
January 1996

TAX
ADMINISTRATION

Diesel Fuel Excise
Tax Change





United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-260143

January 16, 1996

The Honorable Daniel Patrick Moynihan
Ranking Minority Member
Committee on Finance
United States Senate

Dear Senator Moynihan:

In 1993, we briefed your office on potential improvements in the administration of diesel fuel excise taxes that could result from moving the tax collection point from the wholesale level to the terminal level in the distribution system and dyeing fuel not subject to the tax. The Federal Highway Administration (FHWA) and certain motor fuel industry representatives also presented Congress information on the merits of these changes to diesel fuel excise taxation. Congress adopted this revised approach for diesel fuel excise taxation in the Omnibus Budget Reconciliation Act (OBRA) of 1993.

Subsequently, you asked us to report on the changes in tax collections since the OBRA 1993 requirements were enacted. You also asked that we evaluate whether the most prominent concerns of stakeholders regarding the Internal Revenue Service's (IRS) regulations implementing the new diesel fuel taxation requirements had been adequately addressed in the regulations, or whether additional regulatory or statutory changes may be needed. Accordingly, this report discusses (1) changes in diesel fuel excise taxes collected in calendar year 1994, (2) IRS' responses to prominent concerns raised in comments to IRS on its regulations implementing the OBRA 1993 changes to the taxation of diesel fuel, and (3) unaddressed concerns regarding the regulations. In addition, we provide information on recent fraudulent claims for motor fuels excise tax refunds.

In doing our work, we reviewed the comments provided to IRS in response to its proposed regulations implementing the OBRA 1993 diesel excise tax requirements and interviewed IRS and other federal officials, as well as representatives of selected organizations that commented on the regulations. We did our work from July 1994 through October 1995 in accordance with generally accepted government auditing standards. See appendix I for further details on our objectives, scope, and methodology. We obtained oral comments from IRS on a draft of this report, and these comments are discussed on page 14.

Background

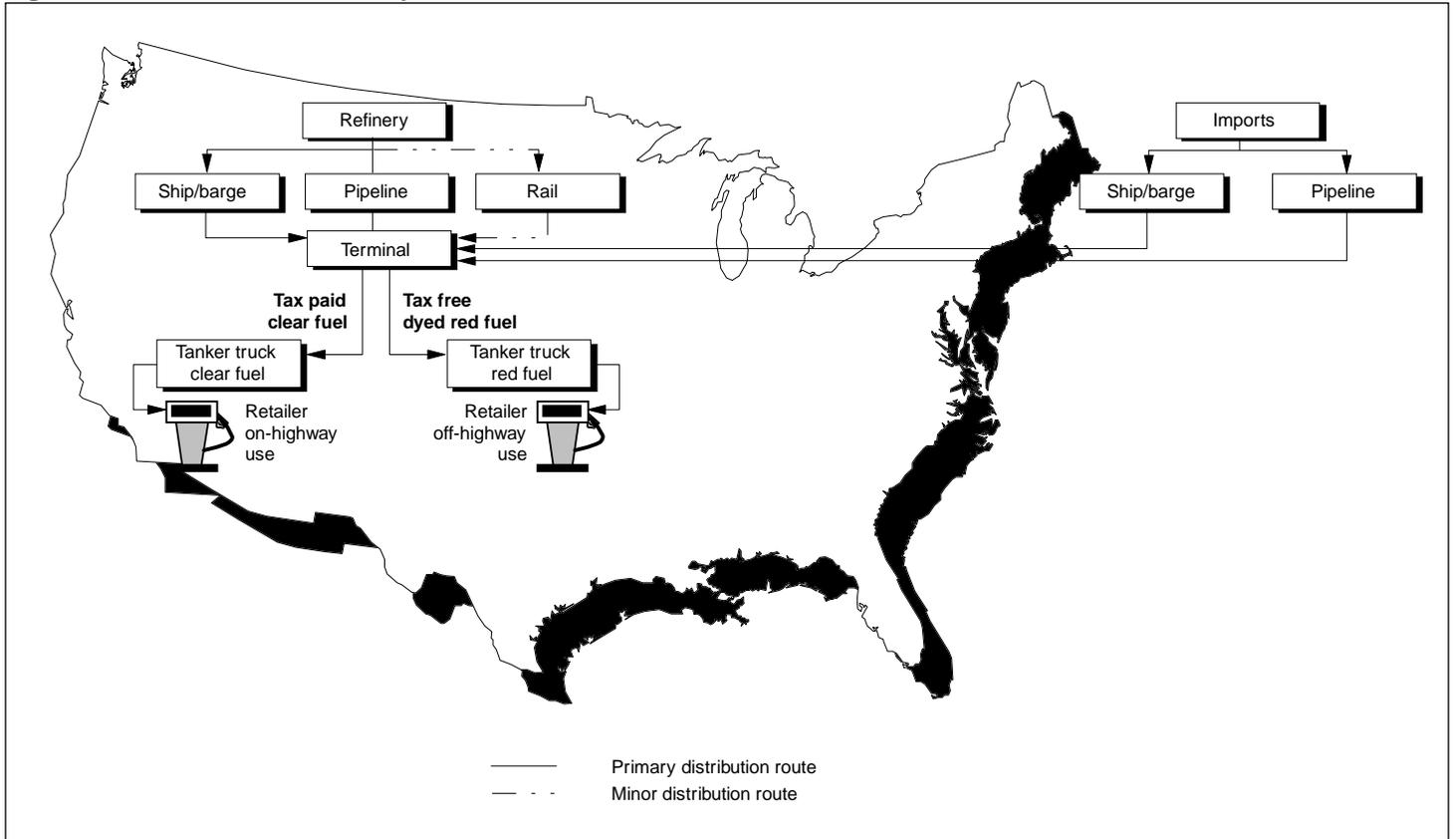
The federal government generally imposes an excise tax of 24.4 cents per gallon on diesel fuel that is used on highways. In calendar year 1994, diesel excise tax collections totaled about \$6.7 billion. Although most of the funds collected by IRS are transferred to the Federal Highway Trust Fund, 6.8 cents per gallon goes to Treasury's general fund¹ and 0.1 cent goes to the Leaking Underground Storage Tank Fund. Diesel fuel for off-highway use, such as home heating or construction, is not taxed. Certain entities—for example, state and local governments—are exempt from paying tax on diesel fuel they use on highways.

In order to strengthen the enforcement of diesel fuel tax collection, OBRA 1993 provisions moved the tax collection point from the wholesale to the terminal level and required that any diesel fuel removed from the terminal for tax-free use must be dyed.² (See figure 1.) Under this system, the position holder—the party that has contracted with the terminal operator to store fuel in a terminal—is liable for the diesel fuel tax when the fuel is removed from the terminal, which frequently occurs when the fuel is sold to a distributor who then picks it up at the terminal. The position holder is to forward the taxes to IRS. If this tax-paid fuel is subsequently sold for a tax-free use, IRS is to refund the tax to purchasers or sellers, or provide credits against other taxes, depending on the specific situation.

¹As of October 1, 1995, 4.3 cents per gallon will go to the general fund, and the difference, 2.5 cents, will be added to the amounts transferred to the Highway Trust Fund.

²In the case of high sulfur diesel fuel, the dye is usually added at the refinery.

Figure 1: Diesel Fuel Distribution System



The OBRA 1993 changes were made in an effort to curtail diesel fuel tax evasion schemes that had been estimated by FHWA, within the Department of Transportation, to cost the federal government several hundred million dollars a year. Environmental Protection Agency (EPA) regulations also require dyeing of high sulfur diesel fuel to help assure that only low sulfur diesel fuel is used on the highways.

IRS issued temporary regulations to implement the OBRA provisions on November 30, 1993. In response to these temporary regulations, IRS received comments from various groups representing sectors of the agriculture, petroleum, transportation, and recreation industries. In addition, FHWA, Federal Aviation Administration (FAA), EPA, and some Department of Defense groups expressed concerns about IRS' temporary regulations. Subsequent changes implemented on October 1, 1994,

provided that all tax-exempt diesel fuel is to be dyed one color and revised the language specifying the concentration level of the dye.

Results in Brief

The new diesel excise taxation approach appears to be having the desired effect. IRS' preliminary data indicate that diesel excise tax collections increased about \$1.2 billion, or 22.5 percent, in calendar year 1994 as compared with 1993. This increase does not include additional revenues due to the OBRA 1993 increase of 4.3 cents per gallon in the tax rate. After adjusting for increased refund and credit amounts, and for a portion of the increase that may be due to economic growth, the Treasury Department estimated that an increase of \$600 million to \$700 million was solely the result of increased compliance.

IRS has addressed two of the prominent concerns about the dyeing requirements that stakeholders expressed in their comments on IRS' November 30, 1993, temporary regulations. IRS settled on one dye color (red) rather than two and, for the time being, declined to require the use of colorless markers. Perhaps the most significant unaddressed concern that could affect tax collection relates to the definition of, and collection of excise taxes on, products (chiefly kerosene) that are added to on-highway diesel fuel after the fuel leaves the terminal. The Treasury Department has expressed support for a legislative proposal that would treat kerosene as if it were diesel fuel—i.e., by mandating the dyeing of nontaxed kerosene. However, before this proposal could be implemented, a system would be needed to account for kerosene sales for use in home space heaters. In addition, concerns remain about such things as the concentration of dye required by IRS and the impact of the dyeing requirements on diesel fuel availability at marinas, especially at those that have only one diesel fuel tank.

Although the new diesel taxation approach appears to be raising significant additional revenue, those who wish to defraud the system continue to have significant incentives to do so. IRS has detected several fraudulent schemes involving refunds of gasoline or diesel fuel excise taxes. IRS does not know how extensive this fraud may be. Evasion problems may persist because the incentives to evade are so great.

Diesel Excise Tax Collections Increased Significantly

Moving the point at which taxes are collected to the terminal level and dyeing diesel fuel on which the full excise taxes have not been paid, together with concerted enforcement on the highways, appear to have increased diesel excise tax collections. IRS' data for calendar year 1994

show that the excise tax collected on diesel fuel increased about \$1.2 billion, or about 22.5 percent, as compared with 1993, while total highway usage increased only about 2.2 percent in the same period, according to preliminary data. This increase does not include amounts collected as a result of the 4.3 cent per gallon increase in the tax rate itself. Treasury's Deputy Assistant Secretary for Tax Policy testified that, after taking into account increased refunds and credits and an estimate for increased collections due to economic growth, diesel fuel excise tax collections increased \$600 to \$700 million due to improved compliance alone.

IRS Addressed Two Diesel Fuel Dyeing Concerns

Several groups expressed concern in their comments on IRS' regulatory proposal about the color of the dye and whether colorless markers³ would also need to be added to diesel fuel. In its final regulations, IRS changed the color of the dye added to tax-free diesel fuel and delayed any decision to use colorless markers until the effectiveness of the current program is determined. As discussed below, we believe that IRS' responses reasonably addressed stakeholders' concerns about these issues.

Pursuant to its responsibilities for implementing provisions of the Clean Air Act, EPA had issued regulations, effective October 1, 1993, requiring that all high sulfur diesel fuel be dyed blue. This dyed fuel was prohibited for use in vehicles on the nation's highways, but was permitted for various off-highway uses. IRS, in its November 30, 1993, temporary regulations, similarly required that untaxed high sulfur diesel fuel be dyed blue and also required that untaxed low sulfur diesel fuel be dyed red. Thus, diesel fuel dyed either blue or red would have been tax-exempt and not allowed for highway use.

Concerns were expressed by FAA and others that blue-dyed diesel fuel might be mistaken for blue or green aviation fuel. The potential existed for misfueling aircraft in remote locations where fuels are dispensed into nonstandard containers or where different fuels are stored in similar containers in close proximity to each other. EPA and IRS agreed that, after September 30, 1994, all tax-exempt diesel fuel, both low and high sulfur, would be dyed red.

OBRA 1993 also permits IRS to require the use of colorless markers, which like dye would be used to differentiate between taxed and untaxed diesel fuel. In its November 1993 regulations, IRS asked for comments on the use

³The preamble to IRS' regulations states that a colorless marker "is a material that does not reveal its presence until the fuel into which it is introduced is subjected to a special test."

of such markers. Several stakeholders said that adding a colorless marker requirement to the dyeing requirement would be overly burdensome and complex. IRS officials told us that they are monitoring compliance with the current tax scheme and will consider requiring colorless markers in the future if necessary.

Unaddressed Concerns

Some concerns expressed by stakeholders remain. For example, IRS is studying how to address what may be the principal open concern that could affect tax collections—the taxation of diesel fuel additives. In July 1995, the Treasury Department expressed support for applying the same dyeing regime to kerosene as is applied to diesel fuel. For this and other concerns, proposals have been offered in Congress or suggested to IRS, but tradeoffs must be considered by policymakers.

Concerns Over Additives to Diesel Fuel

According to IRS officials, the most complex diesel fuel excise tax regulatory problem is the definition and collection of excise taxes on products—primarily kerosene—that are added to diesel fuel for use on the highway. Generally, such products are added to diesel fuel after the fuel leaves the terminal. Fuel excise taxes are intended to be collected on each gallon of fuel used on the highway, including any additives, so that the tax revenues can be used to maintain and improve the highway system. Consequently, IRS requires any party mixing additives into diesel fuel to be used on highways to pay tax on those additives.

Under current federal excise tax regulations, kerosene is not treated as a diesel fuel and is generally neither taxed nor dyed when removed from the terminal. The final IRS regulations do not define kerosene. Industry sources tell us that kerosene, as used in commerce and as regulated by state governments, generally must meet the requirements of American Society of Testing and Materials Standard D 3669, Standard Specification for Kerosene.⁴ Fuels such as No.1 fuel oil (No.1 furnace or heating oil), No.1 diesel fuel, and jet fuel, may be formulated to satisfy all the requirements for kerosene, as well as the requirements specific to these fuels. Many refiners produce a multipurpose No.1 fuel that is refined to meet requirements for one or more of the fuel types listed above—all of which may be referred to generically as kerosene.

⁴These requirements include flash point, distillation requirements, viscosity, total sulfur content, mercaptan sulfur content, copper corrosion rating, freezing point, color, and burning quality.

However, undyed tax-free kerosene or waste oil (i.e., used crankcase oil) can be used in blending schemes (called “cocktailing”) that could result in excise tax evasion. For example, a dishonest retailer could take two gallons of tax-paid diesel fuel and mix it with one gallon of undyed kerosene on which no tax has been paid. The retailer now has three gallons of cocktailed diesel fuel, but has only paid tax on two gallons of the product. The retailer can sell the cocktailed diesel fuel at full normal retail price and pocket the avoided tax as profit. Alternatively, the retailer could reduce the retail price somewhat, draw business from honest competitors, and still pocket that portion of the avoided tax not used to discount the fuel price.

Deliberate attempts to avoid taxation by blending untaxed kerosene into diesel fuel aside, the many legitimate on- and off-highway uses of kerosene make its taxation in the case of highway use difficult to regulate and enforce. Industry sources say over 90 percent of the kerosene/No.1 fuel produced in the United States is used either for home heating or as aviation jet fuel, neither of which is subject to the excise tax. However, in the winter months, kerosene is also used to lower the cloud point⁵ for No.2 diesel in diesel engines used both on and off the highway. During the cold winter months, the No.2 diesel fuel normally used in diesel engines may require more than 30 percent kerosene or other No.1 fuel so that it will not clog fuel lines and filters. Kerosene also may be mixed with diesel fuel in outdoor storage tanks for furnaces used to heat buildings. Finally, kerosene is also used in indoor, unvented home space heaters that, for safety reasons, require “clear” kerosene—another nontaxable use.

Recognizing the potential difficulties for diesel fuel excise taxation arising from the mixing of kerosene and other additives into taxable diesel fuel, IRS established a task force to fully explore the issues and options involved. In July 1995, the Treasury Department’s Deputy Assistant Secretary for Tax Policy, expressed support for subjecting kerosene to the same dyeing requirements as now apply to diesel fuel. However, the Deputy Assistant Secretary said that Treasury would need to work with Congress to develop a system for handling tax-free sales of clear kerosene to consumers for use in home space heaters. Treasury and IRS officials believed that retailers would be authorized to apply for refunds of the taxes on their sales of kerosene for tax-exempt uses. Because thousands

⁵Kerosene is used as a winter blend component for diesel fuel and heating oil throughout the industry. As much as 20 percent of diesel fuel can consist of heavy paraffin hydrocarbons that, when cooled, will form wax. The cloud point is the temperature at which wax crystals start to form in the fuel. The lower the cloud point the less likely that the fuel filter will get plugged, stopping fuel flow.

of retailers could apply for these refunds, IRS would be faced with large numbers of refunds to process and taxpayers to monitor and audit.

Dye Concentration Concerns

In addition to the foregoing concerns, several stakeholders commented that IRS had required too high a concentration of red dye. These stakeholders were concerned that the high concentration of dye might adversely affect engines and be difficult to remove from storage tanks. In its June 30, 1994, final regulations, IRS did not reduce the concentration of dye.⁶ IRS officials maintained the original dye level because dilution of dyed fuel was considered to be a likely tax-evasion tactic.

Some industry officials, however, said that the required dye concentration continues to impose an unnecessary burden on the petroleum industry. A major pipeline company, for example, explained that, when diesel fuel dyed at IRS' required concentration is pumped through a pipeline, the dye contaminates adjacent products in the pipeline. Once contaminated, the adjacent product may have to be sold for a less valuable use. This pipeline company also said that on several occasions its aviation kerosene had been rejected by purchasers due to tinting with red dye. Aviation companies will not accept kerosene containing dye due to concerns about the dye's possible adverse effect on jet engines.

To respond to these concerns, some petroleum industry members want IRS to reduce the required concentration of dye. Both IRS and some industry members have diluted samples of dyed diesel by adding undyed fuel, to determine whether the fuel still maintains a visible dye presence. IRS believes that its demonstrations support the current dye concentration, while industry members believe that their diluted fuel samples show that a visible dye presence remains after dilution even when the initial dye concentration is considerably lower. This difference of opinion about the acceptability of a lower dye concentration seems to center on "dark" diesel fuel. Diesel fuel that is naturally dark in color may not show a visible dye presence upon dilution unless the initial dye concentration is at the IRS standard. Although such dark diesel fuel may not play a large part in the diesel fuel market, IRS officials are concerned that those intent on evading the law could darken other diesel fuel by adding some agent.

One stakeholder proposal is for IRS to reduce the dye concentration for a 1-year trial period. During this period, IRS would monitor the effect on

⁶IRS restated how the dye concentration would be determined, but this did not affect the actual concentration of dye required to be present in nontaxed diesel fuel.

compliance levels and on the petroleum industry. Based on this trial, dye concentrations might then be permanently lowered.

Recreational Boaters' Concerns About Availability of Tax Paid Diesel Fuel

Another unresolved concern is that the excise taxes may reduce the availability of diesel fuel for recreational boating use. Before the OBRA 1993 requirements were enacted, fuel used in diesel-powered boats was not subject to the federal diesel fuel excise tax. Congress then extended the excise tax to apply to diesel fuel used in noncommercial boats.

Pleasure boat owners and builders are concerned about the availability of clear tax-paid diesel fuel. Pleasure boat owners that use diesel fuel now must use undyed fuel and pay the 24.4 cent per gallon federal excise tax. On the other hand, commercial boats, which include chartered fishing boats and cruise boats, may use dyed (tax-free) diesel fuel. Marinas that choose to serve both commercial and noncommercial users thus need separate storage tanks for each fuel.

According to representatives of the recreational boat industry, many marine fuel retailers have only one storage tank for diesel fuel. Various stakeholders told IRS that physical, environmental, and economic restrictions may make the cost of adding another diesel storage tank prohibitive. If retailers were unable to add a second storage tank, they would be forced to choose between selling undyed (tax-paid) diesel fuel and selling the dyed (tax-free) variety. As a result, undyed (tax-paid) diesel fuel might not be available to the recreational user, or the commercial user might have to buy tax-paid fuel and then apply for a refund.

While recreational boating industry representatives suggested to IRS that locating undyed diesel fuel would be a major problem for recreational boaters, we were unable to find databases that quantified the availability of undyed fuel at marinas. During the summer of 1995, the Treasury Department did a limited survey of portions of the country that were thought to have the greatest problem with diesel fuel availability for recreational boaters. According to Treasury, clear diesel fuel generally was available in a marina retail fuel outlet in each of these areas. We did not verify the survey results.

Legislation has been introduced (H.R. 2491) to delay the tax on diesel fuel for recreational boating for 2 years while a solution is worked out. Such a solution might either allow recreational boaters to use dyed fuel and require the retailer to collect the excise tax, or exempt the recreational

boating community from the tax altogether. Allowing recreational boaters to use dyed fuel and requiring retailers to collect and remit the tax would both impose a burden on the retailers and present IRS with the difficult task of monitoring retailers' compliance. However, under this scenario, the potential for evasion might be limited largely to inaccurate collection or remittance of the tax by retailers.

Request to Exempt Alaska From Diesel Dyeing

Some Alaskan residents asked IRS to exempt their state from the diesel-dyeing requirements. The requesters explained that Alaska is exempt from the Clean Air Act of 1990 requirement that high sulfur diesel be dyed,⁷ and they indicated that 90 percent of all diesel used in the state was used for nontaxable purposes. The Alaska Income and Excise Audit Department provided us with data that showed that over 90 percent of all diesel fuel used in the state in fiscal year 1994 was used for tax-exempt purposes.⁸ Legislation would be required to exempt Alaska from OBRA 1993 diesel-dyeing requirements.

In July 1995, the Deputy Assistant Secretary of the Treasury said that the department supports exempting Alaska from the diesel-dyeing requirement. Should Congress grant this request for exemption from the dyeing requirement for diesel used for off-highway purposes, there would be a potential for evasion of a modest amount of federal excise taxes in Alaska, a potential that would not exist in other states. During fiscal year 1994, Alaska used over 61 million gallons of diesel fuel for on-highway purposes. Thus, the potential to evade some portion of the \$14.6 million in federal diesel fuel excise taxes paid in Alaska would exist.

In addition to the potential for some evasion of diesel fuel taxes within Alaska itself, an IRS official said that potential for interstate evasion existed as well. One possible evasion tactic consists of loading clear, untaxed diesel fuel instead of water as ballast in barges returning to the mainland United States. The IRS official said that IRS would work with the Coast Guard and Customs to prevent such evasions.

Intercity Bus Companies' Concerns

Intercity bus companies have been concerned that the diesel-dyeing requirements may adversely affect both their ability to comply with EPA regulations and their operating costs.

⁷The Clean Air Act permits EPA to temporarily exempt Alaska and Hawaii from the dyeing requirement if asked. Alaska requested an exemption. The exemption was granted, but it expires at the end of 1996.

⁸This does not include 787.8 million gallons of jet fuel (probably kerosene).

IRS requires that any diesel fuel on which the full federal tax rate of 24.4 cents per gallon has not been paid be dyed when it is removed from a terminal. The requirement does not differentiate between high and low sulfur fuels. However, intercity buses are required by EPA regulation to use low sulfur diesel fuel on the highway. Intercity buses also qualify for a reduced diesel tax rate of 7.4 cents per gallon. Thus, if companies were to purchase tax-free diesel and pay the 7.4 cent per gallon tax to IRS, the diesel fuel would be dyed red, and neither the bus companies nor EPA would know from the fuel color whether it was low or high sulfur diesel fuel. In this case, the companies might have difficulty ensuring that they were in compliance with the EPA regulations.

In practice, according to the American Bus Association, the diesel vendors used by intercity bus companies generally have chosen to sell undyed diesel fuel only.⁹ Since their vendors do not sell dyed low sulfur diesel fuel, bus companies must purchase clear tax-paid diesel fuel—which is low sulfur fuel. The companies' costs may increase somewhat because they must pay the full 24.4 cent per gallon excise tax and then apply for a refund of the 17 cent per gallon overpayment from IRS. These refunds can be claimed on the taxpayer's annual income tax return; or quarterly estimated income taxes, if any, may be reduced by the refund claim; or, if the total amount of refund due a bus company exceeds \$1,000 at the end of any of the first three quarters in a tax year, the company can file a separate refund claim at that time.

Legislation has been introduced in H.R. 4483 to modify section 6427(1)(5)(A) of the Internal Revenue Code by adding intercity bus operators to the group (including farmers and state and local governments) entitled to use clear fuel without, to the extent that they are exempt, paying the federal excise tax. Under this amendment, wholesalers or retailers would collect the 7.4 cent per gallon tax that intercity bus operators owe and file for an expedited refund for the remainder, following the same procedure that vendors use for farmers and state and local governments. Although this approach would help alleviate the intercity bus companies' concerns, it would increase the workload and cost imposed on wholesalers and retailers. According to IRS officials, this change could lead to hundreds or even thousands of retail vendors becoming eligible for expedited refunds, which is contrary to OBRA 1993's strategy of reducing the number of entities that IRS must monitor. In

⁹Wholesale vendors have little incentive to sell dyed low sulfur diesel fuel for buses because some of their other customers (for example, farmers and state and local governments) can purchase clear fuel on a tax-exempt basis. For these sales, the wholesale vendor can apply for a refund under the 20-day expedited refund process that was mandated in OBRA 1993.

addition, officials said that the expedited timeframe would complicate IRS' efforts to identify incorrect or fraudulent refund claims.

House Conference Report language for IRS' 1996 appropriation calls on IRS to work with appropriate congressional committees to resolve expeditiously the intercity bus companies' problem.

Incentive to Evade Motor Fuels Taxes or Obtain False Refunds Remains

Although increased diesel excise tax collections suggest that legislative and administrative changes have improved motor fuels excise tax compliance, there continues to be an incentive to evade fuel excise taxes or obtain fraudulent excise tax refunds. Combined federal and state taxes on fuels have risen in recent years and can now total \$0.40 or more per gallon. Evading just the federal tax on an 8,000-gallon truckload of diesel fuel would yield an illicit profit of \$1,920. Thus, although the government has taken steps to better assure compliance with motor fuels taxes, a strong incentive to evade these taxes remains.

One approach IRS is considering to help deter future evasion is the development of a database that would track each transaction involving motor fuels, starting at the refinery and continuing on to the lowest point in the distribution system where taxes are collected on the fuel. An August 1993 study, done for FHWA by the Volpe National Transportation System Center, estimated that the hardware and software for a nationwide tracking system would cost over \$5 million to develop and about \$3.6 million per year to operate.¹⁰ The study also estimated that private sector costs for this system would total about \$18.6 million annually. According to the study, of the eight alternatives examined, a nationwide tracking system was the best approach because (1) the cost to implement is among the lowest, (2) its effectiveness in terms of reduced evasion should be high, and (3) administrative obstacles do not appear substantial. IRS has funded the development of a working model in partnership with the state of Michigan and the petroleum industry. IRS officials estimate that a nationwide system would cost IRS between \$12 and \$15 million. However, these officials said that IRS does not have funds for the system, and funds that FHWA was to provide to develop the full system have not been appropriated.

Refund Fraud Schemes

Since 1991, IRS has identified schemes in which individuals claimed fuel tax credits and obtained refunds when they neither purchased nor used

¹⁰We did not evaluate this study.

the fuel. Although these schemes generally seem to have involved false diesel fuel tax credit claims, some may have involved gasoline. Taxpayers can claim a refundable credit for federal excise tax paid on fuel (gasoline, diesel, and other fuels) used for certain purposes. Categories of use for which fuel tax credit claims can be filed include farming, off-highway business use, exports, commercial fishing vessels, intercity or local buses, school buses, and commercial aviation. The credit is claimed by filing IRS Form 4136, Credit for Federal Tax on Fuels, with the taxpayer's Form 1040, Individual Income Tax return.

IRS identified one refund scheme involving several defendants who filed approximately 800 returns in the Houston area during 4 months in 1991. The promoters of the scheme recruited individuals to provide their names and Social Security numbers (SSN). The individuals were told that the government had programs through which they could obtain financial assistance by providing their names and SSNs. The promoters prepared false returns claiming \$1.8 million in refunds, of which \$1.3 million was paid to the promoters. Thirteen defendants were tried and convicted, and four defendants pleaded guilty.

The IRS Internal Audit unit located at the Fresno Service Center has identified other fraudulent fuel tax credit refund schemes operating in Southern California. In 1993 and 1994, Internal Audit identified Form 1040 returns that claimed a fuel tax credit over a specified threshold. During 1993, about 4,500 returns were identified. Between January 1 and June 3, 1994, about 10,500 returns were identified. IRS estimates that 87 percent (9,100) of these returns and 88 percent (\$23 million) of the fuel tax credit dollars were fraudulent-scheme-related. Internal Audit believes that only about \$3 million of the scheme-related refunds were issued to the taxpayers. Most of the fraudulent fuel tax credit return schemes included business income or losses reported on Schedule C. Verifying the accuracy of such income is difficult for IRS because it lacks independent corroborating documentation for the income. This purported income or loss was generally used as the basis for claiming both the fuel tax credit and Earned Income Tax Credits.¹¹ We were told that these cases were referred to IRS' Criminal Investigation Division.

¹¹These same return schemes also claimed \$6.5 million worth of false Earned Income Tax Credits—refundable tax credits available to certain low-income working taxpayers.

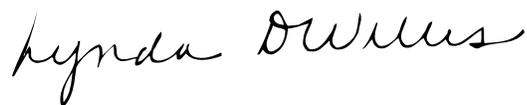
Agency Comments and Our Evaluation

We provided a draft of this report to the Commissioner of IRS for comment. On September 20, 1995, we met with IRS National Office officials, including the National Director, Office of Specialty Taxes, and other officials from the offices of Specialty Taxes and the Chief Counsel. Officials from the Chief Counsel's office were generally satisfied with the discussion of the regulations implementing the diesel fuel taxation changes. Officials from the Office of Specialty Taxes said that the draft should have assessed how well the changes required by OBRA 1993 had been implemented. They said that the diesel taxation changes had required considerable administrative change within IRS and extensive cooperation with state tax departments and others. They also noted that IRS had received an award from the Federation of Tax Administrators that was, in part, based on IRS' extensive work with state tax officials to implement the diesel fuel excise tax changes. Fully assessing how well IRS implemented the changes to the diesel fuel taxation scheme would have required an evaluation of such things as IRS' internal and external training programs and its enforcement programs. However, such an assessment was beyond the scope of our assignment, which focused on the promulgation of implementing regulations. Officials from both offices suggested several changes to improve the report's accuracy, which we have incorporated where appropriate.

As arranged with your office, unless you publicly release its contents earlier, we plan no further distribution of this report until 14 days after the date of this letter. At that time, we will send copies of this report to the Senate Committee on Finance, the House Committee on Ways and Means, other interested congressional committees, the Secretary of the Treasury, the Commissioner of IRS, and other interested parties. We will make copies available to others upon request.

The major contributors to this report are listed in appendix II. If you or your staff have any questions, please call me on (202) 512-5407.

Sincerely yours,



Lynda D. Willis
Associate Director, Tax Policy
and Administration Issues

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Figure 1: Diesel Fuel Distribution System

Abbreviations

EPA	Environmental Protection Agency
FAA	Federal Aviation Administration
FHWA	Federal Highway Administration
IRS	Internal Revenue Service
OBRA	Omnibus Budget Reconciliation Act
SSN	Social Security number

Objectives, Scope, and Methodology

Our objectives were to (1) discuss changes in diesel fuel excise taxes collected in calendar year 1994, (2) identify the most prominent complaints about IRS' regulations implementing OBRA 1993 diesel dyeing requirements, and (3) determine whether these complaints have been adequately addressed in the regulations or whether further regulatory or statutory changes may be needed.

To identify the most prominent concerns of those commenting on IRS' proposed regulations, we reviewed letters sent to IRS in response to the November 30, 1993, diesel dyeing temporary regulations. To further understand their concerns and their level of satisfaction with possible changes, we interviewed selected industry and other stakeholder officials. We judgmentally selected officials to interview in order to obtain coverage of all the prominently raised issues and of the industry segments commenting on the temporary regulations. We also sought to canvass organizations of various sizes. When several stakeholders raised the same issue, we interviewed officials from organizations that represented broad portions of the affected industry and that had most fully explained their concerns in the comment letters they provided to IRS.

We interviewed officials from (1) IRS, FHWA, EPA, and FAA; (2) the state of Alaska; and (3) the American Bus Association, the American Trucking Association, the American Petroleum Institute, the Association of American Railroads, the Independent Fuel Terminal Operators Association, the Independent Liquid Terminals Association, the Petroleum Marketers Association of America, and the Society of Independent Marketers of America.

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