities on the U.S.-Mexico Border Pose Customs Challenges

Accessible Version

GAO Highlights

Highlights of [GAO-18-21](#), a report to the Ranking Member, Committee on Finance, U.S. Senate

Why GAO Did This Study

Since the 1970s, U.S. agencies have recognized that high-volume cigarette sales at duty-free stores near the U.S.-Mexico land border, although lawful, could be related to illicit activity. In 1988, U.S. law limited the quantity of duty-free tobacco products an individual can purchase at stores located in airports, restricting the sale of tobacco products to quantities consistent with personal use. This requirement, however, does not apply to land border duty-free stores.

GAO was asked to review information on sales of cigarettes at duty-free stores along the southwest border. CBP identified 88 such stores and warehouses. This report describes (1) requirements that govern the lawful sale and export of cigarettes from duty-free stores on the southwest border and schemes for illicit trade in such cigarettes, (2) U.S. agency observations about these exports and efforts to counter illicit trade, (3) the extent to which selected cigarette transaction data submitted by duty-free stores indicate compliance issues. GAO analyzed Census data on these exports; reviewed CBP, ICE, and Department of the Treasury documents; and interviewed agency officials in Washington, D.C., and in several ports along the southwest border, including Laredo, Texas, and the San Diego, California, area.

What GAO Recommends

CBP should take steps to strengthen compliance with export reporting requirements for duty-free cigarette sales on the southwest border, such as issuing guidance to all duty-free store operators. DHS agreed and noted CBP plans to address the recommendation.

View [GAO-18-21](#). For more information, contact David Gootnick at (202) 512-3149 or gootnickd@gao.gov.

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What GAO Found

Duty-free stores at the southwest border may sell tax-exempt cigarettes in any quantity to passengers departing the United States for Mexico; agencies have identified schemes associated with duty-free cigarette sales used to evade U.S. and Mexican taxes. U.S. Customs and Border Protection (CBP), an agency within the Department of Homeland Security (DHS), regulates duty-free stores. U.S. regulations require the stores to have procedures to provide reasonable assurance of export of cigarettes and the exporter to report export information on transactions valued at over \$2,500. U.S. Census Bureau (Census) data show that about 18,500 such transactions involving cigarettes occurred from 2010 to 2015. According to information from U.S. and Mexican officials, the Mexican government limits the amount of duty-free cigarettes that can be brought into Mexico (see figure). U.S. agencies identified three schemes to evade U.S. and Mexican cigarette-related tax and other laws: (1) diversion from a duty-free store into U.S. commerce; (2) smuggling into Mexico through U.S. ports; and (3) smuggling back into the United States after export to Mexico.

Allowances for Exporting U.S. Duty-Free Cigarettes and Importing Them into Mexico

 U.S. export	<ul style="list-style-type: none">No U.S. export restriction on quantities of duty-free cigarettes purchased at land port stores by travelers departing the United States.Reporting of information on transactions valued at over \$2,500.
 Mexico import	<ul style="list-style-type: none">Depending on place of residence, one carton allowed per adult entering Mexico, tax-exempt, and up to three additional cartons may be allowed in with tax payment.No amount allowed for Mexican border-zone residents.Individuals with more than the quantities above must register as commercial importers and receive authorization from Mexican health and customs agencies.

Source: GAO compilation of information from U.S. Customs and Border Protection and Mexican customs officials. | GAO-18-21

U.S. agency officials said that some smuggling of duty-free cigarettes across the southwest border has links to organized crime, supplies the illicit tobacco market in Mexico, and poses oversight and enforcement challenges. U.S. Immigration and Customs Enforcement (ICE) officials said they have identified links between the smuggling of large quantities of duty-free cigarettes and transnational criminal organizations that use the smuggled cigarettes to launder money and generate revenue. Inexpensive cigarettes made in the United States are part of the trade in duty-free cigarettes along the southwest border, including brands that a Mexican official stated are prohibited for sale in Mexico. U.S. officials reported that their efforts to counter the illicit trade in duty-free cigarettes face challenges, primarily due to the ability to buy unlimited quantities of duty-free cigarettes at the land border.

According to CBP, in many cases, duty-free stores on the southwest border are filing noncompliant information that they are required to report on cigarette exports valued at more than \$2,500. For example, officials had compliance concerns with filings in which stores identify themselves, and not the purchaser, as the exporter. CBP and Census have met with representatives of one of the largest operators of duty-free stores on the southwest border to clarify regulatory requirements. However, CBP officials said that this duty-free store operator continues to make incorrect filings. CBP has not issued guidance to all operators to clarify the correct procedure. Without accurate export data, agencies may lack the information they need to enhance their enforcement and intelligence efforts.

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Abbreviations

AES	Automated Export System
ATF	Bureau of Alcohol, Tobacco, Firearms, and Explosives
CBP	U.S. Customs and Border Protection
Census	U.S. Census Bureau
Commerce	Department of Commerce
Customs	U.S. Customs Service
DHS	Department of Homeland Security
DOJ	Department of Justice
EIN	employer identification number
ICE	U.S. Immigration and Customs Enforcement
Treasury	Department of the Treasury
TTB	Alcohol and Tobacco Tax and Trade Bureau
USPPI	U.S. principal party in interest

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October 11, 2017

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate

Dear Mr. Wyden:

Since the 1970s, U.S. agencies have recognized that high-volume tobacco sales at duty-free stores near the southwest U.S. border, although lawful, could be related to illicit activity.¹ The U.S. government permits sales of tobacco products at duty-free stores near U.S. points of exit.² According to our analysis of agency data and our communications with U.S. agency officials, cigarettes are the primary tobacco export from duty-free stores on the southwest border. According to federal and state government officials, increases in cigarette taxes in Mexico in 2010 and in border states such as California in April 2017 have elevated the risk of cross-border cigarette smuggling from all sources, including duty-free stores. In a 2014 committee report, the House of Representatives Committee on Appropriations noted its understanding that nearly one in four packs of cigarettes consumed in Texas is smuggled in from Mexico.³

You asked us to review issues related to sales of cigarettes at duty-free stores along the southwest border of the United States. We examined (1) requirements that govern the lawful sale and export of cigarettes from duty-free stores on the southwest border and schemes for illicit trade in such cigarettes that agencies identified, (2) U.S. agency observations about these duty-free cigarette exports and efforts to counter illicit trade, and (3) the extent to which selected cigarette transaction data submitted

¹42 Fed. Reg. 45338 (Sept. 9, 1977); 48 Fed. Reg. 33318 (July 21, 1983).

²We have previously reported that duty-free stores at the land border presented enforcement challenges associated with smuggling cigarettes into Mexico, which were sometimes then smuggled back into U.S. commerce, evading taxes. See GAO, *Tobacco: Issues Surrounding a National Tobacco Settlement*, GAO/RCED-98-110 (Washington, D.C.: Apr. 15, 1998). We reported that available evidence showed that international smuggling was occurring between the United States and Mexico but the extent of the activity was unknown. At the time, the Bureau of Alcohol, Tobacco, Firearms, and Explosives identified duty-free stores along the U.S. side of the border as the primary source of the smuggled cigarettes.

³See H.R. Rep. No. 113-468 (2014).

by duty-free stores indicate compliance issues with reporting requirements.

To address the objectives, we reviewed relevant federal laws, regulations, and agency documents. We also interviewed officials from the Department of Commerce's (Commerce) U.S. Census Bureau (Census); the Department of Homeland Security's (DHS) U.S. Customs and Border Protection (CBP) and U.S. Immigration and Customs Enforcement (ICE); the Department of Justice's (DOJ) Bureau of Alcohol, Tobacco, Firearms, and Explosives (ATF); the Department of the Treasury's (Treasury) Alcohol and Tobacco Tax and Trade Bureau (TTB); and tax-collecting officials from the California state government's Board of Equalization. In addition, we conducted fieldwork at the ports in Laredo, Texas; and the San Diego, California, area, including the ports of Otay Mesa and San Ysidro; we also interviewed cognizant officials in Los Angeles, California.⁴

To describe how duty-free cigarettes are sold and exported and how duty-free stores report data, we analyzed Automated Export System (AES) data from Census for 2010 through 2015 on recorded transactions at the 88 duty-free stores CBP identified as being adjacent to the U.S.-Mexico border, also referred to as the southwest border, spanning Texas, New Mexico, Arizona, and California (see fig. 1). We determined that data were sufficiently reliable to review filing practices with respect to duty-free cigarette transactions. We determined that value and quantity data for those transactions were not reliable for the purposes of this report due to unexplained variations in the calculated prices; we based our assessment on a review of related documentation and on interviews with Census officials about the agency's procedures to ensure the quality of the data and interviews with CBP officials to discuss relevant aspects of how transaction data might be entered in AES. See appendix I for more details on our scope and methodology and appendix II for our assessment of AES data reliability.

⁴U.S. ports of entry are designated as being for air, land, or sea and provide controlled entry and exit in and out of the United States for people and materials.

Figure 1: Locations of Duty-Free Facilities CBP Identified on the Southwest Border, with the Number of Facilities at Each Port



Sources: GAO analysis of U.S. Customs and Border Protection (CBP) information, Map Resources (map). | GAO-18-21

Note: The duty-free facilities include retail stores and distribution centers that CBP classifies as Class 9 bonded warehouses. Authority for establishing bonded warehouses is set forth in Section 1555 of Title 19 of the United States Code. Section 1555(b) provides for a type of bonded warehouse, Class 9, also called a “duty-free sales enterprise” or “duty-free store.”

We conducted this performance audit from November 2016 to October 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Duty-Free Stores in the United States

In the 1960s and 1970s, duty-free stores emerged at airports in the United States and on the land borders with Mexico and Canada to provide duty- and tax-free merchandise, including cigarettes, for the personal use abroad of individuals about to leave the country. U.S. law on bonded warehouses⁵ defines a “duty-free sales enterprise” as “a person that sells, for use outside the customs territory, duty-free merchandise that is delivered from a bonded warehouse to an airport or other exit point for exportation by, or on behalf of, individuals departing from the customs territory.”⁶ In a 1977 *Federal Register* notice about a proposed change to policy, CBP—at that time the U.S. Customs Service (Customs)—concluded that there was a continuing problem involving smuggling along the border between the United States and Mexico, resulting in revenue losses to the United States.⁷ Customs also noted that duty-free shops on the southwest border had become “major wholesale suppliers” while operating under procedures that were never intended to cover wholesale transactions but were instead designed for personal use sales to individuals.⁸ Furthermore, according to the 1977 *Federal Register* notice, wholesale quantities of cigarettes purchased in duty-free stores were entering Mexico illegally without payment of Mexican taxes, and some

⁵Bonded warehouses are facilities regulated by CBP that may be operated by independent warehousing firms or by importers. U.S. taxes on merchandise entered into a bonded warehouse are generally deferred until the goods are withdrawn for consumption within the United States or for export out of the United States.

⁶19 U.S.C. § 1555(b)(8)(D).

⁷42 Fed. Reg. 45,338. Following the 1977 *Federal Register* notice, Customs issued an advance notice of proposed rulemaking in 1983 stating that, due to a number of problems, including smuggling, the agency was considering a number of actions, including the abolition of duty-free stores at some ports on the land border. 48 Fed. Reg. 33,318 (July 21, 1983). In October 1984, Congress passed a law prohibiting Customs from using funds to develop regulations relating to duty-free stores until Congress legislated on the matter. Continuing Appropriations for Fiscal Year 1985, Pub. L. No. 98-473, § 114, 98 Stat. 1837, 1967.

⁸CBP officials said that they were not aware of any regulatory definition for the term “wholesale” in CBP’s regulations or any other federal agency’s regulations that CBP is charged with enforcing. Officials said that wholesale trade generally refers to the selling of goods in quantities other than for personal or household consumption, or, more broadly, purchases intended to be subsequently retailed.

portion was then being smuggled back into the United States without payment of U.S. taxes.⁹

Congress legislated on duty-free stores through the Omnibus Foreign Trade and Competitiveness Act of 1988, which required duty-free stores located in airports to restrict the sale of duty-free merchandise to any one individual to “personal use quantities,” which is defined as “quantities only suitable for uses other than resale.”¹⁰ During consideration of the legislative language that was enacted in 1988, a senator introduced an amendment to permit duty-free stores located along the border to continue to sell goods in wholesale quantities.¹¹ In introducing the amendment, the senator observed that a large part of the sales by the border stores along the U.S.-Mexico border were in wholesale quantities and that restricting the stores’ ability to sell in such quantities would adversely affect the stores’ business and the regional economy. Congress adopted the law with the amendment and applied the concept of “personal use quantities” only to airport duty-free stores.¹² This requirement does not apply to land border stores.

⁹For the purposes of this report, our use of the word “taxes” may also include customs duties, sales taxes, and excise taxes imposed on cigarettes.

¹⁰Pub. L. No. 100-418, § 1908(b), 102 Stat. 1107, 1315 (codified as amended at 19 U.S.C. § 1555(b)). The act does not identify any quantity amount with respect to personal use but defines personal use quantities as quantities that are only suitable for uses other than resale and includes reasonable quantities for household or family consumption as well as for gifts to others.

¹¹133 Cong. Rec. S9937 (daily ed. July 15, 1987) (statement of Sen. Bentsen).

¹²Discussion of this topic occurred as part of congressional consideration of Senate Bill 1420, the Omnibus Trade and Competitiveness Act of 1987. One senator highlighted the potential for economic harm to communities adjacent to the U.S.-Mexico border if the provision precluding duty-free sales in wholesale quantities were applied to land border stores. Congress passed the Omnibus Foreign Trade and Competitiveness Act of 1987, but the President vetoed the bill, and a vote to override the veto failed in the Senate. (See H.R. 3, 100th Cong. (1987). S. 1420 was incorporated into H.R. 3.) The provision limiting the concept of “personal-use quantities” to airports was in the Omnibus Foreign Trade and Competitiveness Act of 1988, which Congress passed and the President signed. Pub. L. No. 100-418, § 1908(b), 102 Stat. 1107, 1316.

Agencies with Roles Related to Duty-Free Cigarette Exports

Cigarettes for sale at duty-free stores are for export only. Commerce, DHS, DOJ, and Treasury carry out activities related to the establishment and oversight of duty-free stores and related cigarette exports:

- At Commerce, Census is responsible for collecting, compiling, and publishing export trade statistics. AES is the primary instrument for collecting export trade data.¹³ Census takes steps to ensure compliance by AES filers, including duty-free store operators, through training and follow-up on unusual transactions, according to Census officials.
- At DHS, CBP and ICE are the components with roles related to duty-free cigarette exports.
 - CBP is responsible for oversight of duty-free stores, including the requirements for establishment of stores and ensuring stores' compliance with various requirements for operations and lawful sales.¹⁴ Duty-free stores are regulated as a type of bonded warehouse. CBP port directors ensure that duty-free stores establish operating procedures.¹⁵ According to CBP officials, the agency is also responsible for enforcing the Foreign Trade Regulations, including consideration of enforcement action when an AES filer submits incorrect information regarding a shipment of merchandise being exported.¹⁶ Such enforcement action may

¹³The Automated Export System (AES) is a computer-based system that collects electronic export information that, according to Census, is a primary source for export statistics and data to assess compliance with export control laws.

¹⁴19 CFR § 19.36 (requirements for duty-free store operations).

¹⁵According to U.S. customs regulations, the Port Director is the person who has jurisdiction within the geographical boundaries of the port of entry unless the regulations provide that particular trade functions or determinations are exclusively within the purview of a Center Director or other CBP personnel. 19 CFR § 101.1

¹⁶The Foreign Trade Regulations are found in Part 30 of Chapter 15 of the Code of Federal Regulations. On April 19, 2017, Census issued a final rule amending the Foreign Trade Regulations to reflect new export reporting requirements. 82 Fed. Reg. 18,383 (April 19, 2017). These changes went into effect on July 18, 2017. However, because we conducted this performance audit from November 2016 to October 2017, this report does not reflect these changes to the Foreign Trade Regulations.

include the issuance of penalties or the seizure of the merchandise intended for export.

- ICE enforces U.S. laws related to tobacco smuggling for cases in which it has investigative jurisdiction, including related offenses such as money laundering. According to agency officials, ICE also coordinates with CBP on enforcement efforts, such as seizures of merchandise due to violations of U.S. laws or customs regulations.
- At DOJ, ATF investigates trafficking in cigarettes that have illegally entered U.S. commerce and enforces federal antitobacco smuggling laws under Title 18 of the U.S. Code, particularly the Prevent All Cigarette Trafficking Act and Contraband Cigarette Trafficking Act (CCTA).¹⁷ As we previously reported, by enforcing the CCTA, ATF seeks to reduce illegal cigarette trafficking, divest criminal and terrorist organizations of money derived from this activity, and significantly reduce tax revenue losses to the affected states.¹⁸
- At Treasury, TTB is responsible for administering and enforcing the federal tax laws relating to tobacco products. Federal law requires that every person, prior to commencing business as a manufacturer or importer of tobacco products or establishing a TTB-regulated export warehouse for the storage of nontax-paid tobacco products pending export, obtain a permit from TTB.¹⁹ According to TTB officials, among the regulations that TTB enforces are those governing the export of tax-exempt tobacco products, under which only tobacco product manufacturers and export warehouse proprietors may remove

¹⁷See Prevent All Cigarette Trafficking Act of 2009, Pub. L. No. 111-154, 124 Stat. 1087 (2010) and Contraband Cigarette Trafficking Act, Pub. L. No. 95-575, 92 Stat. 2463 (1978) (codified as amended at 18 U.S.C. §§ 2341-2346). The Contraband Cigarette Trafficking Act makes it unlawful (a felony) for any person to ship, transport, receive, possess, sell, distribute, or purchase contraband cigarettes. Contraband cigarettes are cigarettes in a quantity of more than 10,000 sticks (currently, 50 cartons) that bear no evidence of applicable state or local cigarette tax payment in the state or locality in which the cigarettes are found, if such state or local government requires a stamp or other indicia to be placed on the packages or other containers of cigarettes to evidence payment of cigarette taxes and which are in the possession of any person other than specified persons, including permit holders under the Internal Revenue Code, common carriers transporting cigarettes with proper bills of lading, or individuals licensed by the state where the cigarettes are found.

¹⁸GAO, *Cigarette Smuggling: Federal Law Enforcement Efforts and Seizures Increasing*, GAO-04-641 (Washington, D.C.: May 28, 2004).

¹⁹26 U.S.C. § 5712 and 27 C.F.R. §§ 40.62, 41.191, 44.82.

tobacco products for export without payment of tax.²⁰ TTB officials also stated that a manufacturer of tobacco products or an export warehouse proprietor is relieved of the liability for tax on tobacco products upon providing evidence satisfactory to TTB of exportation or proper delivery, including delivery to a customs bonded warehouse operating as a duty-free facility. TTB may audit TTB permit holders to confirm such deliveries or exports.

²⁰27 C.F.R. part 44.

Purchasers and Exporters of Duty-Free Cigarettes at the Southwest Border Are Subject to U.S. and Mexican Requirements; Agencies Identified Schemes and Practices That Facilitate Illicit Trade

Duty-free stores may sell tax-exempt cigarettes in any quantity to passengers departing the United States for Mexico at a port on the land border; agencies have identified schemes and practices associated with duty-free sales that are used to evade U.S. and Mexican taxes. U.S. regulations require duty-free stores to have procedures to provide reasonable assurance that duty-free merchandise sold will be exported and requires the exporter²¹ to report information on the export of commercial cargo, which CBP considers to be transactions valued at more than \$2,500.²² Census data indicate that about 18,500 such transactions occurred from 2010 through 2015 at duty-free stores on the southwest border. According to information from CBP and a Mexican customs official, Mexican requirements dictate that, depending on place of residence, some adult travelers to Mexico can bring in one carton of cigarettes tax-exempt, and some residents can bring in an additional three cartons if they pay taxes on them.²³ Bringing in any quantity above four cartons would require an individual to register as an importer with the Mexican government, according to the same Mexican official. U.S. agencies identified three schemes used to evade cigarette-related taxes and other legal requirements in the United States and Mexico: (1) diverting cigarettes from the store directly into U.S. commerce; (2) smuggling duty-free cigarettes into Mexico through U.S. ports of entry by concealing them, while potentially also bribing Mexican customs officials

²¹CBP regulations require the U.S. principal party in interest (USPPI), or its authorized agent, to electronically transmit certain cargo information for receipt by CBP. 19 C.F.R. § 192.14. For the purposes of these filing requirements, CBP defines “exporter” by citing the definition of USPPI in the Foreign Trade Regulations: “the person or legal entity in the United States that receives the primary benefit, monetary or otherwise, from the export transaction.” 15 C.F.R. § 30.1. In this report, we use “exporter” to refer to the USPPI.

²²This reporting requirement applies to commercial cargo that is to be transported out of the United States by vessel, aircraft, rail, or truck. 19 C.F.R. § 192.14.

²³According to information provided by officials from CBP and the Mexican customs agency, Mexican border-zone residents cannot bring any cigarettes into Mexico.

to evade payment of Mexican taxes; and (3) smuggling duty-free cigarettes back into the United States after first smuggling them into Mexico.

U.S. Regulations Require Duty-Free Stores on the Southwest Border to Provide Reasonable Assurance of Export of Cigarettes and Report Transactions Over \$2,500

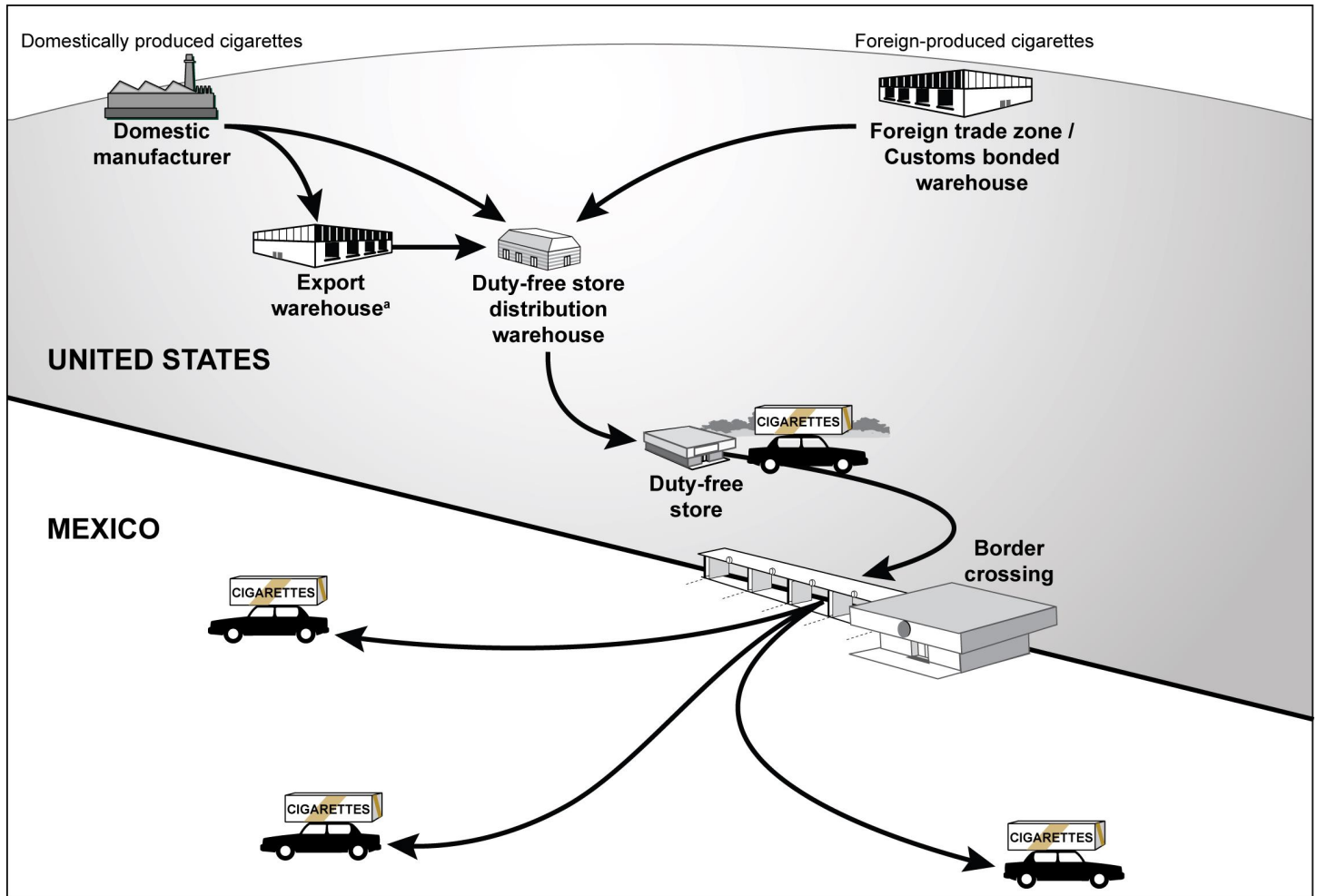
Duty-Free Stores Sell Tax-Exempt Cigarettes to Passengers Departing the United States

Cigarettes manufactured in the United States and labeled for export may be shipped, without payment of federal or state tax, to duty-free stores for export and consumption beyond the jurisdiction of U.S. internal revenue laws. In addition to U.S.–manufactured cigarettes, duty-free stores can sell cigarettes imported from overseas. Duty-free cigarettes, which are cigarettes labeled for export, are considered to be in violation of U.S. law if sold for domestic consumption in the United States.²⁴ According to CBP officials, in the duty-free retail environment, the individual purchasing the merchandise is the exporter.

Cigarettes sold at duty-free stores are generally distributed to duty-free retail outlets from warehouses maintained by the duty-free operator. Figure 2 outlines potential steps in the lawful export of duty-free cigarettes, according to U.S. and Mexican agency officials.

²⁴Tobacco products manufactured in the United States and labeled for exportation may not be sold or held for sale for domestic consumption in the United States unless such articles are removed from their export packaging and repackaged by the original manufacturer into new packaging that does not contain an export label. 26 U.S.C. § 5754(a)(1)(C).

Figure 2: A Pathway for the Lawful Export of Duty-Free Cigarettes at the Southwest Border



Sources: GAO compilation of information from U.S. Customs and Border Protection, the Alcohol and Tobacco Tax and Trade Bureau (TTB), and Mexican customs officials. | GAO-18-21

^aTTB regulates export warehouses.

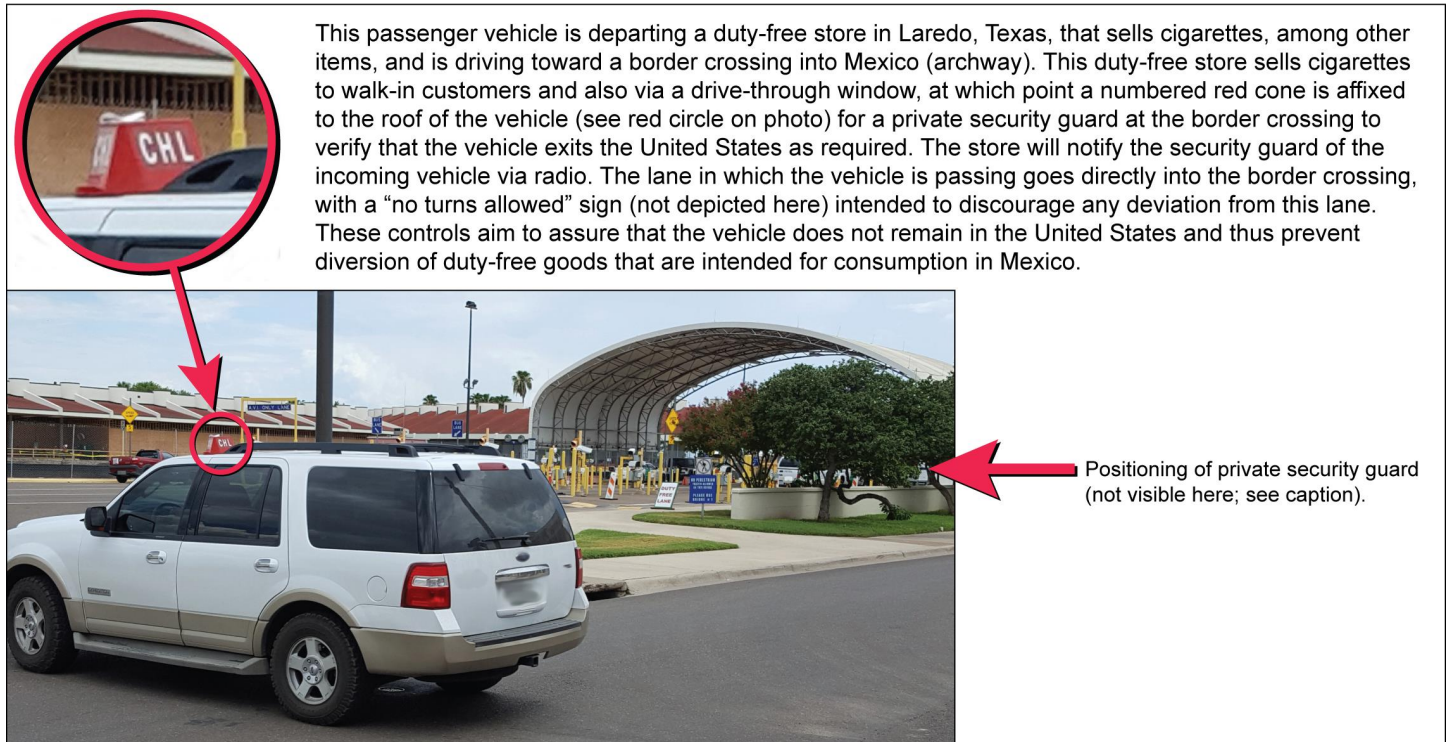
Duty-Free Stores at the Southwest Border Must Provide Reasonable Assurance of Export of Cigarettes to Mexico

CBP requires duty-free stores to have procedures designed to provide reasonable assurance that duty-free merchandise is exported.²⁵ For duty-free stores along the southwest border, such procedures are designed to ensure export by pedestrians and passengers in vehicles crossing into Mexico. The four operating procedures for duty-free stores that we reviewed require that they assure that individuals and their merchandise depart the United States for Mexico under escort or observation.

Figure 3 shows the procedures at a duty-free store in Laredo, Texas, that is located at the border. This duty-free store sells cigarettes from a drive-through window; at the time of purchase, a store employee puts a numbered red cone on the roof of the vehicle. A private security guard employed by the duty-free store removes the red cone at the border crossing to verify that the vehicle exits the United States. In other ports, duty-free stores may be located farther from the U.S. border crossing, and the procedures designed to assure export of duty-free goods could entail having a store employee in a van or other vehicle escort purchasers to the crossing. According to the procedures of one duty-free store we visited, refusal by a pedestrian customer to cross into Mexico should typically result in that customer returning to the store and being given a refund for the duty-free goods purchased, and if the customer refuses to return to the store for a refund and does not cross into Mexico, that individual is not allowed to purchase in the facility again. In the case of a customer in a vehicle, the store should notify CBP, and that customer should not be allowed to purchase in that facility again.

²⁵U.S. laws and a customs regulation stipulate that duty-free stores shall establish procedures to provide reasonable assurance that duty-free merchandise sold by the store is exported. 19 U.S.C. § 1555 and 19 C.F.R. § 19.36. Customs regulations further specify conditions for delivery of such items at land border locations, meaning an exit point from which individuals depart to a contiguous country by vehicle or on foot by bridge, tunnel, highway, walkway, or by ferry across a boundary lake or river. 19 C.F.R. § 19.39.

Figure 3: Passenger Vehicle Leaving Duty-Free Store in Laredo, Texas, for U.S.-Mexico Border



Source: GAO. | GAO-18-21

Duty-Free Cigarette Transactions Valued at More Than \$2,500 Are Subject to Reporting; Operators of Duty-Free Stores Reported About 18,500 Such Transactions in 2010–2015

For every duty-free store transaction in which the value of the goods is more than \$2,500,²⁶ the Foreign Trade Regulations generally require that

²⁶Specifically, this is the value as classified under an individual Schedule B or Harmonized Tariff Schedule of the United States commodity classification code. 15 C.F.R. §§ 30.2(a), 30.37(a). Schedule B numbers are export classification codes that are administered by Census. The Harmonized Tariff Schedule provides the applicable tariff rates and statistical categories for all merchandise imported into the United States; it is based on the international Harmonized System, the global system used to describe most world trade in goods. The regulations provide for a variety of exemptions to this filing requirement. 15 C.F.R. §§ 30.35–30.40.

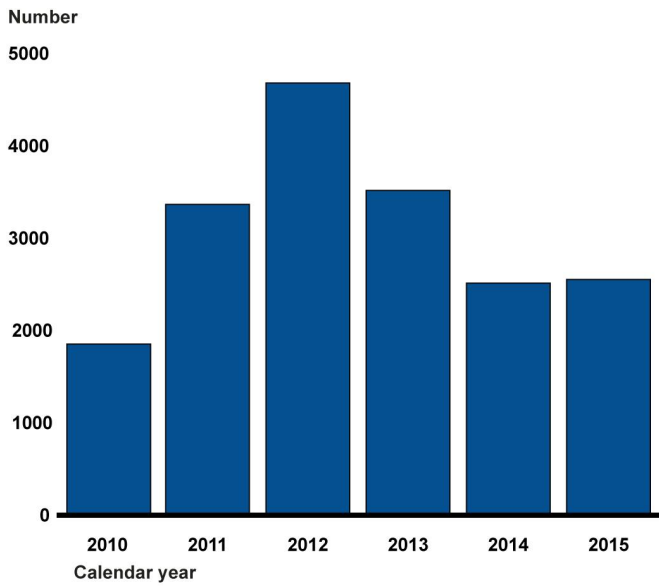
the U.S. principal party in interest (USPPI)²⁷ or its agent file electronic export information through AES. (In this report, we use “exporter” to refer to the USPPI.) According to CBP officials, this requirement extends to purchases of duty-free cigarettes. The export information includes 28 mandatory data elements such as the value, quantity, name of exporter, name of the person receiving the shipment, and method of transportation. AES data from Census showed a total of 18,504 such transactions from 2010 through 2015 from duty-free stores on the southwest border, with almost 70 percent exported from Texas (see fig. 4 and table 1).²⁸ The number of duty-free cigarette transactions valued at over \$2,500 peaked in 2012 at 4,685 and declined to a level about 45 percent lower in 2014 and 2015. According to CBP officials in Laredo and the San Diego area, while it is not possible to determine the exact cause, duty-free stores may have reported greater numbers of these transactions in 2012 due to an increase in enforcement actions at those ports that encouraged greater compliance with export data filing requirements. These officials said stores may have reported fewer transactions valued at over \$2,500 in subsequent years due to CBP’s continued enforcement actions. CBP officials said that they have no way of systematically knowing the full scale of exports that occur through transactions valued at under \$2,500. Those transactions are not captured in data that are required to be reported to the U.S. government.

²⁷The USPPI is defined as “the person or legal entity in the United States that receives the primary benefit, monetary or otherwise, from the export transaction.” 15 C.F.R. § 30.1. The USSPI (exporter) can vary based on the nature of the transaction. We discuss related findings later in this report.

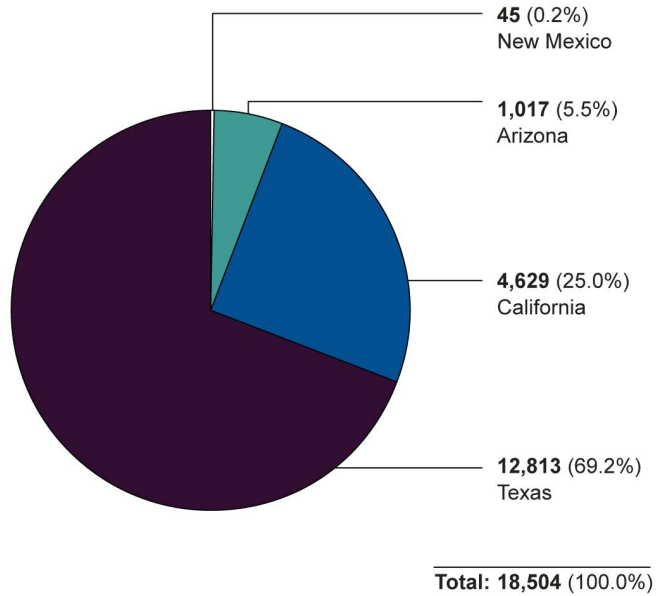
²⁸We tested these data and found that the unprocessed, transaction-level AES data on duty-free cigarettes for 2010 through 2015 are not reliable for use in describing the value and quantity of duty-free cigarettes sold over time in the U.S. states bordering Mexico. For more information on the steps we took to assess the reliability of these data, please see app. II.

Figure 4: Number of Duty-Free Cigarette Transactions Valued at More Than \$2,500 Reported by Stores on the Southwest Border, 2010–2015

By year



By state



Source: GAO analysis of U.S. Census Bureau data from the Automated Export System. | GAO-18-21

Table 1: Number of Duty-Free Cigarette Transactions Valued at More Than \$2,500 Reported by Stores on the Southwest Border, by Calendar Year and by State

Year	Arizona	California	New Mexico	Texas	Total
2010	66	632	0	1159	1,857
2011	93	1022	0	2254	3,369
2012	70	1830	0	2785	4,685
2013	196	601	0	2724	3,521
2014	254	256	43	1963	2,516
2015	338	288	2	1928	2,556
Total	1,017	4,629	45	12,813	18,504

Source: GAO analysis of U.S. Census Bureau data from the Automated Export System. | GAO-18-21

Mexican Customs Regulations Limit the Amount of Cigarettes Individuals Crossing the Southwest Border May Bring with Them

According to information provided by officials from CBP and the Mexican customs agency, Mexican residents above the age of 18 are allowed to bring up to four cartons of cigarettes into Mexico, depending on where they live.²⁹ Specifically, officials from CBP and the Mexican customs agency provided the following details:

- The Mexican customs agency allows each adult who is a resident of the interior of Mexico (not living in towns adjacent to the border) crossing from the United States to bring up to four cartons of cigarettes into Mexico; the first would be exempt from Mexican taxes, and the remaining three would be taxed at a 573-percent rate.
- Mexican border-zone residents, defined as those who live in towns along the U.S.-Mexico border such as Ciudad Juarez and Tijuana, are subject to different rules and are not permitted to bring cigarettes into Mexico.

A Mexican customs official said that bringing in any quantity of cigarettes above these amounts would require an individual to register as an importer with the Mexican government, including both the customs agency and health ministry, and obtain a health authorization in advance of the importation. This official also said that commercial cigarettes are charged a 67-percent import duty, a 16-percent value-added tax, and other special duties or taxes that may be applicable.

U.S. Agencies Identified Three Schemes and Related Purchasing Practices by Which Duty-Free Cigarette Traffickers Evade Taxes in the United States and Mexico

Officials from ICE and CBP described three key schemes by which duty-free cigarette exports on the southwest border, although resulting from purchases consistent with U.S. laws, illicitly enter the commerce of the United States or Mexico: (1) diverting duty-free cigarettes directly into the United States, (2) smuggling duty-free cigarettes into Mexico, and (3)

²⁹Each adult nonresident international passenger is permitted to bring in a maximum of one carton of cigarettes tax-exempt, according to a Mexican customs agency official.

smuggling duty-free cigarettes back into the United States after initially smuggling them into Mexico (see fig. 5).³⁰

³⁰For purposes of this report, we use “divert” and “diversion” to refer to the unlawful introduction of duty-free cigarettes into U.S. commerce using a scheme that does not involve the crossing of the southwest border. We use “smuggle” and “smuggling” to refer to the surreptitious exporting or importing of duty-free cigarettes that involves the crossing of an international border.

Diverting Duty-Free Cigarettes Directly into the United States

In this scheme, cigarettes are purchased from a land border duty-free store and diverted into the United States without paying applicable taxes. According to ICE officials, individuals diverting cigarettes use methods that include bribery of a duty-free store official to allow a vehicle to stay in the United States without informing CBP instead of observing its crossing into Mexico. CBP and ICE officials also reported instances of individuals loading cigarettes into a car after the duty-free store had closed. CBP officers in the San Diego area also identified the following deceptive practices in the course of a 2010 operation, some of which were carried out with the complicity of store employees who took actions such as

- escorting vehicles using unapproved exit routes,
- allowing purchasers of large quantities to leave the store unescorted, and
- assisting purchasers in their efforts to conceal goods in the door panels and engine compartments of their vehicles.

In April 2013, ICE received information of a pending large purchase of cigarettes from a duty-free store in Nogales, Arizona. ICE agents were surveilling the store when they observed an individual loading cigarettes into a van and leaving without an escort from the store. The van did a U-turn just before reaching the crossing into Mexico. ICE seized 840 cartons of cigarettes purchased from a duty-free store after pursuing the van in which the purchaser drove north away from the border into the United States instead of traveling across the border into Mexico.

Smuggling Duty-Free Cigarettes into Mexico across the Land Border, Contrary to That Country's Laws

In this scheme, according to CBP and ICE officials, individuals legally purchase cigarettes from duty-free stores in the United States and smuggle them into Mexico through U.S. ports of entry by concealing these goods in their vehicles or on their person. The individuals may attempt to bribe Mexican customs officials to evade payment of Mexican taxes, according to CBP and ICE officials.

CBP and ICE officials reported that they observed individuals in the parking lots of duty-free stores near the port of San Diego loading cigarettes into concealed compartments in personal vehicles to smuggle them into Mexico. An ICE officer in California told us that smugglers had

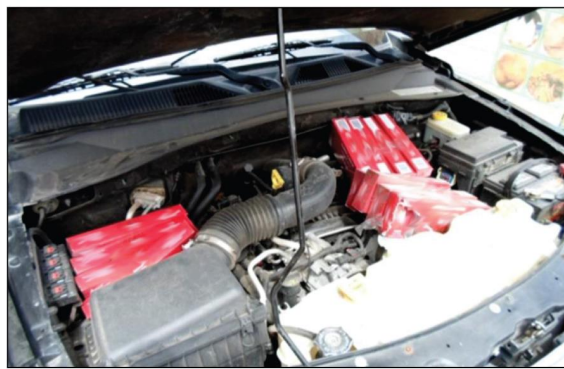
posted Internet advertisements online to recruit runners to move cigarettes across the border from the United States. ICE officials provided data that they obtained from the government of Mexico on cigarette seizures its officials conducted from 2012 through 2015 at numerous locations along the border, including entry points in Mexico directly opposite El Paso, Texas, and San Diego, California, as well as in other parts of Mexico. The data indicate that the Mexican government seized 1.2 million cartons of cigarettes in 2012; the number of cartons seized steadily decreased to about 320,000 cartons in 2015. At least one of the brands among those seized is associated with the operator of multiple duty-free stores on the southwest border.³¹ (See fig. 6 for photographs of duty-free cigarettes concealed in vehicles and discovered by Mexican customs officials.)

³¹The duty-free store operator owns the trademark for this brand of cigarettes and operates 35 of the 88 facilities (stores and warehouses) that CBP identified along the southwest border. This operator's stores accounted for nearly 89 percent of the export data we reviewed based on the number of transactions valued at more than \$2,500.

Figure 6: Examples of Duty-Free Cigarettes Concealed in Vehicles and Discovered by Mexican Customs Officials



These top two photos show the back of a pickup truck before and after an inspection by Mexican customs officials at a border crossing between El Paso, Texas, and Ciudad Juarez in the Mexican state of Chihuahua. According to information from the Mexican customs agency, officials found and seized 41 cartons of undeclared cigarettes in cardboard boxes in the truck.



This photo shows several cartons of cigarettes tucked among engine parts under the hood of a vehicle. According to information from the Mexican customs agency, these were part of a seizure of 100 undeclared cartons of cigarettes near the port of Mexicali in the Mexican state of Baja California.

Source: Government of Mexico's Tax and Customs Administration Service. | GAO-18-21

CBP officials in Laredo told us that they had conducted joint operations with Mexican officials at the passenger crossings but that counter surveillance by smugglers often limited their effectiveness. Typically, a short time after initiating an operation, they would observe that smugglers had ceased activities temporarily and that every vehicle CBP officers examined contained only one or two cartons of cigarettes, an amount

that, according to the CBP officials, complies with Mexican import restrictions.

Smuggling Duty-Free Cigarettes Back into the United States after First Smuggling Them into Mexico

In this scheme, duty-free cigarettes that are smuggled into Mexico are brought back across the border and introduced into U.S. commerce without declaring the goods to CBP upon reentry, thus avoiding relevant U.S. taxes. Smugglers might bring these goods back into the United States in small amounts, to avoid detection, and take them to rented storage facilities along the border, according to CBP officials at the port of San Diego. The smuggled cigarettes are bundled into larger quantities and subsequently transported for sale at locations in the interior of the United States. During our fieldwork at the port of San Ysidro, CBP officials identified warehouses where such cigarettes had been stored in the past.

Traffickers Can Facilitate Diversion and Smuggling by Avoiding the \$2,500 Threshold for Reporting Transactions or by Moving to Another Port

According to agency officials, traffickers engaged in diversion and smuggling schemes minimize their visibility to the U.S. government by dividing a large purchase of duty-free cigarettes into smaller ones to avoid the AES reporting threshold of \$2,500. Such structured transactions can be carried out by individual buyers or by multiple individuals making purchases on behalf of the holder of an account at a duty-free store. As part of a 2012 enforcement operation, CBP officials reviewed receipts for cigarette sales from three duty-free stores in San Ysidro and identified six people who made multiple purchases during the same day at one of the stores. One of these six individuals made 14 consecutive purchases of cigarettes valued at \$200 and then a final purchase of \$100 for a total of \$2,900 which, as a single transaction, would have exceeded the \$2,500 threshold for reporting such exports. In addition, CBP officials in Laredo described a 2010 scenario in which U.S. citizens moved \$100,000 worth of tobacco products into Mexico over the course of a month by making repeated crossings on foot with under \$2,500 in merchandise each time so that no reporting was required. Further, CBP officials at the port of San Diego said that following a series of CBP operations related to duty-free stores from 2010 through 2012, they reviewed the stores' sales records and noticed a decrease in high-value sales. An ICE official said, however,

that cigarette smuggling operations may have moved eastward in response to CBP operations in California. In addition, according to these CBP officials, a 2010 operation discovered multiple store operators maintaining two sets of accounts to link cash outlays upfront for multiple purchases.

Smuggling of Duty-Free Cigarettes across the Southwest Border Is Reportedly Linked to Organized Crime and Supplies the Illicit Tobacco Market in Mexico; U.S. Efforts to Counter This Illicit Activity Face Challenges

U.S. agency officials said that some smuggling of duty-free cigarettes across the southwest border has links to organized crime, supplies the illicit tobacco market in Mexico, and poses oversight challenges. ICE officials told us that transnational criminal organizations use smuggled, duty-free cigarettes to launder money and generate revenue.³² Furthermore, a Mexican customs official noted that relatively inexpensive cigarettes manufactured in the United States, which cannot legally be sold in the United States or in Mexico, are routinely sold for export from duty-free stores on the southwest border; such cigarettes are then smuggled across to supply Mexico's illicit tobacco market. One brand of such cigarettes has been cited in recent studies as a significant part of the illicit tobacco trade in Mexico. U.S. officials reported that their efforts to counter the illicit movement of duty-free cigarettes face challenges related to the purchaser's ability to buy duty-free cigarettes in unlimited quantities and to use passenger, not commercial, crossings from the United States into Mexico.³³ According to U.S. officials, while U.S. agencies do not have the authority to seize exports that violate Mexico's laws related to these cigarettes, U.S. officials reported working with Mexican officials on activities to enforce the customs laws and regulations of both countries.

³²According to Treasury, money laundering is defined as (1) placement, in which illicit proceeds are introduced into the financial system; (2) layering, in which the criminal attempts to separate the proceeds from the crime through a series of transactions; and (3) integration, where the illicit funds reenter the economy disguised as legitimate funds.

³³For purposes of this report, commercial crossings are those that accommodate truck cargo containers (loaded or empty).

Criminal Organizations Reportedly Use Duty-Free Cigarettes to Launder Money and Generate Revenue

ICE officials said that the same transnational criminal organizations that smuggle narcotics and humans into the United States generate additional revenue streams by legitimately purchasing low-cost duty-free cigarettes and other items in the United States and smuggling them into Mexico, and sometimes back into the United States, for black market resale.³⁴ According to ICE officials, after Mexico raised taxes on cigarettes in 2010, transnational criminal organizations identified smuggling cigarettes as a method of generating funds.³⁵ In addition to U.S.– manufactured cigarettes, foreign cigarettes are also smuggled into Mexico.³⁶

According to ICE officials, transnational criminal organizations launder money by depositing illicit funds into client accounts at duty-free stores along the southwest border. They then make withdrawals from these accounts, just as they would from a bank account, to purchase duty-free tobacco and alcohol.³⁷ According to ICE officials, transnational criminal organizations purchase in quantities such that some duty-free stores give them substantial discounts on the stores' in-house cigarette brands. Subsequently, these goods are smuggled either by concealment or bribery of Mexican customs officials, according to ICE officials. According to an official from the Mexican customs agency, some drug cartels add their own product identification codes onto packs of cigarettes from duty-free stores for sale in areas that they control.

³⁴The term “black market” refers to trade in goods or commodities in violation of laws and regulations.

³⁵In addition, ICE officials in Laredo attributed the use of cigarettes to launder money in part to changes in Mexican financial regulations that began in 2010 and limited Mexican citizens' deposits of U.S. dollars to \$500 per day in some instances. Officials compared this to the corresponding limit in the United States that requires the issuance of a currency transaction report for amounts over \$10,000.

³⁶For example, an ICE official said large quantities of cigarettes are brought in from overseas and transported to duty-free stores on the southwest border. According to this official, the stores sell these cigarettes, sometimes in large quantities, although the cigarettes would not be approved for sale in either Mexico or the United States.

³⁷ICE defines trade-based money laundering as the use of trade to legitimize, conceal, transfer, and convert large quantities of illicit cash into less conspicuous assets. ICE officials in San Diego explained that, in Southern California, criminals use other commodities more frequently than cigarettes for trade-based money laundering.

Certain Duty-Free Cigarettes from the United States Comprise a Large Share of the Illicit Mexican Market

Relatively inexpensive cigarettes manufactured in the United States, which, according to a Mexican customs official, do not meet requirements for sale in Mexico are routinely sold at duty-free stores on the southwest border. According to this Mexican customs official, one particular brand of cigarettes, which is sold exclusively at U.S. duty-free stores, is prohibited for commercial distribution in Mexico because the cigarettes do not comply with packaging and labeling regulations, including those related to health messages.³⁸ This brand of U.S.-made cigarettes has been among the illicitly trafficked cigarettes that the Mexican government confiscated at various locations in the country from 2012 through 2015. In addition, in 2013, the Mexican customs agency executed a number of seizures of this brand of duty-free cigarettes that were undeclared at ports of entry on the U.S.-Mexico border (see fig. 7). This brand of cigarettes has been cited in recent studies as a significant part of the illicit tobacco trade in Mexico.

- ICE officials provided a November 2015 report issued by the National Cyber-Forensics & Training Alliance, a public-private partnership, which stated that this U.S.-made brand of cigarettes was recognized as the largest illegal brand being sold in Mexico. The report also stated that this brand of cigarettes was being diverted into Mexico through various duty-free stores in Laredo, Texas, and San Diego, California.³⁹
- Another study reported that, as of June 2014, 64 percent of the inflow of tobacco into Mexico from the United States consisted of this brand of cigarettes manufactured and trademarked in the United States and sold at duty-free stores on the southwest border.⁴⁰ The study also

³⁸According to a public health warning issued by a federal commission of the Mexico health secretariat, this particular brand of U.S.-made cigarettes for duty-free sale is among those cigarettes “which can be counterfeit, adulterated, and even made with unknown ingredients, increasing the possibility that they contain potentially toxic non-tobacco chemicals.”

³⁹National Cyber-Forensics & Training Alliance (NCFTA), *Southern Border Illicit Tobacco Activity* (Pittsburgh, Penn.: November 2015). The NCFTA is funded by private sector entities, including tobacco firms. ICE has a partnership agreement with the NCFTA and assigns agents there through the National Intellectual Property Rights Coordination Center that it leads.

⁴⁰This was a study commissioned by British American Tobacco (Investments) Ltd. KPMG, LLP, *Project Frost* (United Kingdom: May 2015).

noted that this brand of cigarettes accounted for about 13 percent of the overall illicit cigarette market in Mexico.

The company that owns the trademark for this brand of cigarettes also operates many of the duty-free stores on the southwest border; the majority of the transactions we reviewed from 2010 through 2015 were exports from this company's stores. Representatives of the company reported to us that, as the duty-free operator, the company complied with all CBP regulations regarding the requirement to post signs in the stores reminding customers of the need to comply with foreign laws.⁴¹ These representatives told us that they had no knowledge of whether the cigarettes in question were prohibited from commercial distribution in Mexico and that they did not have an obligation to know since the company is not the exporter of the cigarettes.

Figure 7: U.S.-Made Duty-Free Cigarettes That Mexican Customs Officials Seized at a U.S. Border Crossing



According to information from the Mexican customs agency, these two photos depict a 2013 seizure of 1,215 cartons of undeclared cigarettes by officials at the port of entry in Ciudad Juarez in the Mexican state of Chihuahua. The seizure included a U.S.-made brand sold in duty-free stores along the southwest border that a Mexican official said is prohibited for commercial distribution in Mexico.

Source: Government of Mexico's Tax and Customs Administration Service. | GAO-18-21

⁴¹U.S. regulations require that duty-free stores display notices to customers that include, among other items, that duty-free merchandise purchased from the store "is subject to the customs laws and regulations, including possible duties and taxes, of any foreign country to which it is taken." 19 C.F.R. § 19.35(e)(3).

U.S. Officials' Efforts to Counter Illicit Trade in Duty-Free Cigarettes Face Challenges

Agencies Cite the Ability to Buy Unlimited Quantities of Duty-Free Cigarettes at the U.S. Land Border as a Factor That Facilitates Smuggling

CBP and ICE officials in Laredo said that the ability to buy unlimited quantities of duty-free cigarettes at the land border facilitates large shipments of these goods to be clandestinely smuggled into Mexico. CBP officials acknowledge that duty-free stores on the southwest border are functioning as wholesale suppliers of cigarettes. During congressional consideration of duty-free store legislation, a senator raised the issue of the potential for economic harm to communities adjacent to the U.S.-Mexican border if a provision precluding duty-free sales in wholesale quantities were applied to land border stores.⁴² Congress later enacted the Omnibus Foreign Trade and Competitiveness Act of 1988, which required duty-free stores located in airports to restrict the sale of duty-free merchandise to any one individual to "personal use quantities," a requirement that does not apply to land border stores.⁴³ According to CBP officers in San Diego, duty-free store representatives told them in 2010 that the stores at the port of San Ysidro were some of the most profitable in the country and that merchandise sold in wholesale quantities was an important part of their business.⁴⁴

Use of Passenger Crossings to Export Large Quantities of Duty-Free Cigarettes Creates Oversight Challenges; CBP Officials Said They Are Reviewing Proposed Options at One Port

U.S. officials said that the ability to use passenger crossings to export wholesale quantities of duty-free cigarettes enables these goods to enter Mexico with less scrutiny and oversight than if they were processed

⁴²133 Cong. Rec. S9937 (daily ed. July 15, 1987) (statement of Sen. Bentsen).

⁴³Pub. L. No. 100-418, § 1908(b).

⁴⁴In enacting legislation on duty-free sales enterprises, Congress found that duty-free sales enterprises play a significant role in attracting international passengers to the United States and, thereby, their operations favorably affect the U.S. balance of payments. Congress also found that concession fees derived from the operations of authorized duty-free sales enterprises constitute an important source of revenue for the state, local, and other governmental authorities that collect such fees. 19 U.S.C. § 1555, note.

through a commercial crossing. U.S. ports on the land border may have multiple crossings, some designated for passenger traffic and others for commercial traffic. CBP officials said that duty-free cigarettes are treated as noncommercial goods that exit via passenger crossings and, therefore, are not subject to the same requirements and potential for CBP oversight as commercial exports. Requirements for commercial cargo leaving the United States include submission of electronic information to CBP in advance of departure. CBP and ICE officials in Laredo noted that CBP does not define what constitutes a commercial export, enabling the use of passenger crossings by purchasers of “commercial-type” quantities.⁴⁵ CBP officials in Laredo and San Diego said that individuals purchasing large quantities of duty-free cigarettes would likely be less able to evade Mexican taxes if the goods were to exit from a commercial crossing.

In the San Diego area, which has one of the highest concentrations of duty-free stores among ports on the southwest border and has multiple crossings into Mexico,⁴⁶ CBP took steps to try and address the challenge of large quantities of duty-free cigarettes moving through passenger crossings. In 2010, CBP in San Diego prepared a draft notice for members of the area trade community, including duty-free stores, announcing that the Port Director had decided more controls were necessary to ensure the export of duty-free merchandise purchased for resale.⁴⁷ The draft notice identified four scenarios that would meet the definition of a commercial purchase and identified appropriate exit procedures for any commercial purchases to include exit from a commercial (or cargo) export facility, instead of from the passenger crossing.⁴⁸ In July 2017, CBP officials indicated that no change in exit

⁴⁵Officials said that CBP-enforced regulations also do not provide a definition for what would constitute a commercial quantity and that the agency has not adopted its own definition or guidelines in part because commercial transactions can have different quantities and varying price points. CBP officials said that they view commercial exports to be merchandise for business resale or for profit, rather than for individual use, such as for personal or household consumption.

⁴⁶Ports in the San Diego area have crossings to accommodate passenger traffic or both passenger and commercial traffic.

⁴⁷According to U.S. customs regulations, the Port Director’s decision as to what constitutes reasonable assurance of exportation is final. 19 C.F.R. § 19.35(d).

procedures for duty-free tobacco products had taken place; previously, they had stated that CBP had not issued the notice because it was still undergoing review. Officials at CBP headquarters in Washington, D.C., informed us that the agency was planning to engage with port officials in San Diego to plan appropriate next steps in assessing the type of crossing through which duty-free cigarettes should be exiting.

U.S. Agency Officials Report That They Are Not Authorized to Seize Exports That Violate Mexico's Laws but Have Taken Steps to Work with Mexico on Enforcement

CBP officials said the agency does not have the authority to seize goods that are being smuggled into Mexico contrary to that country's laws. Officials at CBP headquarters said that enforcing Mexican laws is not the responsibility of U.S. agencies, but officials at two different ports of entry also described efforts to work with Mexican counterparts on activities related to enforcing customs laws and regulations of both countries. In addition, CBP in Laredo instructed duty-free store operators to discourage customers from concealing duty-free items by including procedures about this in their employee manuals. We reviewed the procedures manual for one of these operators and found that it directed employees to inform customers that they were not allowed to hide or conceal duty-free items.

CBP and ICE officials told us they are able to take some actions in concert with their Mexican counterparts related to coordination and information sharing at both the border and headquarters levels.⁴⁹ Specifically, CBP officials in Laredo told us that they conduct joint enforcement operations with Mexican officials to inspect passenger vehicles as they exit the United States and enter Mexico. ICE and CBP

⁴⁸The draft notice identified four scenarios that would meet the definition of a commercial purchase: (1) a purchase price of \$2,500 or more per line item, except for a single item valued at over \$2,500; (2) an aggregate purchase by the same individual totaling \$2,500 or more during a single day; (3) all purchases that a purchaser or duty-free store declares as commercial in nature; and (4) any purchases made by individuals known to engage in commercial activity or that CBP deems to be commercial in nature.

⁴⁹CBP and ICE officials have identified several legal bases on which these cooperative efforts rest. They include Section 1628 of Title 19 of the United States Code, which allows the Secretary of Homeland Security to authorize customs officers to exchange information or documents with foreign customs and law enforcement agencies under certain conditions; the North American Free Trade Agreement; the Customs Mutual Assistance Agreement between the United States and Mexico; and the *Bilateral Strategic Plan between Mexico's Administration General of Customs, U.S. Customs and Border Protection, and U.S. Immigration and Customs Enforcement*, signed on August 13, 2007.

officials in Laredo also said that the issue of cigarette smuggling has been raised at bilateral security cooperation meetings that are routinely held with Mexican customs and law enforcement counterparts. Additionally, according to officials there, ICE's National Intellectual Property Rights Coordination Center, under terms of the U.S.-Mexico Customs Mutual Assistance Agreement, has obtained information from the Mexican customs agency on that country's seizures of cigarettes nationwide to advance related investigations in the United States. An ICE official said that the agency has also worked concurrently with its counterparts in Mexico to advance an investigation related to the smuggling of cigarettes from U.S. bonded warehouses that were destined for duty-free stores but were being smuggled directly into Mexico and possibly diverted back into the United States. According to the ICE official, ICE has continued to keep Mexico abreast of developments through its attaché in Mexico City.

Selected Export Data Reported by Duty-Free Stores Show Irregularities, Which CBP Has Taken Some Steps to Address

Multiple Duty-Free Stores Are Filing Some Noncompliant Information on Cigarette Exports

According to CBP, in many cases duty-free stores on the southwest border are filing some noncompliant information that they are required to report on cigarette exports valued at more than \$2,500. Our analysis of export data from Census also showed that many transactions include some noncompliant information.⁵⁰ Specifically, we identified the following three compliance issues:

- According to CBP, in most instances, the duty-free store should identify the purchaser of the cigarettes as the exporter, and subsequently, report the purchaser's name and also provide a unique numerical identifier for the purchaser such as a passport or border crossing card number. In our analysis of reported data for 18,504 transactions involving cigarettes at duty-free stores on the southwest border from 2010 through 2015, we found that 99 percent of these transactions indicate that the duty-free store operator sold the merchandise to an individual purchaser but identified itself as the exporter through use of its Internal Revenue Service employer identification number (EIN). According to CBP officials, these transactions pose potential compliance concerns.

⁵⁰We determined that data were sufficiently reliable to review filing practices with respect to duty-free cigarette transactions. We determined other AES data, including value and quantity of export, to not be reliable for reporting purposes. See app. II for more information.

- Duty-free stores on the southwest border owned by one operator commonly used the operator's postdeparture filing privilege⁵¹ for cigarette transactions while also reporting them as routed export transactions.⁵² However, the Foreign Trade Regulations specify that postdeparture filings cannot be made for routed export transactions. This duty-free store operator incorrectly used its postdeparture filing privilege and marked transactions as routed exports in 16,384 of the 16,387 transactions it reported during 2010 through 2015.⁵³
- In response to our inquiries, CBP reviewed AES filings for this duty-free store operator and found additional compliance concerns related to filings showing Otay Mesa, California, as the port of exit. Specifically, according to CBP, the duty-free store operator was filing information indicating that the cigarettes were leaving the country through the port of Otay Mesa, although CBP officials had previously observed the sales leaving through the port of San Ysidro, California.

⁵¹Two electronic filing options, predeparture and postdeparture, are available for transmitting electronic export information. Postdeparture filings must be reported within 5 calendar days after the date of export. The electronic postdeparture filing takes into account that complete information concerning export shipments may not always be available prior to exportation. Companies must have Census, CBP, and other partnership agency approval to file under the postdeparture filing program. In August 2003, Census and CBP placed a moratorium on accepting new applications for the postdeparture filing program. Among the reasons for the moratorium, CBP cited misuse of the program and passage of the Trade Act of 2002. Those exporters already approved for postdeparture filing before the moratorium maintained their status, including the operator of multiple duty-free stores.

⁵²A routed export transaction is a transaction in which the foreign principal party in interest authorizes a U.S. agent to facilitate export of items from the United States on its behalf and to prepare and file the electronic export information. The foreign principal party in interest is the party abroad who purchases the goods for export or to whom final delivery or end use of the goods will be made.

⁵³This was out of the 18,504 transactions we reviewed from AES during this time period. This duty-free store operator accounted for nearly 40 percent of the stores that CBP identified on the southwest border.

CBP Has Provided Information to One Duty-Free Store Operator Reporting Inaccurate Data on Cigarette Transactions but Has Not Taken Steps to Finalize Any Guidance

CBP has acted to address its compliance concerns with one duty-free store operator, but other possible actions remain, including the issuance of final instructions and guidance to all operators on the border and the public. According to CBP, one of the ways it fosters adherence to rules and regulations in the trade community is through “informed compliance,” the idea that, in order to maximize voluntary compliance with trade laws and regulations, the trade community needs to be clearly and completely informed of its legal obligations.⁵⁴ We have previously found that information programs are a key part of CBP’s informed compliance strategy at both headquarters and the ports.⁵⁵ For example, CBP issues directives, handbooks, and a series of “informed compliance publications” that provide guidance on various trade-related matters.

In 2012, CBP informed the duty-free store operator with the largest number of AES transactions we reviewed that its transactions incorrectly identified its stores as the exporter when in fact the purchaser was the exporter. Regulations state that knowingly failing to file or knowingly submitting false or misleading export information through AES is a violation subject to penalties.⁵⁶ CBP is authorized to enforce the Foreign Trade Regulations, which include regulations on reporting through AES. With regard to the compliance issue that CBP raised in 2012, CBP did not take action until after April 2014, when a CBP assessment of export transactions found that the problem with the operator’s cigarette export filings continued. In August 2014, CBP issued a penalty to the duty-free store operator, and the operator requested that CBP give it time to arrive at an agreement with the agency and remove the penalty, noting that a

⁵⁴According to CBP, Title VI of the North American Free Trade Agreement Implementation Act (Pub. L. No. 103-182, 107 Stat. 2057), also known as the Customs Modernization or “Mod” Act, introduced the concept of informed compliance. According to CBP, the Mod Act also imposes a greater obligation on CBP to provide the public with improved information concerning the trade community’s rights and responsibilities under customs regulations and related laws.

⁵⁵GAO, *Customs Service Modernization: Impact of New Trade Compliance Strategy Needs to Be Assessed*, GAO/GGD-00-23 (Washington, D.C.: Dec. 15, 1999).

⁵⁶15 C.F.R. § 30.71.

change to current practices might have adverse consequences on its business and further emphasizing that its practices had been widely known for years. According to CBP officials, due to the operator's confusion over correct procedure, the penalty was canceled, and officials decided to take steps to ensure proper filing of AES through informed compliance.

In October 2015, CBP provided the operator with interim instructions on how to comply with its requirements under the Foreign Trade Regulations. Those instructions included scenarios illustrating both compliant and noncompliant export data filings for transactions involving cigarettes.⁵⁷ CBP officials also told us that a planned meeting with the duty-free store operator to finalize instructions never took place and that CBP never provided final instructions to that operator.

According to CBP officials, this duty-free store operator continues to identify itself as the exporter and to use its postdeparture filing privilege. CBP officials said that duty-free stores assert that they are working to be compliant, but it is challenging for them in part because the cigarette purchasers are often unaware of their role and do not have accounts established to file the electronic export data. Additionally, one CBP official said that purchasers may be reluctant to provide a verifiable numeric identifier, such as a passport number or border crossing card, if they are involved in smuggling operations. Furthermore, CBP and ICE officials said that employees working at land border duty-free stores may not be fully trained and aware of proper filing procedures.

In response to our inquiries, Census re-sent the 2015 interim instructions to the duty-free store operator in March 2017, after confirming that the operator was still using its postdeparture privilege when it should not. CBP officials indicated in July 2017 that they plan to conduct outreach to duty-free stores on the southwest border and provide guidance to the ports there to ensure proper data submission and appropriate use of postdeparture filing. CBP headquarters officials informed us that they had recently held initial discussions on this topic with agency officials in Laredo, but they had not issued any further information to the duty-free store operators and to the public; they said further discussions were

⁵⁷ According to officials at both agencies, CBP consulted with Census in crafting the information and in outreach to the duty-free store operator. Census is responsible for writing and interpreting the Foreign Trade Regulations and has delegated enforcement to CBP and other agencies.

planned. CBP officials did not identify instances of providing similar information to, or having discussions with, the other duty-free store operators.

The Foreign Trade Regulations state that the filer of export information in AES is responsible for transmitting accurate data as known at the time of filing. An ICE official said that properly completed export data with purchasers' verifiable identification numbers would allow ICE to corroborate that information against other databases, such as the Automated Targeting System (ATS), during an investigation. ATS compares traveler, cargo, and conveyance information against law enforcement, intelligence, and other enforcement data to assess risk. In addition, ICE sought data from Mexico, such as names and dates of birth of individuals arrested in connection with cigarette seizures in that country, to keep that information on file in the event the individuals were associated with cases in the United States. Agency officials said that verifiable identification information, such as the type that is collected in AES filings, would further help ICE corroborate and identify individuals participating in the illicit trade of duty-free cigarettes. CBP officials said that accurate data on the identity of the exporter would benefit law enforcement and intelligence operations. Without accurate data, including correct and complete information on the exporter, agencies may lack the information they need to enhance their enforcement and intelligence efforts related to the illicit trade of duty-free cigarettes on the southwest border.

Conclusions

Unlike duty-free stores at U.S. airports, duty-free stores associated with U.S. land borders may sell tax-exempt cigarettes in any quantity. Since Congress legislatively adopted this policy in 1988, changes on both the U.S. and Mexican sides of the southwest border have affected this trade. Agencies have cited a number of schemes used by individuals to divert these products into Mexico and into U.S. commerce, despite efforts by CBP to enforce relevant regulations and procedures. Agencies have noted that, as smuggling has become potentially more lucrative, an existing linkage may grow stronger between cigarette smuggling and organized crime on the southwest border, where they believe that criminal organizations have created distribution networks to illicitly move cigarettes in both countries. CBP officials also state that the agency does not have the authority to seize goods that are being smuggled into Mexico contrary to that country's laws.

CBP has made efforts to utilize available data collected on transactions valued at over \$2,500 to evaluate duty-free store compliance with regulations. However, despite various outreach and enforcement efforts, agency officials said that inaccurate filings by one large operator—comprising nearly 89 percent of the transactions we reviewed—continue, and other store operators are still potentially out of compliance. Until steps are taken to ensure that duty-free store operators and exporters fully comply with reporting requirements, U.S. agencies will lack the accurate, complete information that can help them conduct their enforcement and intelligence efforts.

Recommendation for Agency Action

The Commissioner of the U.S. Customs and Border Protection should take steps to strengthen compliance with export reporting requirements related to duty-free cigarette sales on the southwest border, such as issuing guidance to all duty-free store operators. (Recommendation 1)

Agency Comments

We provided a draft of this product to Commerce, DHS, DOJ, and Treasury for comment. DHS provided substantive comments that are reproduced in appendix III. Commerce and DHS also provided technical comments, which we incorporated as appropriate. DOJ and the Treasury provided no comments.

In its comments on our draft report, DHS concurred with our recommendation. DHS stated that CBP's Office of Field Operations will issue guidance and engage field personnel to strengthen compliance with export requirements. In addition, DHS stated that ports would be instructed to provide guidance to all duty-free store operators on correct filing procedures for electronic export information (EEI), including use of the correct port of export and identifying the party responsible for filing the EEI. DHS gave an estimated completion date for these actions of October 31, 2017.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the appropriate congressional committees, the Secretary of Commerce, the Secretary of Homeland Security, the Attorney General, the Secretary of

the Treasury, and other interested parties. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff members have any questions about this report, please contact me at (202) 512-3149 or gootnickd@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix IV.

Sincerely yours,

A handwritten signature in black ink, appearing to read "David Gootnick". The signature is fluid and cursive, with the first name "David" written in a larger, more prominent script than the last name "Gootnick".

David B. Gootnick,
Director, International Affairs and Trade

Appendix I: Objectives, Scope, and Methodology

This report examines (1) requirements that govern the lawful sale and export of cigarettes from duty-free stores on the southwest border and schemes for illicit trade in such cigarettes that agencies identified, (2) U.S. agency observations about these duty-free cigarette exports and efforts to counter illicit trade, and (3) the extent to which selected cigarette transaction data submitted by duty-free stores indicate compliance issues with reporting requirements.

To obtain background information on duty-free stores, we reviewed documents related to the legislative history of duty-free stores, including those from the *Congressional Record* and U.S. laws and customs regulations. To describe relevant agency roles related to duty-free cigarette exports, we reviewed documents from the agencies and utilized information from interviews with their officials.

To address the first two objectives, we collected and analyzed information through several methods. We reviewed relevant federal laws and regulations. We also interviewed officials from the Department of Commerce's U.S. Census Bureau (Census); the Department of Homeland Security's U.S. Customs and Border Protection (CBP) and U.S. Immigration and Customs Enforcement (ICE); the Department of Justice's Bureau of Alcohol, Tobacco, Firearms, and Explosives; the Department of the Treasury's Alcohol and Tobacco Tax and Trade Bureau; and tax-collection officials from the state of California.¹ We also interviewed representatives from private sector tobacco and duty-free firms. We conducted field work in California in the areas around San Diego, including Otay Mesa and San Ysidro, and Los Angeles. We selected these locations based on the presence of duty-free stores or reports of cigarettes being diverted from duty-free stores into the United States, supplemented by insights from agency officials. We also used information gathered from field work in Laredo, Texas, that we conducted under a related review. We spoke with U.S. agency officials in Nogales,

¹During the course of our work, FDA officials we contacted did not identify agency activities that were within the scope of this review. At the conclusion of our work, FDA officials said that the agency does not play a role with respect to tax revenue for duty-free cigarette exports from the southwest border.

Arizona, and in the Washington, D.C., area. Lastly, we spoke with and obtained data from an official from the Mexican customs agency, the Tax and Customs Administration Service.

To describe how cigarettes are sold and exported from duty-free stores on the southwest border, we also reviewed relevant U.S. laws and customs regulations and collected information from U.S. and Mexican officials on allowances and requirements for duty-free cigarettes imported into Mexico. In addition, to describe the views that agency officials have expressed with regard to cigarette exports from duty-free stores on the southwest border, we reviewed CBP documents that described operating procedures at the ports of Laredo, Texas, and San Diego, California; a draft port information notice from the port of San Diego; and reports from the private sector and a public-private partnership, the National Cyber-Forensics & Training Alliance, on the illicit tobacco market in Mexico. We also analyzed data on seizures from the Mexican Tax and Customs Administration Service and information from interviews with officials from CBP, ICE, and the Mexican government.

We also analyzed Automated Export System (AES) data from Census for 2010 through 2015 on recorded transactions at the duty-free stores CBP identified as being adjacent to the U.S.-Mexico border, also referred to as the southwest border, spanning Texas, New Mexico, Arizona, and California. We determined that value and quantity data for those transactions were not reliable for the purposes of this report; we based our assessment on a review of related documentation and on interviews with Census officials about the agency's procedures to ensure the quality of the data and with CBP officials to discuss relevant aspects of how transaction data might be entered in AES. According to Census officials, it is not possible to identify from AES whether or not an export came from a duty-free store, as such information is not required when filers submit electronic export information. We used an alternative method to identify the AES data associated with transactions at duty-free stores on the southwest border: We obtained the employer identification numbers (EIN) for those duty-free stores from CBP, which identified 88 duty-free stores on the southwest border that in some cases used the same EIN because some stores owned by the same proprietor used the same EIN. We obtained 54 EINs covering the 88 border stores. In one instance, a single EIN applied to 7 duty-free stores.

Census provided us with the export transactions recorded in AES that corresponded to the 54 EINs provided by CBP. Census protects the confidential data contained in export transaction records it receives from

firms but may disclose the data to other government agencies if the agency determines it is in the national interest to do so.² For each transaction record, we requested the data for 24 of the 28 mandatory fields in AES for which exporters must provide information.³ In addition, we asked Census to filter the information by several fields to include country of destination (Mexico) and the Harmonized Tariff Schedule codes associated with cigarettes. Census identified 19,101 transaction records in response to our request. After removing those records that fell outside of our parameters (e.g., entries from 2009 and entries for which the value was \$2,500 or less), 18,504 export transaction records remained. To identify the schemes related to the illicit trade in duty-free cigarettes, we reviewed court documentation from criminal cases at the state and federal levels. We also reviewed *Federal Register* notices for historical references to cases of smuggling in addition to interviewing officials from the U.S. and Mexican governments.

To evaluate the extent to which duty-free cigarette export data presented potential compliance issues with reporting requirements, we reviewed such data from AES and compared select data elements to reporting requirements as stated in the Foreign Trade Regulations. We also reviewed summaries of events that CBP provided relating to a specific penalty issued by the port of Laredo to a duty-free store operator for failure to comply with AES reporting requirements. We examined a document Census provided to us that was submitted to that agency and CBP from the operator's lawyers as well as the interim document provided to that operator by CBP and Census. We also analyzed a subset of our data concurrently with agency officials to evaluate the compliance of the specific transaction records we received from Census with a requirement in the Foreign Trade Regulations. Additionally, we reviewed

²Census is authorized by Title 13, United States Code, Section 30l(g), and the U.S. Department of Commerce Organization Order 35-2A to make such a determination.

³The 28 mandatory fields are the (1) U.S. principal party in interest (USPPI) and USPPI identification; (2) date of export; (3) ultimate consignee; (4) port of export; (5) U.S. state of origin; (6) country of ultimate destination; (7) method of transportation; (8) conveyance name/carrier name; (9) carrier identification; (10) related party indicator; (11) domestic or foreign indicator; (12) commodity classification number; (13) commodity description; (14) primary unit of measure; (15) primary quantity; (16) shipping weight; (17) value; (18) export information code; (19) shipment reference number; (20) line number; (21) inbond code; (22) routed export transaction indicator; (23) filing option indicator; (24) ultimate consignee type; (25) hazardous material indicator; (26) license code/license exemption; (27) shipment filing action request indicator; and (28) line item filing action request indicator. We requested mandatory fields 1 through 24.

documents from the Commercial Customs Operations Advisory Committee to contextualize one of the largest duty-free store operator's use of its postdeparture filing privilege.

We conducted this performance audit from November 2016 to October 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Assessment of Duty-Free Cigarette Export Data Reliability

Background

We analyzed U.S. Census Bureau (Census) transaction-level data from the Automated Export System (AES) on sales of duty-free cigarettes purchased at stores located on the U.S. southwest border from 2010 through 2015. Census collects electronic export information in AES to report trade statistics, including the export of duty-free cigarettes. Stores that are principal parties to a sale of duty-free cigarettes for export generally self-report the transaction through AES.¹ Some duty-free operators integrate point-of-sales systems to AES for automatic entry, and some enter the data manually or into software programs that are approved by Census, according to U.S. Customs and Border Protection (CBP) officials. Self-reported data captured in AES include transaction-related variables such as date of export, port of export, value, quantity, weight, method of transportation, and ultimate consignee. Census then uses the AES data to compile and publish export trade statistics.

CBP and Census share responsibility for monitoring compliance with trade law, including the data reporting requirements that duty-free stores must meet.² According to CBP officials, CBP officers regularly review duty-free store operators' inventory control and recordkeeping systems during unannounced spot checks and compliance assessments. However, according to these officials, CBP's compliance reviews of inventory control systems do not generally include an examination of how

¹The Foreign Trade Regulations generally require that the U.S. principal party in interest (USPPI) or its agent file electronic export information through AES for each transaction where the value of the goods is more than \$2,500 by Schedule B of the Harmonized Tariff Schedule of the United States. 15 C.F.R. §§ 30.2(a), 30.37(a). Generally, the USPPI is the U.S. seller, manufacturer, or order party, or the foreign entity while in the United States when purchasing or obtaining the goods for export. 15 C.F.R. § 30.1. According to Census officials, individuals may also be the beneficiary of a duty-free sale, in which case the individual (not a store) must report information to AES.

²CBP classifies duty-free stores as bonded warehouses and regulates these stores similarly to other bonded warehouses.

store operators report data in AES. AES is built to include automated electronic checks of stores' AES submissions as the data are entered; these data-entry validation checks produce alerts when required information is invalid or missing. Census also sometimes sends staff to meet with companies that have a high rate of submission errors, such as reporting shipments late.

If they identify problems with the accuracy of the information that store operators are filing in AES, CBP and Census can take appropriate steps to enforce compliance with the law. CBP is responsible for the enforcement of the Foreign Trade Regulations.³ When data are incorrectly entered in AES, CBP can take enforcement action, including issuing penalties or seizing merchandise, according to CBP officials. Census can also respond to noncompliant reporting of electronic export information by operators by revoking special privileges granted to some, such as permission to file export information after a shipment has been exported, among other actions.⁴ In compiling and analyzing AES data, Census makes corrections to some data that appear erroneous, but CBP officials said that Census does not flag or report the data corrections it makes to CBP. Census officials stated that, while they reach out to some filers to suggest corrective action, the scale of the trade data program and the number of transactions processed every month precludes comprehensive outreach.

Duty-Free Cigarette Data Collected through AES Are Not Reliable for Analysis of Value and Quantity of Exports or Associated Trends

Evaluating Unprocessed, Transaction-Level AES Data on Duty-Free Cigarettes

Our testing found that the unprocessed transaction-level AES data on duty-free cigarettes for 2010 through 2015 are not reliable for use in describing the value and quantity of duty-free cigarettes, and associated trends, exported from the southwest border. For that time period, we

³15 C.F.R. § 30.73. Immigration and Customs Enforcement may also enforce Foreign Trade Regulations.

⁴15 C.F.R. § 30.5(c)(3).

received data on 18,504 transactions of duty-free cigarettes that had a reported value of \$2,500 or above, in keeping with AES reporting requirements. To examine the data on value and quantity, we evaluated the reasonableness of the ratio of these variables, the unit price (value divided by quantity), and the consistency and stability of reported prices. We found that many of these transactions' reported unit prices are far below reasonable price levels. For example, 2.3 percent of transactions in these unprocessed data are associated with a unit price of under \$4.42 per 1,000 cigarette sticks—the cost of tobacco on commodity markets as of calendar year 2015, which excludes necessary costs of cigarettes such as paper costs and manufacturing costs.⁵ However, these transactions with extremely low unit prices account for more than 98 percent of the quantity of trade in duty-free cigarettes as reported in the AES data we obtained.⁶ Moreover, 39 percent of the reported transactions (accounting for more than 99.6 percent of the total reported quantity sold) were associated with unit prices lower than what we conservatively estimate to be the price at which duty-free stores could procure cigarettes from manufacturers, as discussed in the section below.⁷ We also found high levels of reported price variation in the data, with reported median unit sales prices frequently doubling or halving from year to year, even within the same port location.

Evaluating Census's Data-Processing Methodology and Assumptions

Census is responsible for collecting, compiling, and publishing AES trade data for duty-free cigarettes, and Census officials said that they clean and

⁵According to the World Bank Global Economic Monitor Commodities DataBank, the 2015 global commodity price for tobacco was \$4,908.30 per metric ton (nominal 2015 USD). According to Organisation for Economic Co-operation and Development Health Statistics 2016, U.S. cigarettes contain an estimated average 0.9 grams of tobacco per stick.

⁶A number of transactions in the data had even more extreme reported prices. For example, 73 percent of the reported quantity of cigarettes exported had a reported sales price of under \$0.01 per 1,000 cigarette sticks. Separately, numerous transactions were reported with large transaction sizes. For example, 256 transactions were reported with a quantity exported of 100,000,000 or more cigarettes.

⁷As discussed below, Census has established a price range for cigarettes to identify "outlier" transactions that require correction. Thirty-nine percent of transactions in the raw data are also associated with prices that would be considered outliers under Census's current price range, and 95 percent would be considered outliers under the price range that Census was using at the time the data were collected.

correct (process) these data by changing value entries to equal a “price adjustment factor” when the unit price of transactions falls outside of an expected range, as explained below. For cigarette exports as of February 2017, including those transactions exempt from taxes and duties, these officials said that this range includes a minimum of \$11 per 1,000 cigarette sticks, a price adjustment factor of \$40 per 1,000 sticks, and a maximum of \$75 per 1,000 sticks. According to these officials, Census sets its price range and adjustment factor by examining the data and identifying outlier levels based on judgment. Census officials stated that they updated this expected price range in February 2017. Census officials stated that price adjustment factors are not updated on a fixed schedule and do not automatically adjust for inflation. Instead, Census may choose to update factors when it believes there have been significant changes in an industry’s trade patterns. According to these officials, prior to February 2017, the price range for cigarettes was last updated in 2007. From 2007 through January 2017, the price adjustment factor for cigarettes was \$11.46—about one-fourth of its current value—with a minimum of \$8.87 and a maximum of \$27.39.

Census’s current price range for cigarettes is not appropriate for cleaning data to analyze trends in duty-free cigarette exports because it may significantly underestimate a reasonable expected price range for cigarettes. Approximately 39 percent of the observations in the unprocessed, duty-free cigarette data are associated with sales prices below Census’s minimum price or above Census’s maximum price. We estimated minimum and maximum expected prices for cigarettes that are substantially greater than Census’s current price adjustment factor range for cigarettes.

- To estimate a minimum expected price for cigarettes, we examined commodity prices, production costs, and revenue data from a large, publicly traded cigarette manufacturer.⁸ We found that the manufacturing cost of cigarettes exceeded Census’s estimated minimum sales price by 30 percent, \$14.26 per 1,000 cigarette sticks

⁸Business models, including revenue and cost ratios, may vary greatly within an industry. To ensure that our estimate of minimum costs is conservative, we have based our analysis on a large manufacturer that is likely to have reduced costs through economies of scale.

instead of \$11.⁹ Thus, even if the manufacturer sold its cigarettes directly to a duty-free store, and neither the manufacturer nor the duty-free store made a profit, we would still expect a price greater than Census's lower bound.

- This expected minimum retail price increases significantly if we account for cigarette manufacturers' revenue. Using revenue data from the public accounting statements of the same manufacturer, and again conservatively assuming direct sales to a duty-free store that itself sells for no profit, we would expect to see a price of \$43.65 per 1,000 cigarette sticks, which is nearly 300 percent greater than Census's lower bound of \$11 per 1,000 cigarette sticks and about 9 percent larger than Census's current price adjustment factor of \$40 per 1,000 sticks.¹⁰
- To estimate a maximum expected price for cigarettes, we examined the price of a premium cigarette brand listed for sale on a duty-free store's website. We found that this price was 163 percent higher than the upper bound in Census's price range, \$197.50 per 1,000 cigarette sticks instead of \$75 per 1,000 sticks.¹¹

For any observed prices in trade data outside of this expected range for a given tariff code, Census officials said that they attempt to correct these observations by adjusting the reported quantity such that the reported price is equal to the price adjustment factor—\$40 per 1,000 cigarette sticks. For example, if a reported sale is \$80 per 1,000 cigarette sticks, Census will adjust the reported quantity to 2,000 sticks while leaving the reported value unchanged, so the reported price (value divided by quantity) becomes \$40 for each unit of 1,000 sticks. Census officials

⁹Our analysis of the manufacturer's production costs includes variable costs, such as raw materials, but excludes fixed costs, such as facilities and equipment purchased to manufacture the cigarettes. The above estimates use Census's current price adjustment factor range. From 2010 through 2015, the period during which the data we reviewed were reported, Census would have used a price adjustment minimum of \$8.87. Our estimated manufacturing cost exceeds this amount by 61 percent.

¹⁰The manufacturer's sales price estimate is less conservative than the raw materials cost as an estimate of the minimum possible retail sales price but is still a conservative estimate because, as noted above, it assumes no intermediate costs and no profit by the retail store. The above estimates use Census's current price adjustment factor range. Our estimated manufacturer's sales price is, respectively, 392 percent and 281 percent greater than the price adjustment minimum of \$8.87 and factor of \$11.46 that Census would have used during the 2010 through 2015 time period that our data were reported, respectively.

¹¹Our estimated maximum of \$197.50 is 621 percent greater than the price adjustment maximum of \$27.39 that Census would have used during the 2010 through 2015 time period that our data were reported.

stated that this data cleaning process is sufficient for their use in producing aggregated trade statistics because of the volume of transactions they must review and the ease with which Census analysts can apply this method to clean trade data.¹²

Census's process of correcting missing or outlying data (unreliable data) with its price adjustment factor is not appropriate for our use because it would significantly alter the relationships among subgroups within our data, distorting trends that we otherwise would intend to analyze. For example, in a hypothetical dataset where the average sales price is \$40 per 1,000 cigarette sticks across exports from the United States, Census's replacement of missing and outlying data using a price adjustment factor of \$40 would not change this overall average. But if one state in the data has an average sales price lower than the national average, reflecting lower costs of doing business, any missing or outlying data replaced with the same price adjustment factor as other higher costing states would increase the state's reported average sales price. The distinction between high-price states and low-price states would thus become less clear.

Moreover, we cannot determine the appropriateness of Census's decision to preserve reported value and adjust reported quantity when processing data to manage the relationship between value, quantity, and price. This is because we cannot determine whether the unprocessed value or the unprocessed quantity data are reliable. Applying our minimum expected price for cigarettes, discussed above, excludes many transactions in the unprocessed data, indicating problems with value, quantity, or both. Census officials stated that they believe the value data are more reliable than the quantity data and so change the reported quantity data when processing the data, though they also stated that this is a general assumption without specific insight as to whether or why this method may be valid for cigarettes. While CBP officials stated that high-level postaudit checks can be used to ensure that a store's AES system is working properly, they said that these checks are rare, and the inventory control system compliance review does not otherwise provide assurance that data self-reported into AES are reliable. CBP officials stated that they were not confident about which transaction data in AES were more

¹²Census officials stated that, as resources allow, they continue to evaluate other cleaning methods that may improve the quality of monthly trade statistics but that these efforts are limited by the complexity and variability of trade patterns across more than 9,000 Schedule B tariff codes.

reliable: value or quantity.¹³ Because neither agency's control process provides strong assurance that either the value or the quantity data are reliable for our use, we cannot appropriately use value, quantity, or price as a benchmark to correct the other variables.

¹³CBP officials said that the agency's compliance review process, which regularly evaluates stores' inventory control systems, provides stronger assurance that quantity data generated by the stores' inventory control systems are more reliable than value data. However, there is not necessarily any linkage between a store's inventory control system and AES.

Evaluating Alternative Data-Processing Techniques

Alternative methods for determining appropriate replacement values for outlying data, referred to as imputation, would not make the duty-free cigarette data reliable for our intended use. For example, stochastic regression imputation replaces a missing or excluded variable value within an observation by drawing randomly from within the error distribution of a best-fit model. Correctly specifying such a model allows data processing to occur while preserving the dataset's overall average values, correlations, and variation. However, identifying the observations that require correction remains a challenge. As discussed above, we can estimate the approximate manufacturer's sales price for cigarettes. In the absence of additional proprietary data, we are unable to determine a price range that accounts for retail store costs and profit. Without this information, and given that the duty-free cigarette data include significant and questionable variation of reported prices even within our estimated price band, it is not possible to identify which observations require correction or deletion with appropriate levels of confidence. Lacking a clear basis for finding either the value data or quantity data reliable, we also cannot appropriately determine how to manage the relationship between value and quantity if we were to impute replacement price levels for these observations.

Appendix III: Comments from the Department of Homeland Security

U.S. Department of Homeland Security
Washington, DC 20528



**Homeland
Security**

September 20, 2017

David Gootnick
Director, International Affairs and Trade
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Re: Management's Response to Draft Report GAO-18-21, "TOBACCO TRADE: Duty-Free Cigarettes Legally Sold in Unlimited Quantities on the U.S.-Mexico Border Pose Customs Challenges"

Dear Mr. Gootnick:

Thank you for the opportunity to review and comment on this draft report. The U.S. Department of Homeland Security (DHS) appreciates the U.S. Government Accountability Office's (GAO) work in planning and conducting its review and issuing this report.

DHS is pleased to note GAO's recognition of the U.S. Customs and Border Protection (CBP) efforts to enforce relevant regulations and procedures to prevent attempts to evade U.S. export-only tobacco taxes and laws. CBP's Office of Field Operations continues to work with duty-free store operators and exporters to ensure they are compliant with reporting requirements for the sale of export-only tobacco.

The draft report contained one recommendation with which the Department concurs. Attached find our detailed response to the recommendation.

Again, thank you for the opportunity to review and comment on this draft report. Technical comments were previously provided under separate cover. Please feel free to contact me if you have any questions. We look forward to working with you again in the future.

Sincerely,

A handwritten signature in black ink, appearing to read "Jim H. Crumpacker".

JIM H. CRUMPACKER, CIA, CFE
Director
Departmental GAO-OIG Liaison Office

Attachment

**Attachment: DHS Management Response to Recommendation
Contained in GAO-18-21**

GAO recommended that the Commissioner of U.S. Customs and Border Protection:

Recommendation 1: Strengthen compliance with export reporting requirements related to duty-free cigarette sales on the southwest border, such as issuing guidance to all duty-free store operators.

Response: Concur. CBP's Office of Field Operations, Cargo and Conveyance Security, Cargo Security and Controls will issue guidance and muster field personnel in order to strengthen compliance with export requirements. In addition, ports will be instructed to provide guidance to all duty-free store operators on the requirement to use the correct port of export for goods being exported from a duty free store. Additional guidance will be issued regarding the requirement for correct filing of the Electronic Export Information (EEI) specifically identifying the United States Principal Party in Interest (USPPI), responsible for filing the EEI. This guidance will also discuss how to determine whether the USPPI is approved for post departure filing status and the appropriate timeframes for filing the EEI on a pre-departure and post departure basis. Estimated Completion Date: October 31, 2017.

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

David Gootnick, (202) 512-3149 or gootnickd@gao.gov

Staff Acknowledgments

In addition to the contact named above, Emil Friberg (Assistant Director), Farhanaz Kermalli (Analyst-in-Charge), Giff Howland, David Dayton, Neil Doherty, Andrew Kurtzman, and Grace Lui made key contributions to this report. Pedro Almoguera, Ming Chen, Jill Lacey, and Mary Moutsos provided technical assistance.

Appendix V: Accessible Data

Agency Comment Letter

Text of Appendix III: Comments from the Department of
Homeland Security

Page 1

September 20, 2017

David Gootnick

Director, International Affairs and Trade

U.S. Government Accountability Office 441 G Street, NW

Washington, DC 20548

Re: Management's Response to Draft Report GAO-18-21, "TOBACCO
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Director

Departmental GAO-OIG Liaison Office

Attachment

Page 2

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Recommendation 1: Strengthen compliance with export reporting requirements related to duty-free cigarette sales on the southwest border, such as issuing guidance to all duty-free store operators.

Response: Concur. CBP's Office of Field Operations, Cargo and Conveyance Security, Cargo Security and Controls will issue guidance and muster field personnel in order to strengthen compliance with export

requirements. In addition, ports will be instructed to provide guidance to all duty-free store operators on the requirement to use the correct port of export for goods being exported from a duty free store. Additional guidance will be issued regarding the requirement for correct filing of the Electronic Export Information (EEI) specifically identifying the United States Principal Party in Interest (USPPI) , responsible for filing the EEI. This guidance will also discuss how to determine whether the USPPI is approved for post departure filing status and the appropriate timeframes for filing the EEI on a pre-departure and post departure basis. Estimated Completion Date: October 31, 2017.

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