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BEFORE THE  
COMMITTEE ON FINANCE  
UNITED STATES SENATE  
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Mr. Chairman and Members of the Committee, I appreciate the opportunity to describe recent compliance trends and issues in highway-related excise taxes and to highlight Internal Revenue Service activities to address them.

Background:

The IRS is responsible for administration of more than 40 separate excise taxes, including taxes on various fuels. Fuel excise taxes are an important source of federal and state revenues and finance a large share of improvements to the nation's transportation system. The separate excise taxes imposed to finance the Federal Highway Trust Fund program include the tax on gasoline, diesel fuel, and kerosene.

Gasoline, diesel fuel, and kerosene (or taxable fuel) account for more than 90 percent of trust fund receipts. When taxable fuel is removed from a terminal at the rack, it is taxed unless it is dyed diesel fuel or kerosene. The registered position holder is liable for payment of the tax. All position holders must be registered with the IRS. Additionally, terminal operators must register with the IRS as a condition of storing untaxed (undyed) motor fuels.

Taxpayers report their excise tax liability quarterly on Form 720, which is due one month following the close of the quarter. On the Form 720, taxpayers report their liability (for example, the number of gallons of each type of fuel and the tax due) and may make claims of nontaxable use of the fuel. Any balance due is paid at the time the Form 720 is filed. Taxable fuels are taxed as follows:

- gasoline at a rate of 18.4 cents per gallon; and
- diesel fuel and kerosene at 24.4 cents per gallon.

These rates include 0.1 cents per gallon to fund the Leaking Underground Storage Tax (LUST) Trust Fund.

For FY 2004, the fuel tax receipts deposited in the Federal Highway Trust Fund totaled \$35.7 billion.

## Compliance Problems

Maintaining the flow of receipts into the Highway Trust Fund requires vigorous compliance activity. Federal and state excise tax rate increases over the years have increased incentives for tax evasion, with the tax exceeding the profit margin and/or the cost of the product, in many instances. The ongoing revenue losses resulting from tax evasion are a significant problem for tax administrators and honest business taxpayers facing competition from tax evaders.

When taxpayers do not voluntarily meet their tax obligations, the IRS must use its enforcement powers to collect the taxes due. During FY 2004, IRS examined 1,293 Forms 720 and recommended \$90.2 million in additional taxes. However, we simply do not have the resources to address every case of non-compliance. Consequently, we apply the bulk of our resources to the most critical areas of excise tax noncompliance, while still maintaining coverage for all other areas.

The IRS has identified multiple points within the Fuel Distribution System (FDS) that facilitate fuel tax non-compliance. These points occur between the importation of crude oil and finished petroleum products and the ultimate use of taxable fuel. The IRS continues to address the most critical areas of excise tax non-compliance, including:

- the continued misuse of dyed diesel fuel;
- “bootlegging” to evade payment of taxes at a higher rate;
- improper declarations on import/export documents to evade payment of any and all taxes; and,
- “cocktailing” to illegally reduce the effective tax rate.

I will describe each of these in greater detail.

The first of these critical compliance problems is the continued misuse of dyed diesel fuel for tax evasion purposes. This activity persists despite the numerous legislative and regulatory steps taken by Federal and state governments. The IRS currently has approximately 120 Fuel Compliance Officers (FCOs) to monitor over 1,300 terminals, all fuel wholesalers, thousands of retail motor fuel outlets, and U.S. border crossings. Additionally, these Officers are charged with conducting periodic inspections of on-road vehicles on highways throughout the country.

The FCOs continue to uncover fuel misuse. For example, during FY 2004, the IRS FCOs conducted more than 120,000 fuel inspections and assessed over \$4.6 million in penalties for misuse of dyed diesel fuel. A further analysis of these results indicates that 70 percent of the penalties involved the misuse of fuel by taxpayers in the construction and agriculture industries. Both of these industries are subject to broad-based tax exemptions for non-highway use of motor fuels, thereby, presenting opportunities for abuse.

Fuel “bootlegging” is a second significant problem. This form of tax evasion occurs when a low tax jurisdiction is located near a high tax jurisdiction, and taxpayers scheme

to evade payment of taxes at the higher rate by “bootlegging” the fuel from the jurisdiction with the lower rate. This activity occurs between states frequently – costing states tax revenues and their share of the Federal Highway Trust Fund. For example, if the tax rate in Georgia is 7.5 cents, taxpayers may illegally bootleg the fuel for sale in North Carolina where the tax rate is 24.2 cents. The pennies-per-gallon difference is huge in an industry where over 600 million gallons of product move through the Fuel Distribution System daily. The IRS is currently partnering with its state tax counterparts to establish the first “joint compliance center.” This center will be staffed with both Federal and state enforcement personnel to share information, leads, and conduct joint examinations. This coordinated approach will allow both the IRS and state revenue organizations to better leverage resources to address this, and other, critical areas of noncompliance.

A third critical compliance problem is associated with improper declarations of motor fuel. Tax is imposed on the entry of taxable fuel into the United States. This activity involves the illegal entry of fuel to the United States in a manner that evades payment of any and all excise taxes, and occurs at border crossing points and points of entry for ocean-going vessels. There are 55 border crossings between Canada and Mexico, and more than nine million trucks cross these borders into the United States each year. Currently, these activities can only be detected by conducting border checks. Each check involves detaining a truck, reviewing the manifest, extracting a sample of the cargo, and analyzing the sample to determine if the substance matches the description on the manifest. These border checks are constrained by both the limited resources – IRS has only 120 FCOs to perform all fuel compliance activities throughout the country – and the potential disruption of international traffic due to the time required for each truck inspection under the existing processes.

In one case, we identified an evasion scheme whereby the taxpayer brought fuel into the U.S. and avoided the fuel information reporting requirements implemented in the late 1990s by diverting and storing the fuel in a facility operated by unregistered persons. We also have identified instances where individuals sought to evade the tax by misusing the bulk transfer system, which allows fuel to be moved from one barge-loading facility to another barge-loading facility tax-free. In this instance, the individuals diverted the non-taxed fuel, in route from one barge-loading facility to another, by off-loading the fuel from the barge to tanker trucks to be delivered directly to retail outlets. This illegal action enabled these individuals to bypass the intervening, and statutorily mandated, movement of the fuel from the barge-loading facility to a registered fuel terminal where the federal excise tax is imposed.

Another critical compliance problem is the use of adulterated fuel through “cocktailing” or blending the product. This tax evasion technique creates higher profits by increasing the volume of diesel fuel with used motor oil and other distillates including pollutants, cleaning agents, and unfinished refinery products. This form of tax evasion is attractive for two reasons. First, the substances used to extend the fuel are often not regulated and, hence, are not in any fuel reporting system. Second, adding substances that are regulated as waste materials to diesel fuel allows an unscrupulous individual to get paid to dispose

of the waste product(s) and then get paid again by blending the waste product in the fuel. This tax evasion technique not only results in an ongoing revenue loss, but also may be dangerous to the public when hazardous waste is blended with taxable fuels.

Even activities not connected with the taxation of fuel at terminals, such as the cleaning of barges that deliver crude oil and other products to refineries, have been linked to schemes to evade excise tax. In these examples, the barge companies pay to have the waste products that accumulate in the bottom of barges removed and disposed of properly. Individuals engaged in this “stripping” activity combine these waste products with legitimate diesel fuel destined for highway uses, as seen in a recent conviction in the state of Texas.

### Compliance Strategies and Successes:

In the last decade, there have been four major Excise Tax compliance success stories. First, moving the point of taxation for motor fuels to the terminal rack significantly reduced opportunities for tax evasion, some of which were carried out on a multi-million dollar scale by sophisticated criminal organizations. Second, requiring home heating oil and other diesel products to be dyed red if sold tax-free eliminated another key source of evasion. The third was the taxation of undyed kerosene on the same basis as the regular diesel fuel with which it is often mixed. The fourth was the implementation of the Excise Summary Terminal Activity Reporting System (ExSTARS) to collect and share information about the movement of all fuel and related products throughout the country.

### What is ExSTARS

Matching information received from employers, financial institutions, and other businesses with information reported by taxpayers has long been recognized as one of the most powerful tools that the IRS uses to ensure income tax compliance. In fact, when third parties provide information reporting to IRS (such as for interest and dividends) that is fully matchable, we find that at least 90 percent of the personal income received by taxpayers is reported.

Responding to industry concerns and recognizing that compliance with the Excise Tax laws of this country would be greatly enhanced by a similarly constructed Excise information matching system, Congress mandated the development of such a system in the 1990s. ExSTARS is the information reporting system created by this mandate. It enables the IRS to track all fuel transactions that occur within the fuel industry’s bulk shipping and storage system – pipelines, barges, and terminals. ExSTARS also provides the capability to track fuel from the pipeline system to the point of taxation for the Federal Excise Tax at the terminal rack.

The design, development, and implementation of ExSTARS is a tribute to the working collaboration between the IRS, contractors, the Federal Highway Administration, state tax administrators, and industry stakeholders over more than a five-year time period.

This success story was a direct result of the sustained investment provided by the Congress through the Transportation Equity Act for the 21<sup>st</sup> Century.

I am pleased to report that, as part of the ExSTARS implementation, we are currently receiving information on six to nine million fuel transactions monthly. Approximately 70 percent of these are filed electronically – the rest are received on paper. When the system was first rolled out in April 2001, we received information from only 894 out of 1346 (66%) registered terminals. As a result of our outreach with industry groups and individual taxpayers, we now have received information from over 96% of registered terminals. As the universe of filers has increased, we have been able to rely on the data to identify failures to comply with the information reporting requirements, identify unusual and/or questionable movements of fuel, and identify leads for possible non-compliance.

I must also report, however, that we have been limited in our efforts to use the data thus far to detect underreported tax on individual excise tax returns. While the system has been designed to perform this function, it has remained cost prohibitive to transcribe the detailed and extensive information associated with the 30% of filings that we receive on paper. I want to acknowledge this Committee for its lead role in including mandated electronic filing of information reports with 25 or more transactions in the recently passed American Jobs Creation Act. This requirement will be effective January 1, 2006. Once the database is populated sufficiently throughout 2006, we will be in a position to begin fully using the system as it was designed – to detect unreported transactions subject to excise taxes and to verify the tax liabilities reported on the quarterly Forms 720.

In addition to mandating electronic filing, Congress enacted other legislation designed to increase not only the filing compliance with ExSTARS, but also the accuracy of the data reported on the returns. Penalties of \$10,000 for the initial failure to register; failure to file ExSTARS information returns; and failure to include all required information were enacted. These penalties, coupled with the mandated electronic filing, will enable us to close the gaps in information reporting for ExSTARS.

I know this Committee is exploring several options for expanded ExSTARS reporting. If these proposals are enacted, we are prepared to work with you and all impacted stakeholders to leverage the existing technology of ExSTARS to meet the new requirements.

#### Other Key Internal Revenue Service Compliance Strategies

While ExSTARS will enhance compliance efforts, including detecting the misuse of dyed fuel, instances of willful non-compliance will continue to require IRS intervention. In several of these areas, the IRS has explored the use of technology to address excise tax evasion resulting from bootlegging, cocktailing and improper declarations.

For example, the IRS developed “fuel fingerprinting” technology to combat fuel tax evasion occurring “below the rack.” This technology examines the “chemical fingerprint” of samples taken from retail stations for adulteration, or for a mismatch with samples taken from the terminal racks that normally supply those stations. Fuel fingerprinting allows for the detection of “transmix” taken out of pipelines, waste vegetable oils, used dry-cleaning fluids, and other chemicals that may be mixed with diesel fuel and find their way into the tanks of trucks on the road. This technology, which provides a more efficient and comprehensive method to monitor compliance compared to traditional audit techniques, is currently available throughout the country. Additionally, we are expanding its use from diesel fuel to gasoline this fiscal year.

In the past, our examinations have focused on transactions arising from the sale of fuel at terminals, wholesale distributors and retail stations. This was based on the principle that the federal excise tax attaches as fuel leaves a terminal. In addition, we have had a “below the rack” compliance program to address issues around illegal blending of non-taxed products into legally taxed fuel. Now we are expanding our examination focus to address recent examples of non-compliance as products leave refineries. Refineries produce a number of petrochemical products from every barrel of oil. Only a portion of these products are taxable. We have detected instances of products such as solvents or cleaners (which are nontaxable if appropriately used for other purposes) being brought into the fuel distribution system at later stages to avoid the excise taxes due. These products are frequently blended with taxable fuel and sold on the retail market. Another example involved the disbursement of fuel from terminals under a product name that qualified for a non-taxable removal from the terminal. Millions of gallons of diesel fuel were shipped as “distillate blendstock.” The purchaser of the fuel claimed it was exported, but has been unable to provide any proof of export.

The above examples are part of an overall concern we are addressing. We have determined that 12.5 billion gallons of fuel disbursed non-bulk each year from registered terminals are classified as nontaxable. This represents over 6% of all fuel leaving these terminals and is reported to the IRS as being for industrial use. We are starting a national examination effort to verify that these disbursements are actually used for industrial purposes and not diverted for use as a fuel in a motor vehicle.

In addition, we have partnered with external parties to provide specialized training to excise agents on refinery accounting, production and shipping practices. This training gives our agents the expertise to decipher complex chemical names and to determine the true functionality of the product and whether it should be taxable. In our first examination employing these new techniques, we are proposing over \$130 million in tax and penalties, and we have made referrals on several potential criminal cases for the companies that purchased the fuel from the refineries.

Additionally, shortly after becoming Commissioner of IRS’ Small Business/Self-Employed Division, I created a National Territory dedicated to managing the fuel tax program. Once it is fully implemented, this operation will consist of a Territory Manger, five Fuel Tax Managers and 50 Fuel Tax Agents. They will receive specialized training,

including forensic accounting and auditing techniques relevant to each of the stages of the Fuel Distribution System, to enable them to better detect the inappropriate and illegal diversion of taxable fuel.

### How Can the Congress Help

The progress we have made to date is due in no small measure to the continued leadership, guidance, and active support of our Excise Tax Programs from this Committee and the Congress. We are pleased to report the successes described here today, and seek your assistance with future efforts to address and eliminate noncompliance with federal excise tax requirements.

As I have described, significant challenges remain. Continued funding – as requested in the President’s Budget – is needed to sustain the gains that have been made to date and to move forward to implement the excise tax provisions included in the American Jobs Creation Act. Future funding also will be critical for the maintenance and enhancement of the ExSTARS and its related systems.

### Conclusion

Mr. Chairman, in conclusion, I believe that we are making progress in our goals to ensure that federal motor fuels taxes dedicated to the Federal Highway Trust Fund are reported and paid. In addition, we are using technology in the administration of the excise tax program more efficiently and effectively than ever before. I thank you for your continued support.