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SCHEMES, SCAMS, AND CONS: FUEL TAX FRAUD

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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SCHEMES, SCAMS AND CONS: FUEL TAX FRAUD

WEDNESDAY, JULY 17, 2002

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room 215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Also present: Senator Thomas.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

First, I welcome everybody this Wednesday to the Finance Committee. I particularly appreciate the time you are taking out of your busy days to come here and help us on this issue. So, thank you very much.

Today, the committee is holding its second hearing on transportation trust funds. This is part of the Finance Committee effort to increase revenue into the transportation trust funds as Congress approaches reauthorization of both surface and air transportation. This is also the fourth of a series of hearings on schemes, scams, and con operations against the Federal Government.

This hearing will provide an overview of different strategies used to perpetuate fuel tax fraud. We will also examine how this fraud affects the highway, airport, and airway trust funds.

I am aware that this issue is a bit heated, but one that we must address. This fraud represents money that the Federal Government is losing, while crooked individuals are getting rich on the backs of good, honest citizens.

Uncovering this kind of corruption is what we mean by "practicing good government." We need to catch these people, make sure the money is going where it should, that this is money that goes to transportation projects and creates transportation jobs. It is very important to all States, and especially my State of Montana which very much depends upon the highway trust fund.

Given Finance Committee oversight of all of the transportation trust funds, it is incumbent upon this committee to examine those funds and do our very best to make sure the funds increase to meet our Nation's transportation needs.

As Congress approaches reauthorization of both TEA 21 and the Air bill, we call Air 21, the current multi-billion dollar transportation laws, the Finance Committee will examine the taxes, the

revenues, and the balance projections that will be the basis for the Federal highway program over the next several years. In May, we did just that with our first hearing on the highway trust fund.

As a result, in both TEA–21 and Air 21, revenues collected by the trust funds are directly tied to spending on surface and air transportation. Therefore, adequately funding the Nation's transportation infrastructure, both surface and air, is almost entirely based on actually collecting all of the taxes that should be collected by law.

By ensuring collections of all fuel excise taxes, this committee will be able to grow the surface and air transportation programs without raising taxes. I introduced a bill in June that will help do that, S. 2678, the Mega-Trust Act, which recoups for the highway trust fund both the interest and revenue for the losses due to the ethanol subsidy. Now we embark on an effort to ensure that revenue that should be going into the trust fund actually does go into the trust fund.

Before I get into the nuts and bolts, let me first say how pleased I am to see Senator Grassley is very interested in this subject, as he is in transportation issues, generally. I look forward to his attending this hearing at a later time.

Iowa, like Montana, is very rural and has a lot of highways. Our States have needs that are different from other areas of the country. I look forward to working with Senator Grassley not only on this issue, but on TEA–21 reauthorization as well.

I also particularly want to thank Senator Jeffords. He is not here at this moment, but as chairman of the Environment and Public Works Committee he is the main person, the point person, on surface transportation in the Senate, and fortunately is also a member of this committee so that we can work together on trust funds, as well as on highway reauthorization.

I have served on that committee, that is the Environment and Public Works Committee, for 20 years. I have had the good fortune of working on both ISTEA and TEA–21. Those two highway bills helped create jobs, certainly in my State of Montana.

Skilled and unskilled jobs in highway construction are good-paying jobs. In many States, these jobs provide employment opportunities for workers who have lost manufacturing jobs with minimal training requirements.

I plan to do all I can to help create more jobs for all States under the next highway bill, and the best way to increase jobs is to increase funds into the trust fund. A good way to increase funds going into the trust fund is to ensure that taxes are paid.

In light of that responsibility, today we continue what is a series of transportation-related hearings. We will discuss the subject that is crucial to all States, especially my State of Montana, one that I have always cared about and have been very involved with, that is, transportation trust funds.

This hearing will provide members an opportunity to better understand the fuel excise tax structure in a tax collection system for fuel excise taxes. You will also hear about schemes, scams, and other shady operations that are used by participants in the fuel distribution chain to evade Federal and State fuel taxes.

Additionally, there will be discussion of some of the efforts under way by both the Federal Government and the States to combat this evasion. I understand that there will be some fairly interesting stories about the elaborate strategies and dishonest use to circumvent the fuel excise tax system. I look forward to hearing about those efforts, and also efforts undertaken by various agencies, the IRS, and States to curtail this fraud.

Let me also say that today, for the first time before this committee, we have Mary Peters, Administrator of the Federal Highway Administration. Ms. Peters has been a good friend to highways, and I look forward to working with her on upcoming reauthorization.

I would also like to mention that Senator Graham of Florida has asked me to extend his apologies for not being present. He is not able to be here today, but would like to welcome the witness from Florida, Mr. David Skinner, and all of the witnesses here today.

I am also aware that Senator Lott would like to introduce the witness from Mississippi, Mr. Wayne Rhoads, and Senator Lott will do so if he is able to get here. He is busier than all of the rest of us, so I am not sure he will be able, but I know he would like to.

I look forward to the testimony from all of you today, and we will also ask questions, as you would expect, afterwards, to try to get down to the heart of the matter.

I would like, now, to turn to my good friend from Wyoming, Senator Thomas, for any statement he might have.

OPENING STATEMENT OF HON. CRAIG THOMAS, A U.S. SENATOR FROM WYOMING

Senator THOMAS. I do not really have a statement. I am very much interested in highway funding. I was on the Public Works Committee when we did TEA–21. My State is very similar in terms of mileage per capita, and so on.

So I do not know much about this issue, but I have looked at a little bit of some of the things that have been said and the allegations that are there. If they are true, then I am very disappointed in the agencies that have the responsibility for doing something, to either not do something or come to the Congress and say they need changes in the law to do something.

In any event, I look forward to hearing about it, and hopefully we can make some changes, if that is necessary.

The CHAIRMAN. Thank you, Senator.

I will begin with you, Mary. We look forward, again, to having you here for the first time. I suspect there will be some others down the road. But thank you very much for all that you do. I know how hard you work, and we appreciate it.

STATEMENT OF MARY PETERS, ADMINISTRATOR, FEDERAL HIGHWAY ADMINISTRATION, WASHINGTON, DC

Ms. PETERS. Good morning, Mr. Chairman, Senator Thomas and members of the committee.

Thank you very much for scheduling a hearing on this very, very important topic today, the continuing problem of fuel tax evasion.

Today I would like to provide an overview of FHWA's fuel tax evasion program, including measures that have been taken to en-

courage compliance and enhance enforcement, as well as some significant problems that remain.

I would ask that my written statement be made part of the record for this hearing.

The CHAIRMAN. Without objection. All of the statements will be included. I forgot to remind you, about 5 minutes, if you could summarize your statements.

Ms. PETERS. Certainly.

The CHAIRMAN. But all of your statements will be included.

Ms. PETERS. Thank you, sir.

[The prepared statement of Ms. Peters appears in the appendix.]

Ms. PETERS. As you know and as was mentioned, the Federal Highway Trust Fund finances virtually the entire Federal investment in our Nation's highways and a major portion of Federal transit programs as well.

The Highway Trust Fund itself is supported by highway system users through payment of Federal excise taxes on gasoline, gasohol, and diesel fuels, and on the sale of large trucks, trailers, and truck tires, as well as a special-use tax on heavy trucks.

The most significant portion of the revenues comes from fuel taxes, projected at approximately 90 percent of the revenues into the Highway Trust Fund over the next 10 years. Loss of motor fuel taxes poses a serious threat to both Federal and State transportation programs.

Fuel tax evasion exists because illicit profits on sales of untaxed fuel can dwarf the profits made on legitimate sales. Enforcement is often difficult because of the complexity of the motor fuel distribution system.

I have two slides I would like to project, and they are up on the screen for you. The first slide illustrates the basic fuel distribution process, although there can be many variations to this process. Fuel moves from the oil refinery in bulk shipment by pipeline, ship, or barge to a terminal—the storage and distribution facility. Some 30 million gallons of fuel move through these systems daily.

When fuel leaves the terminal by truck or rail, it must pass through a rack, that is, a mechanism used to dispense motor fuel products into tank trucks or rail cars. It is at this time that the use of the fuel is determined and the Federal taxes are imposed, unless the fuel is determined to be tax-exempt. Some exempt uses include school buses, construction equipment used off-road, farming and home heating.

At this point in the distribution system, the tax-exempt diesel fuel and kerosene are dyed red. However, aviation-grade kerosene may be removed from the terminal without taxes being imposed and without being dyed if certain conditions are met. State fuel taxes may be imposed at any level in the distribution system, including the bulk level.

Substantial revenue losses caused by motor fuel tax fraud, involving organized crime, were first discovered in the New York metropolitan area in the 1980's. Subsequent investigations revealed a nationwide problem.

The Internal Revenue Service and the Federal Highway Administration began to combat fuel tax evasion by supporting changes in tax collection procedures and promoting enforcement activities.

Congress responded with a number of legislative changes that brought about significant progress in reducing evasion.

Under the Tax Reform Act of 1986, progress was made in gasoline tax enforcement by moving the point of tax collection from the wholesale level to the rack level, reducing the number of gasoline taxpayers from about 8,000 to 1,000, and considerably simplifying payment tracking.

In ISTEA, Congress provided funding for the Joint Federal/State Motor Fuel Tax Compliance Project. I will, in the future, refer to that as the Joint Project. Three million dollars were allocated annually to the States for participation in regional motor fuel tax enforcement task forces, and another $2 million was provided to the IRS to supplement its fuel tax enforcement efforts. Forty-nine States and the District of Columbia now participate in one or more of the Joint Project's nine task forces.

Diesel fuel tax enforcement was strengthened by two provisions in the Omnibus Budget Reconciliation Act of 1993. The Federal point of taxation for diesel fuel was moved up to the terminal rack level, consistent with gasoline, and any untaxed—that is, exempt—diesel moved from the terminal was required, again, to be dyed red.

In the first year of the new law, Federal diesel tax revenues increased by over $1 billion, with $700 million of that increase attributed to improving compliance. States that have piggy-backed legislation on the point of taxation and have dyed fuel provisions, such as was done in Arizona during my tenure there, have also seen substantial revenue improvements.

TEA–21 continued support for fuel tax compliance projects and gave States the option of using one-fourth of 1 percent of their STP funds for such projects. However, the main focus of the fuel tax compliance program shifted to developing and maintaining a Federal automated fuel tracking system.

Over the life of TEA–21, the IRS was provided $31 million to develop and implement the system. States shared $4 million for compliance activities. But, because of competing priorities for STP dollars, most States have not been able to benefit from the option of using the STP funds for fuel tax compliance projects.

While legislative changes have made substantial inroads in the motor fuel tax evasion problem, fraud schemes have quickly adapted to take advantage of any remaining loopholes.

I would like to quickly review some of these evasion schemes for you. Before the dyeing of diesel fuel and the change to the terminal rack point of taxation, a daisy chain was a popular evasion method.

This involves multiple paper transfers of fuel among fictitious companies to conceal the party liable for remitting the tax. Schemes involving false information filing continue to operate today, and may be ongoing especially in the jet fuel distribution system.

Bootlegging, where the fuel is smuggled across State lines, or perhaps tribal boundaries or international borders, without paying taxes due, is a particular threat to State fuel taxation and it usually occurs where a high-tax State borders a lower tax State.

The importation of foreign-finished motor fuel products is an area of potential motor fuel evasion that, to date, has not been fully addressed. With the Joint Project, FHWA is currently studying the

finished motor fuel importation process, focusing on truck and rail shipments across our borders, barge movements, seaports, and fuel moving through foreign trade zones.

While a number of agencies collect data on imported fuel, complex processes and overlapping responsibilities for tracking foreign fuel may allow loopholes for fuel to enter unreported and untaxed.

So-called "cocktailing" refers to the blending of tax-paid fuel with untaxed products to extend the supply. This results in the loss of both Federal and State taxes. Additives can include jet fuel, petroleum waste products, and even hazardous waste materials, leading to potentially dangerous emissions and damage to motor vehicle engines, in addition to revenue losses.

The potential for aviation fuel to find its way onto the highway system untaxed has recently become a particular area of concern. Because jet fuel can be used in diesel engines "as is" or can be blended with diesel for use in on-road trucks, exempt removal of clear, untaxed jet fuel from the terminal rack provides evasion opportunities.

The second slide that I would like to put up compares the trend in jet fuel production and consumption from July of 2001 to March of this year. It suggests that there is a considerable quantity of jet fuel remaining after taxable airline consumption, although some of the difference can be accounted for by tax-free exports of that fuel.

Because Federal taxation of jet fuel is not currently required at the terminal rack level, tracking fuel and revenues can be difficult. Florida is the only State to tax aviation fuel at the rack, and in doing so they reported a 21.4 percent increase in aviation fuel taxes collected in the first year under the new system.

A study prepared in December, 2001, by KMPG Consulting, using data from the Energy Information Administration at the Department of Energy, FHWA, the FAA, and the IRS, estimated that the potential revenue loss from jet fuel diversion could range from $1.7 to a high of $9.2 billion for the period fiscal years of 2002 through 2011. This estimate was arrived at, in part, based on the difference in volume of fuel production and the volume of airline consumption.

An ongoing commitment to enforcement is needed to continue the progress already made in combatting fuel tax evasion. Increased tax compliance means increased revenues.

FHWA will continue, through the Joint Fuel Tax Compliance Project, to promote enforcement activities and develop new strategies to encourage compliance. This is also an important part of our role as stewards of the Federal-aid highway program investments. Revenues do not yet meet the gap that is there with the need.

Mr. Chairman and members of the committee, this concludes my statement. I again thank you for the opportunity to testify today on this very important topic, and I would be pleased to answer any questions you may have at the appropriate time. Thank you.

The CHAIRMAN. Well, thank you very much for that overview, Ms. Peters.

Next, Joseph Brimacombe, who is Deputy Director for Compliance Policy, Small Business-Self-Employed Division at IRS.

Mr. Brimacombe, thank you very much for taking the time to come and talk to us.

STATEMENT OF JOSEPH R. BRIMACOMBE, DEPUTY DIRECTOR, COMPLIANCE POLICY, SMALL BUSINESS-SELF-EMPLOYED DIVISION, INTERNAL REVENUE SERVICE, LANHAM, MD; ACCOMPANIED BY W. RICKY STIFF, PROGRAM MANAGER, EXCISE TAXES, INTERNAL REVENUE SERVICE; AND C.A. BLOCK, VICE PRESIDENT, BUSINESS DEVELOPMENT AND TECHNOLOGY, MEHL, GRIFFIN & BARTEK, LTD

Mr. BRIMACOMBE. Thank you for inviting me. 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.

The IRS is responsible for administration of more than 40 separate excise taxes, including motor fuel. Motor fuel excise taxes are an important source of Federal and State revenues and finance a large share of the improvements to our Nation's transportation system.

Six separate excise taxes are imposed to finance a Federal Highway Trust Fund program. Three of these taxes are imposed on highway motor fuel.

Federal and State excise tax rate increases over the years increased incentives for tax evasion with the tax significantly exceeding the margin of profit for these products. The corresponding revenue losses 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 power to collect the taxes due. However, we simply do not have the resources to attack every case of non-compliance. Therefore, we must apply our resources to where non-compliance is greatest, while still maintaining adequate coverage of all other areas.

The IRS identified and is addressing critical areas of excise tax non-compliance. These include the continued misuse of dyed diesel fuel, bootlegging to evade payment of taxes at a higher rate, smuggling to evade payment of any or all taxes, and cocktailing to illegally reduce the effective tax rate, and the diversion of aviation jet fuel to highway.

In the last decade, there have been four major exise tax compliance success stories. They are: the moving of the point of taxation for motor fuel to the terminal rack; requiring home heating oil and other diesel products to be dyed red if sold tax-free; taxation of undyed kerosene on the same basis as a regular diesel fuel; and the development and implementation of the Exise File Information Retrieval System, EXFIRS.

The EXFIRS system is made up of a number of subsystems that will support the collection of motor fuel industry operational information. One of the most critical subsystems to ongoing compliance efforts is the Exise Summary Terminal Activity Reporting System, EXSTARS.

EXSTARS is the information reporting system that enables the IRS to track all fuel transactions that occur within the fuel industry's bulk shipping and storage system. It provides tracking capabilities of fuel from the pipeline system to the point of taxation for the Federal exise tax at the terminal rack.

The IRS is currently receiving information reports on 10 to 14 million fuel transactions monthly; approximately 60 percent of these are filed electronically. We are currently processing both the paper and electronic documents, transcribing all of the summary data into the system.

However, we are finding it both impractical and cost-prohibitive to transcribe the supporting detailed information on the paper document. This detailed data transcription is critical to State compliance activities.

One other area that continues to pose a challenge is the reporting of carriers of fuel involving highway-borne traffic. Recent regulations have required the registration of pipelines and barges, however, there is no tax or economic penalty for failure to comply.

The IRS is developing sophisticated and state-of-the-art technology to address exise tax evasion techniques such as smuggling, bootlegging, and cocktailing. For example, the IRS developed fuel fingerprinting technology to combat fuel tax evasion occurring below the rack, particularly bootlegging, smuggling, and the adulteration of fuel through cocktailing or blending of products.

In another example, the IRS is also developing state-of-the-art technology to identify smuggling of motor fuel at the U.S. border points of entry and ocean-going vehicles and barge traffic over the intercoastal waterways.

Under existing processes, illegal smuggling activities can only be detected by physically detaining a truck at the border, reviewing the manifest, extracting a sample of the cargo from the tank, and analyzing the sample to determine if it is the same thing as reported on the manifest.

The IRS worked with the Department of Energy's Pacific Northwest National Laboratory, PNNL, to design, develop, and test a new technology called an Acoustical Identification Device, AID, that uses hand-held sonar technology to identify the liquid content of a sealed container, such as a tanker truck.

Concurrent with this effort, PNNL is working with the U.S. Customs Service to use the same technology for other purposes, such as drug interdiction. I would like to show you a couple of slides on this device, and also do a quick demonstration of it.

The CHAIRMAN. Sure. That would be great.

Mr. BRIMACOMBE. This is a picture of the device that we are using, the yellow device that looks like a drill. That is the actual device, and that is a computer screen below it.

This shows an individual actually using it on a tanker truck. On the right-hand side of the slide is what would actually show up on the screen of the computer. Here is another example of somebody using it.

And the last slide. This is the commercial product which I am going to demonstrate right now. This uses a PDA.

The CHAIRMAN. I am sorry. PDA?

Mr. BRIMACOMBE. Like a Palm Pilot.

The CHAIRMAN. All right.

Mr. BRIMACOMBE. He just shot through a can of pink grapefruit juice.

The CHAIRMAN. And what resulted?

Mr. BRIMACOMBE. That it is fine to drink, Senator.

The CHAIRMAN. All right.

Mr. BRIMACOMBE. And that was a can of pineapple juice. This will device will be available after the hearing for anybody who wants to look at it or try it.

The CHAIRMAN. Now, wait a minute. I am not sure what we did here. You shot the device at two different cans, right?

Mr. BRIMACOMBE. I am sorry?

The CHAIRMAN. You aimed the device and used the device with two different cans, with liquid in each can.

Mr. BRIMACOMBE. Right.

The CHAIRMAN. And they both had juice in them.

Mr. BRIMACOMBE. Correct. I can bring a technician up here to explain it, but basically, based on the density of the product when the sonar goes through it, it can actually, using the computer, determine what kind of liquid is within the can. They have 60 different kinds of liquid loaded into the computer.

The CHAIRMAN. I see.

Mr. BRIMACOMBE. So basically they get, like, a fingerprint of the liquid, compare it to what is on the computer, and identify what the liquid is.

The CHAIRMAN. And it can go through certain thicknesses of vessels?

Mr. BRIMACOMBE. Yes.

Mr. BLOCK. Yes. And it does not make any difference what the thickness is. We can do anything up to eight inches to eight feet.

The CHAIRMAN. Oh, really? All right. Thank you.

Senator THOMAS. But what do you decide? If it is taxable, it does not look any different than if it is not taxable.

Mr. BRIMACOMBE. Well, let me give you an example. If you are at the border, a truck could come. It could have "Milk" on the side. Before, we would have to stop the truck, go in, dip, see what was on the manifest, see what was inside the truck.

Senator THOMAS. This does not have anything to do with cocktails or any of that sort of stuff, though.

Mr. BRIMACOMBE. No. It really is to identify fuel coming in illegally at the border where it may be disguised as something else.

The CHAIRMAN. Thank you.

Mr. BRIMACOMBE. Mr. Chairman, in conclusion, each of the compliance concerns outlined thus far involve diesel fuel. However, bootlegging, smuggling, and cocktailing can be used for gasoline evasion schemes as well. But our efforts to explore and address this have been constrained by resources and a limited ability to mitigate safety hazards involving handling and shipping samples of a more volatile gasoline.

I believe that we are making progress in our goals to ensure that the Federal motor fuels taxes are reported, paid, and collected, and made available to the Highway Trust Fund. We are using technology in the administration of the exise tax program more efficiently and effectively than ever before.

I thank you for your continued support.

The CHAIRMAN. Thank you very much, sir. We appreciate it.

[The prepared statement of Mr. Brimacombe appears in the appendix.]

The CHAIRMAN. Next, is Mr. Barnhart. Mr. Barnhart is director of the Center for Balanced Public Policy here in Washington, DC.

STATEMENT OF RAY BARNHART, DIRECTOR, CENTER FOR BALANCED PUBLIC POLICY, WASHINGTON, DC

Mr. BARNHART. Thank you very much, Senator.

I am Ray Barnhart, a former administrator of the Federal Highway Administration during the Reagan years, a resident of Texas, and a man who this morning is not only hoarse from allergies, but very genuinely grateful to you all for holding a hearing on this pet subject of mine.

The record documents that motor fuel tax theft dates back 20 years, back to 1982, and enactment of the highway bill wherein the Federal gasoline tax was increased from 4 cents to 9 cents a gallon, and diesel from 4 to 15.

Since that time, through the cooperation of Federal and State officials, as well as industry, we have recovered for transportation literally billions of dollars in fuel taxes that previously were being stolen. Nonetheless, those efforts are inadequate and organized crime continues to siphon billions of dollars that should be now going to the Highway Trust Fund and to State departments of transportation.

The written testimony I have submitted for the record details some of the history of evasion schemes and the revenue leakage analysis that you have, along with other material, further elaborates on those schemes starting on page 5 of that document.

Jet fuel scams have been operating for years, but the magnitude of the theft finally became evident after the tragedies of September 11, when airline travel plummeted and fuel consumption by the commercial airlines was, thus, drastically curtailed.

I refer in particular to this colored graph that I believe you have entitled "Civilian Jet Fuel Supplied Versus Airline Consumption."

The volumes of jet fuel reported by the commercial airlines to have been consumed by those airlines in a particular month are shown in blue, whereas the volumes of jet fuel allegedly supplied to those airlines are shown in that magenta color.

Since 9/11 occurred, as the graph shows, the major airlines used, on an average, each month, 300 million gallons of jet fuel less than what was allegedly supplied to them. Even in March, 3 months ago, the differential was almost 280 million gallons, as you can see from the sheet immediately following this color graph. It has a list of months and the differential.

For years we have been told that jet fuel cannot be used in trucks, that is too powerful and will burn up the diesel engines. So, there was no problem. But that is nonsense. Jet is kerosene that has been through one more stage of refinery. You add motor oil to jet fuel to provide lubricity, and you effectively have diesel motor fuel.

Most folks who work on transportation issues—and I am as guilty of this as anyone, and I have been in it for 20 years—have misread this problem. I am concerned about highways and highway safety, not the aviation trust fund. If the trust fund is losing money due to theft, it is somebody else's problem, not mine. But that is a wrong concept.

When jet fuel, modified with that motor oil, is bootlegged to truck stops and sold illegally as diesel motor fuel, from my perspective that is not a problem of the Aviation Trust Fund losing 4.4 cents a gallon, that fuel is displacing diesel that is taxable, and 24 cents should be going into the Federal Highway Trust Fund, and another 20 cents or so going to State transportation programs direction. That is 300 million gallons at month at 44 cents a gallon being lost to transportation. That is $120 million a month. It is a big-time deal.

Where am I? I am afraid I get caught up in this. [Laughter.]

The CHAIRMAN. You are doing very well.

Mr. BARNHART. Now, how does this happen? Because, you see, while Congress has required that gasoline and diesel fuels be taxed at the terminal rack, you excluded taxing jet fuel at that terminal rack.

Like in the old days back when we started on this thing, if you wanted to be a dealer in gasoline or diesel, all you had to do was fill out a little, old proper Form 637, wherein you promise, on my honor, when I sell this fuel I am going to collect the taxes, and so help me, I will remit the money to you.

Well, today that is what happens with jet fuel, only you have a 637–H. And who is there to check on it? IRS, 3 months, 4 months, a year later. That is where the problem is. We must move the point of incidence of jet fuel to the terminal rack, like these other fuels, if we are ever going to get this under control.

Let me make this clear. I do not in any way suggest that the major oil refineries, the vast majority of fuel distributors, or the airlines are parties to stealing taxes. They are not. They are, however, extremely clever mafia-types and other dishonest individuals who grasp every opportunity to make a dishonest buck, and they have been robbing us blind for decades.

Unlike on gasoline and diesel, this is a special problem for IRS. I feel for these guys because it is great press to attack the blasted tax collectors. It is a national past-time in Washington and throughout the country.

But they are critical to our survival as a country and to the integrity of the collection process. They are under-funded, quite frankly. They have an especial burden on jet fuel, because, you see, most States have practically no tax on jet fuel.

My State of Texas—and I hate to say this because I am a proud Texas—is among the worst in the whole Nation in enforcing tax collection laws. I will stand behind that, for the record.

So what happens? Texas does not even have a State tax on jet fuel. Your State, sir, has a tax of, what 4 cents?

The CHAIRMAN. Right.

Mr. BARNHART. Yes. Iowa has 3 cents, New Jersey, 2 cents. I believe you have 5. California has one cent. Louisiana has none. The State revenue people cannot direct their people to enforcing the collection of jet fuel taxes because the revenue received cannot be justified by the expense.

So these guys are the goats. By God, they are inefficient. We have got all this corruption going on here and they sit and watch it. Why? Because they are not equipped to handle this thing.

Judge for yourself. Now, put yourself in their places. Nationwide, there are approximately 140 Federal fuel compliance officers in the entire Nation, who not only ride herd on 1,500 terminals that handle hundreds of millions of gallons of fuel, but they also are responsible for on-the-road checks to see that truckers are not cheating and burning tax-exempt diesel.

Now, they have got big help, though. They have got 300 audit-types for the Nation to audit all of these companies, thousands of them. Now you see why a thief says, I am not going to worry about it. These guys are not going to get around to us for four or 5 years.

That is what happened with the daisy chains. Those daisy chains, one dealer can peddle it to another guy and says, oh, well, I did not sell it so there is no real tax due. But this guy needed fuel, I had an over-abundance, so I moved it over to him.

Then he moves it to here, to here, to here. Suddenly, when you get over here, this guy's statement says, hey, this is taxable and I collected the money. By the time IRS goes from this audit, to this, to this, to this, that paper does not exist. It is paper. It has disappeared, along with billions of dollars.

Then when we catch him, what happens? Like these guys from New Jersey who steal $200 million. What do the judges do? We are going to throw it to you. We are going to fine you $2 million and give you 6 months in jail. My God, this is an Enron opportunity for crooks. We have got to change the law.

And here is another thing that really, really disturbs me. I understand from the grapevine—and I do not know if these career guys can respond to it—that this division is subject to a 20 percent reduction in its budget on enforcement next year. Good heavens. Billions of dollars, and we are going to save money by cutting down enforcement?

Hey, I am a Republican. I support this administration. I want to horse whip whoever wants to cut that budget. I am serious about it. Call a spade a spade. It is absolutely irresponsible. I hope you folks will not allow that to occur.

Another point, then I will shut up very soon, Senator. Like the CIA and FBI got chastised for failing to communicate prior to 9/11, it is startling to be in a meeting with Federal law enforcement officials and hear one of them say to another comparable official in another agency, oh, we cannot discuss that. Because of jurisdictional problems, it is inappropriate for us to discuss this with you.

Also, to have a Federal official tell a State guy who says, hey, I understand this guy is a thief, he has been convicted over here, he is moving into my State, give me the low-down on him, oh, we cannot do that. That would be improper. We have got to clean up the jurisdictional problems if we are going to control this thing.

I have used up my time and I do not like to abuse you gentlemen. I do want to conclude with this. Seventeen years ago, as Administrator of the Federal Highway Administration, I started on this issue to stop this terrible abuse of our system, the unconscionable theft of motor fuel.

I hope, before I die, that we will finally get it under control. I cannot do it. These folks cannot do it. The only key to stopping it, quite frankly, sir, is you and your committee, and I pray that you will do so.

Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Barnhart. That has been a very compelling statement. Thank you very much.

[The prepared statement of Mr. Barnhart appears in the appendix.]

The CHAIRMAN. Mr. Rhoads? I may have to leave a few minutes into your testimony, Mr. Rhoads, because there is a vote going on now. But Senator Craig Thomas is going to come back as quickly as he can, so we will try to continue without any interruptions.

Mr. RHOADS. I understand, sir.

The CHAIRMAN. Go ahead, Mr. Rhoads.

STATEMENT OF WAYNE RHOADS, ADMINISTRATOR OF FUEL TAX COMPLIANCE, MISSISSIPPI DEPARTMENT OF TRANSPORTATION, JACKSON, MS

Mr. RHOADS. I want to take this opportunity to tell you it is an honor to testify. I am not quite as great a public speaker as the ones who have just spoken, but I do know what I am doing, and we speak from the heart.

The Mississippi Highway Department was changed to the Mississippi Department of Transportation, MDOT, in 1992. By this act of the legislature, it now includes highways, transportation such as rails, ports, aeronautics, and public transit.

Also during that legislative act, the fuel tax enforcement and weight enforcement came under the Department of Transportation. Now, this is a little different from a lot of your State agencies. Most of the time, the State agencies that enforce the fuel tax laws are from the Revenue Department. This is a twist on enforcement. Most Revenue Departments trail paperwork.

At the Mississippi Department of Transportation, our enforcement is on the road, on the barges, actually as they transport the fuel, checking for documentation such as import notices.

Import notices. When a fellow wants to bring a load in from Louisiana, then he must file an intent to import, a notification with the Tax Commission, our revenue agency, or he can stop at the first weigh station, which we regulate, on his way in and he will get an import notice number.

Well, that was an enforcement tool. The penalty for not having an import notice was—and what we are talking about here is bootlegging—was that he must pay the tax on the fuel right then, we impound the vehicle, and enforce 25 percent penalty.

Well, we did not have to do that but a few times, and all of a sudden everybody got right and they got right quickly.

As a matter of fact, I will say this. Most of our trucking associations, truck drivers, and barge operators were very professional. We did not have one complaint out of them the whole time. As a matter of fact, we got responses like, well, it is about time you all started looking at what is going on out here. We had the same thing come up from our honest fuel distributors; thank God you all are doing this.

So that beefed us up a little bit more, and we got a little more courage. So we started stopping every fuel tanker truck moving in the State of Mississippi. My good friend Ricky Stiff from the IRS,

in talking about the EXFIRS and EXSTARS program said, that if it moves, we want to know about it.

I thought, if we are going to do on-the-road enforcement, we need to know about it. So we are going to stop every fuel tanker moving for a short period of time and do a survey.

We had an MDOT fuel tax form they filled out declaring who owned the fuel, where the fuel originated from, where it was going, and the bill of lading number. By doing that, our MDOT officers became very familiar with who is supposed to be where, at what time. This started in January of 2001.

We did this for 6 months, and again we had no complaints from anybody. As a matter of fact, we had compliments that we were out there doing it.

When September 11 hit, our officers were educated on who was supposed to be where, so they could tell unfamiliar tankers in unfamiliar territory, in strange places. So, we were at a heightened alert to check for everything and that really benefitted us a lot. Our guys knew who was supposed to be where.

The CHAIRMAN. Mr. Rhoads, I apologize. I am going to have to leave to go vote. I will be right back. So the hearing will be in recess indefinitely until either I or Senator Thomas returns. I expect that to be in the next 5 and 10 minutes, then we will continue where we left off.

Mr. RHOADS. Thank you.

The CHAIRMAN. Thank you.

[Whereupon, at 10:47 p.m. the hearing was recessed.]

Senator THOMAS. I think we will go ahead. The Senator will be back in a moment. I think, Mr. Rhoads, if you would like to go ahead, we will move forward.

Mr. RHOADS. All right. In late 2001, we had been monitoring the fuel that was coming in from the State of Louisiana, from the State of Alabama, and from Tennessee by the import notices.

We started noticing something a little bit different. We had folks bringing in jet fuel to municipalities in the State of Mississippi that did not have a jet port within 100 miles. So, that was a little alarming to us.

We found out that about an average of 30,000 gallons a month had been coming in for the last year around these areas. So we sent out an alert with all of the law enforcement officers to start looking around these municipalities and cities and doing fuel samplings of diesel tanks. Sure enough, we found some interesting sites.

This picture here, sir, shows, behind a truck restaurant—truck drivers usually know the best places to eat—that tanker truck you see there has jet fuel. It is placarded "1863," which is jet fuel. There are some more shots of it. We also found that this tanker truck was equipped with gasoline pumps, hoses, and nozzles.

Now, some of our officers were asking, what in the world is this jet fuel doing here. Is it not much higher in price? Well, if you can buy it tax-free, it is much cheaper than diesel fuel. So we started finding clear fuel, crystal clear fuel, in these areas from the diesel truck tanks. That stirred up a lot more research.

We went to the Web site of a Dodge Ram truck, and found, as you can see on the second line, it says that these fuels are alright

to burn in Cummins diesel, which is equipped in the Dodge truck: number 1 and number 2 diesel, number 1 and number 2 kerosene, Jet A, Jet A1, JP–5, and JP–8. So that told us for sure that, yes, jet fuel is being burned on the road.

We went on and did a little more research and wanted to see what the consumption of jet fuel was like in the State of Mississippi during that year. You would think the consumption of jet fuel would go down after September 11, when all the airlines were sitting on the ground in September and October.

But if you see this chart up here, this next page, you will see that the month of October was the highest month of jet fuel reported in the State of Mississippi. We have a fuel tax of 5.25 cents a gallon on jet fuel.

Well, we were alarmed about that and we started really beefing up our enforcement, doing a lot more sampling of diesel tanks out on the road. In February and March, we had extensive details.

You can look at the results in April. In April, the jet fuel consumption dropped 1.9 million gallons. At the same time, you can look over here at undyed diesel. On-the-road diesel went up 1.9 million. That might be a coincidence. We think it is good law enforcement.

We wanted to see also if our State was different from a lot of other States. We called the State of Louisiana and they did not have a tax on jet fuel, so there were no records. So we went and looked at Alabama. Alabama did not show a big dip in their sale of jet fuel, either, after September 11.

Now, here is a comparison that you can see between what we call crystal clear fuel—this can be kerosene, number one diesel, jet fuel, and the normal diesel that is run on the highway. You can see that the fuel on the left is water clear, crystal clear. You can smell the difference. It smells like kerosene.

In Mississippi, we are bordered by the Mississippi River on the one side, the Tennessee Tom Bigbee on the other side, and the Gulf Coast intercoastal waterway also borders us. So ,it makes us a good place for large amounts of fuel to be barged in.

We are also the only place in the United States that a coast-to-coast, east-west, north-south, rail service meet right there in Jackson, Mississippi, so it is also a good place to monitor rail movement of fuel.

But our law gives us the authority to check barge traffic, so we initiated a detail with the Coast Guard on the Tennessee Tom Bigbee, including the Bureau of Narcotics, Department of Wildlife and Fisheries with the State, and the Corps of Engineers.

We stopped several barges going back and forth. We found out a lot of different things about the amount of fuel that as going up the Tennessee Tom Bigbee, the classification of some products such as solvents, fuel oils, and things like that.

It was an education for us because the barge captains and the Corps of Engineers personnel both told us that it was about time somebody started looking at what is going through these locks.

So that led to some more study. Right now, we are involved with, trying to set up a systematic monitoring of the river systems and the inland waterways in Mississippi.

Now, what this is going to entail? Probably flying the Mississippi, the Tennessee Tom Bigbee, and all the intercoastal waterways looking for sites where a barge and truck can come in close range to off-load fuel into a tanker truck. By the way, there are 60 tanker trucks in a barge. They can carry 60 tanker truckloads of fuel.

After doing this detail, we got a lot of response. A lot of folks were asking different things about what is going on in Mississippi, and are you all doing anything about barge transfers.

Well, this is a site that the IRS and I found on one of our waterways. It is a very extensive, elaborate sea wall built out of power poles where a barge could pull up. That dark object that you see under the crane up there is a huge pump. It can actually offload a truck on that gravel road and a rail car at the same time.

We have not found anybody offloading fuel here, but it is a type of site that could offload fuel. As a matter of fact, we have not found anything since we went in there with a marked car. Some of our officers do not understand undercover yet. [Laughter.]

On the Mississippi River, the average tow is 25 to 35 barges. On the Tennessee Tom Bigbee, the average tow is somewhere between 10 and 15 barges. That is a lot of fuel if you want to carry one load up the Mississippi.

We flew the Mississippi with the Bureau of Narcotics and one other Federal agency. We were looking for sites where, possibly, barges could be tied to trees and offload fuel.

Now, this shot shows a place where they had a stone sea wall built up. Evidently, it was a site for some type of offloading.

We found a lot of portable pumps in the area, a lot of flexible hose, and mooring rope. We have still got this site under investigation. To our knowledge right now, no one has proven that anybody has used this for a fuel offloading site, but it is still under investigation.

After seeing all of this, we found that one thing that is common out there, is that nobody is communicating with anybody else. The Coast Guard does not know what is going on a lot of the time. They are not familiar with it because they have not been told about it. Customs was kind of vague on it. So, we decided to establish an enforcement task force.

On April 18, we had our first meeting in the southeastern States. We had Coast Guard, Customs, the IRS, some State agencies, and we had the Corps of Engineers. Everybody was amazed about the number of fuel barges that traffic up and down the rivers.

Since that time, we have established some other investigations going on with other smuggling. But one of the things we feel that could help us a lot in enforcement, is first of all, take away the ability to buy tax-free jet fuel, except by the commercial airlines, from the rack.

Put money in on-the-road enforcement. This is an area where you can stop the activity in its tracks. You do not have to go through a year of paperwork and auditing, then catch a guy and put him in jail for, did you say, $2 million fine? (Referring to Ray Barnhart's speech) We are just educating the crooks that it is a profitable business out there.

We need some more resources to be able to do this, to fly the Mississippi, to enforce barge traffic. We need boats, we need unmarked cars, and things like that. But I will be available for any questions you all want to ask later. Thank you.

Senator THOMAS. Thank you.

[The prepared statement of Mr. Rhoads appears in the appendix.]

Senator THOMAS. The Chairman has returned.

The CHAIRMAN. Thank you.

Mr. Skinner?

STATEMENT OF DAVID L. SKINNER, FUEL TAX COMPLIANCE COORDINATOR, FLORIDA DEPARTMENT OF REVENUE, TALLAHASSEE, FL

Mr. SKINNER. Thank you, Mr. Chairman, and thank you to the committee for inviting me to come here to speak.

I have been aware of the proposals to change the Federal tax on jet fuel to the terminal rack, and am also aware of the reasons behind some of those proposals.

Florida, to my understanding, is the only State that currently already taxes jet fuel at the terminal rack, so it may be that some of our experience may be of some use to the committee in considering the proposal to make the Federal change.

I need to explain, though, that there are some idiosyncracies here that might have an effect. It is not a real simple matter to try to look at Florida's experience and gain any insight from it because there are some real complexities.

First of all, in the Florida law, we very closely link the jet fuel with kerosene. Basically, jet fuel is just kerosene that has been refined to the Federal specifications to keep us flying when we are flying in a jet. But they can be used pretty much interchangeably. At least, jet fuel can be used for the same purposes that kerosene can be used for.

In Florida, we do impose the tax on both jet fuel and kerosene, if it is undyed, at our aviation fuel tax rate, which is 6.9 cents per gallon. We do not tax kerosene at our highway rate, as the Federal law does, which in Florida is very similar. It is currently 26.4 cents a gallon, the highway tax on diesel fuel.

In Florida, very similar to the current Federal law, kerosene is exempt if dye is injected at the terminal rack before it is delivered. If undyed kerosene is used for home heating or other exempt purposes, we allow credit or refund.

There are a few little differences that were available to us in our law that eliminates some of the problems with consumer refunds, but nonetheless, we do allow the credit of the 6.9 cent aviation fuel tax if kerosene is used for an exempt purpose.

What I would like to briefly do this morning, is explain to the committee how we arrived at this solution for jet fuel kerosene, what the results have been since we did this—and this goes back to July of 1996—and then also to share with the committee some of the recent trends in Florida as far as jet fuel or aviation fuel tax collections since September 11.

First of all, as I mentioned, kerosene and jet fuel are tied together in our law. The way we ended up approaching the taxation

of kerosene and jet fuel when we made some changes back in 1996, was just one very small part of a much larger legislative change.

What happened back in 1994, is we had observed that a couple of States—I think Indiana and Michigan—and the Federal Government had changed their taxation point on diesel fuel and imposed the law that required a dye to be injected if it was not taxed when it left the rack.

So a group of us got together in what we called a PIT crew—it stands for Process Improvement Team—comprised primarily of Department of Revenue people, representatives from the mid-level wholesalers, the Florida Petroleum Marketers Association, and from the major oil companies through the Florida Petroleum Council, which, I do not exactly understand, is somehow linked to the API, to the American Petroleum Institute.

So that core group, along with other interested parties, formed this team to just look at our whole overall fuel taxation system and to see how it might be improved to make it more efficient, to limit any unnecessary burden, and so forth.

We had a lot of issues, as you might imagine, in considering these changes. But we very quickly came to the conclusion that, to the extent that we could model after Federal law, it would create some efficiencies, both for the government administrators and for the industry, to pay the tax.

Without going into the detail of the other changes, the kerosene and jet fuel basically was left to the end of our decision. We really did not know, up until very close to the end of the workings of this PIT crew, what we were going to do.

We knew that at that time the Federal Government was considering some changes to kerosene, which ultimately were adopted, I believe, in July of 1998, to impose a tax on kerosene at the rack. But that had not taken place, so we did not really have a model to follow.

So, basically what happened, is that we knew that kerosene and jet fuel, as has been heard here today, that those products could easily be blended into a highway fuel, a diesel fuel, and could be illegally used on the highway. So, we felt we needed to do something.

What we came up with, was simply to tax both jet fuel and kerosene at the aviation fuel tax rate, the 6.9 cents per gallon, on the idea that at least if the crooks were trying to evade tax by doing it, at least they would have to pay part of the tax, the 6.9, not under any delusions that this would be the cure-all to the problem.

So, really, the reasons that we made the change was that we knew that the products could be blended with diesel fuel and we were trying to limit the amount of tax that could be evaded, and in fact some studies that were given to the group indicated that as much as 90 percent of the kerosene/jet fuel that was in our terminals in Florida had been refined to jet fuel specifications. So, they were basically the same product, and interchangeable.

We also looked at the efficiencies of the tax reporting. We had already put both gasoline and diesel fuel at the terminal rack. So by putting the aviation fuels at the same point, we could merge them all on one tax form, have the same taxpayers paying it, and we could derive all of the efficiencies that you might imagine you

would get from having the same taxpayers doing it the same way for all three types of fuel.

The results, I believe, have been published in the KPMG report after the first year under this law. We set about to examine what the revenue was. Really, of course, our purpose or main focus was not on the jet aviation fuel tax so much as it was on the highway taxes, the diesel fuel and the gasoline.

But to our surprise, quite frankly, we found that there was over a 21 percent increase in the aviation fuel tax. Now, understand that the products that are taxed at that aviation fuel tax rate, 6.9 cents a gallon, include not only jet fuel, but also aviation gasoline and any kerosene that was not exempted, that was taxed at that 6.9-cent rate.

So the obvious question is, you got a 21 percent increase. Why did that happen? Well, we have not done any kind of detailed cause-and-effect analysis to try to really get to the bottom of that question, but I can offer several possibilities to the committee.

One, is that, simply, the tax structure that we have in Florida may have resulted in that. Basically, if the kerosene is not taxed at the 6.9 cents, then it becomes subject to our general sales tax, which is, in most counties, 7 percent of the purchase price.

So what that means, is if the kerosene sells for a dollar a gallon net of tax, that a person has a choice: for a gallon, pay 7 cents sales tax, or pay the 6.9 cents aviation fuel tax. I believe that kerosene generally sells for even more than a dollar a gallon.

So it is quite possible that part of the increase in our aviation fuel tax resulted from people simply not claiming the refund on the 6.9 cents, because if they did that they would have to pay 7 percent of the purchase price.

I do not know for certain to what extent that exists, but it is certainly plausible that that is at least one factor. Now, do not be confused. Home heating is exempt.

The other possibility, is simply evasion of the fuel tax law. It could be that the 6.9 cents was being paid in order to avoid paying the highway tax, or it could simply be the economic growth factors.

I also included in the prepared written testimony the results since September 11 in our aviation fuel tax. It is very interesting that the average since then comes to a decrease of 19.8 percent, which is very close to what the airlines had been reporting as their decreased consumption. I do not know for sure what that means, but that is some information that might be useful to you.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Skinner.

[The prepared statement of Mr. Skinner appears in the appendix.]

The CHAIRMAN. I would like us to pull out this chart. Help me better understand, at least collectively, what you all think happened as a consequence of jet fuel supply, as well as consumption, post-September 11.

I ask the question because, as I look at this chart, in July/August there is roughly, I would say, 30 percent more still supplied than consumed. Then the big fall-off, of course, is September 11.

What is it here that sort of compellingly shows that, even though airline fuel consumption dropped and is very low, that civilian fuel

supply is high? What does this show as to what happened to that fuel?

Mr. Barnhart, you were talking a lot about this. If you could just kind of explain that a little more fully, please.

Mr. BARNHART. We do not know what happened to that fuel. We believe that it has been bootlegged over there and sold at truck stops. Where did it go?

The CHAIRMAN. And mixed with motor oil or mixed with something?

Mr. BARNHART. Sure. Some motor oil, or in some instances you could use it straight. As a matter of fact, an interesting thing. Saturday night, just casually, I attended a 50th anniversary of a friend of mine. There was a gentleman there who was a mogul in the aviation industry.

My friend had mentioned to him that I was on fire about all of this, the aviation fuel tax. This guy said, that is why I bought my diesel truck. That is all I burn, is jet fuel. I was floored. But I have always ignored that because I thought it was just the Aviation Trust Fund.

The CHAIRMAN. So where does he get his fuel?

Mr. BARNHART. He gets it from a distributor who supplies the airline. They get that fuel that is supposed to go in here to this airplane. They kind of divert before they get there and go over here and bootleg.

The CHAIRMAN. Now, why should the imposition of a jet fuel tax not be at the rack?

Mr. BARNHART. It should be.

The CHAIRMAN. Does anybody have any reason why it should not be?

Mr. BARNHART. Well, I will tell you what the objection is. I ran into that 20 years ago. Good people who were not involved, business corporations, what have you, are more comfortable with the status quo. Everybody is afraid of change because it may gig them in some way and increase their costs.

But we worked with the commercial airlines. They will not be hurt on this, I guarantee you. There is no reason for them to object any longer.

The CHAIRMAN. We have four others here, now. Ms. Peters, do you have any thoughts on that?

Ms. PETERS. Senator, I think it is something that we do need to look at. We did not move the incidence—of taxation and I am going to speak to my prior experience in Arizona—of aviation fuel. But, like Mr. Skinner indicated, it was simply because we just did not know the potential for problems.

I do not know of a reason why it should not be taxed at the rack, but I would suggest that we look at it within the context of the whole issue to determine if there are reasons why it should not be, or what the impacts and burdens would be if we were to move it.

The CHAIRMAN. Now, you have implied, Mr. Barnhart, that airlines have objected in the past. Is that correct?

Mr. BARNHART. Yes, sir. Commercial airlines.

The CHAIRMAN. Why?

Mr. BARNHART. They are not stealing.

The CHAIRMAN. Why do they object?

Mr. BARNHART. I have never really understood it, except I think it is that same old thing, that the status quo is safest. Let us not take a chance on a change lest we get hung up in it somehow.

The CHAIRMAN. Or it might be cash flow, too.

Mr. BARNHART. Yes. But you see, they have been promised we will not give them the shaft on the cash flow, because they can get that exempt on their purchase until they use it. We can work that deal out very easily.

The CHAIRMAN. But do you think, the five of you, that if jet fuel were taxed at the rack, that that would significantly reduce any potential or actual scam and so forth?

Ms. PETERS. Mr. Chairman, I think based on what we are seeing today, it would appear to be so. It would appear to at least alleviate this issue. One of the things you asked was the question of what happened to this fuel.

It could be, as I indicated earlier, tax-free exports; it could be stockpiling of supply. Yet, the graph does not indicate that the supply was stockpiled, because the usage figures then go up post-September/October.

One of the real problems that we have is a lack of total fuel accountability. We do not have good data on the different types of fuels, on on-road use of fuels, on exempt fuels, on aviation fuels.

That lack of good data on total fuel accountability allows some of the things to occur that have been described here today.

Some of the things that we would suggest, would be looking at the total issue, the total supply of fuel; what fuel is out there; whether it is taxed or exempt based on what the intended use is; and include sales tax, as Mr. Skinner indicated. At the state level, if it is not being taxed as an excise tax for on-road or aviation use, it ought to be taxed based on a sales tax.

Then, look at what the actual use is and see if the actual use is consistent with the intended use, to see if it was taxed properly. Unfortunately, we do not have a system that gives us that total fuel accountability to date.

The CHAIRMAN. Right. Well, let us talk about that a little bit. I would ask each of the five of you, where is the greatest gap in fuel accountability and/or where is the greatest need? We are in this homeland security debate in the country right now, trying to coordinate agencies and so forth.

It has been touched on here, there is lack of coordination, to some degree, among State agencies and the Federal Government, and so forth, which allows malfeasors to take advantage.

Mr. BARNHART. Mr. Chairman, there is another problem here with the IRS now. They mentioned EXSTARS. For the first time, when we get this thing implemented, we will know how much fuel is distributed in a particular State. That is so necessary.

The problem is, when you get into that, that is after the fact. The law enforcement official out here that stops this guy who is stealing stuff, he has not stolen it because he has still got a month and a half before he has to report it. So if he gets stopped, he can go in and alter his records.

The CHAIRMAN. Right. Right. But where is the biggest gap in reporting? Would you all agree? Would you all have different gaps?

If Congress is going to do something about all of this, what should we do?

Mr. RHOADS. Mr. Chairman?

The CHAIRMAN. Yes, Mr. Rhoads?

Mr. RHOADS. I think the way this thing is sitting, is on a three-pronged stool, but we are just sitting on two prongs right now, or two legs. We have got the IRS doing the EXFIRS and the automation reporting. Then you have the States doing their bookkeeping.

But somewhere along the line there is no on-the-road enforcement tool. In other words, every time you see that chart for lines going from a tank, farm, or refinery, those lines represent means of transportation.

If we had one DOT regulation that required anybody moving fuel by barge, rail, truck, or pipeline—well, it would have be a little different on pipeline, but I could address that—to have a certified notification on board that he has contacted the next taxing jurisdiction that he is about to go into and he has given the information, who owns the fuel, where it originated from, where it is going, so an on-the-road officer or Coast Guard officer that is monitoring the barge traffic can see that.

He will call in that same automated system and get the same information back and let him go. We can take that to one step further. A lot of our officers are radio-equipped with these truck drivers. CBs are wonderful. We can just do it right on there while he is following and never have to slow him down.

With pipeline right now, Mr. Chairman, you have got three people involved. You have got a buyer, you have got a seller, and you have got a gauger. All of these people are independent businessmen. All these people are independent of each other.

Where is the government's checkpoint? If we just had one meter, if the government had a meter either here or here that went into a computer that registered the flow amount, it would take the possibility away of those three guys collaborating, getting together to cheat. We are talking about millions and millions of dollars here. But we just have to take those steps.

The bad thing about it is, even an honest distributor working in his business has to compete with these guys who are cheating, and to survive, sometimes he may have to let a load slip through and not report it.

The CHAIRMAN. As Mr. Rhoads mentioned, there is a third leg here, on the road, some kind of data confirmation system of some kind.

What do the rest of you all think about that, or do you have another candidate?

Mr. SKINNER. I certainly agree with Mr. Rhoads about that. That is probably the leg that is broken in Florida right now. We are very much aware of it and are trying to improve in that area.

I think that the accountability will be solved, to a great extent, with the EXSTARS program. I think that collecting that data will enable the States and the Federal Government to at least isolate the legal transactions in fuel from the illegal transactions so that the efforts can be focused on the illegal. That is one thing.

The CHAIRMAN. I am sorry. Could you explain the EXSTARS program again, please? What is it?

Mr. STIFF. Mr. Chairman, I am the program manager for Excise Staff. My name is Ricky Stiff, with the Internal Revenue Service. EXSTARS is a newly inactive reporting system. I am sure you are familiar with the 1099 system that is used in income.

The CHAIRMAN. Very familiar.

Mr. STIFF. It works the very same way. Each carrier that delivers fuel to a terminal reports to us how much they deliver. Each terminal operator than reports on a monthly basis their beginning and ending inventory, plus their disbursements. They also report to us the taxpayers that owe the tax on the fuel that is disbursed on a monthly basis.

We take that information, then just like a 1099, at the end of the quarter we add it up and we match that against a 720 to see if, in fact, it does match. We believe that EXSTARS is going to go a long way to handling and tracking what I would call all legal fuel. When we say that, it is because all legal fuel in this country moves through a terminal. It comes in through the system through refineries into the pipelines, into the terminals.

The greatest obstacles that we face in the future, if aviation fuel is taxed at the rack, which we acknowledge is a problem, we will still have instances of people trying to cocktail, mixing waste products and things of that nature with fuel. They go buy 100 gallons of diesel fuel, pay the tax, mix in 100 gallons of waste product, and they save 50 percent of the tax. That will be an ongoing problem. I do not believe we will adequately fix it.

The CHAIRMAN. Now, where will that be sold, that product?

Mr. STIFF. They will sell it at retail stations. In most situations, the retail stations do not even know that they are buying the product. Some unscrupulous person buys waste products and, in many cases, we found evidence where the person who blends the product has actually been paid by a company responsible for disposing of hazardous waste. They pay the blender.

The blender goes and gets paid for getting the bad product, the waste product. They then take that waste product and mix it with diesel fuel and go sell it to some unsuspecting retail outlet that then sells it to people who burn it in trucks and cars.

The CHAIRMAN. How much of this is going on?

Mr. STIFF. That, I do not have the answer for. The only way we can ascertain that is on a hit-and-miss basis with the resources we have. We have to find it and sample the fuel.

We have a fuel fingerprinting program now that we do use that enables us to go to a retail station, we can pull a sample directly out of the pump, and we run the fuel through a test very much like a human fingerprint. Fuel has a distinctive pattern that we can match to determine if it does contain a waste product or some adulterations that may have been added.

We find that, based upon the studies that we have done to date, roughly 5 percent of the fuel that we have sampled falls into that category.

The CHAIRMAN. I am sorry. What is that percentage, again?

Mr. STIFF. Roughly 5 percent of the fuel that we have sampled over the past 2 years falls into that category.

The CHAIRMAN. And that gun that you have, that can determine it?

Mr. STIFF. That gun also will assist us in determining that and checking the tanker. But the gun was developed by us primarily to assist us in the border crossings. There are millions of trucks crossing the Mexican and Canadian border every year. For us to stop those trucks and inspect them would basically shut down international traffic.

So we have to have a method that enables us to do a quick check, then when we find something wrong, then pull the truck over. That is what the gun was developed for.

The CHAIRMAN. You said unsuspecting retailers sometimes buy these mixtures. I mean, would a retailer not want to make sure he has got good product?

Mr. STIFF. The retailer would naturally want to know that. But they are buying from someone. The tanker truck pulls up and unloads the mixture right into his underground storage. To hold the retailer 100 percent responsible for that would require the retailer to have to conduct a chemical test on each and every load.

The CHAIRMAN. Yes. Right.

Again, we are kind of going down the row here, and we have mentioned the third leg here, on-the-road confirmation, and then we talked about EXSTARS helping. What are the other gaps that we should know about that perhaps we should focus on or help you with? Or do you agree on those?

Ms. PETERS. Mr. Chairman, I think that we have to do a couple of things, a combination of the two. The on-the-road inspection is certainly very important, particularly, as was indicated by IRS, at the borders. There is a tremendous amount of product that moves across the borders, so I think that on-the-road enforcement, both intrastate and interstate, as well as international, is important.

The CHAIRMAN. Right.

Ms. PETERS. But, using the database system along with that will help us. We need to be able to focus our enforcement efforts where the greatest potential for evasion exists. Having a good data system that tracks that fuel so that we know where the greatest potential is for evasion will allow us to maximize our efforts.

A number of people on the State level, as was indicated by several of my fellow panelists here, have responsibility for this, as do people on the Federal level. But we need to capture the efficiencies of using this on-the-road workforce in a manner where it is going to give us the biggest bang for the buck and give us the greatest efficiencies.

The CHAIRMAN. Right. But examples. EXSTARS sounds like a good data system that is going to help here. What other data systems or what other reporting systems? We have talked about the gun here, we have talked about Mississippi experience with on-the-road reporting.

Ms. PETERS. I would suggest, then I will yield to the rest of the panelists, where you have someone who is not playing fair and is not doing the right thing, being able to share that data from State to State would be important. Otherwise these schemes may move from one State to another. You do not have the ability to track them because of the inability to share data right now.

The CHAIRMAN. Have any of you got a good idea how much U.S. taxpayers are being cheated by these operations, or do you know? Do you have any sense?

Mr. STIFF. Yes, sir. We have an estimate, just on cocktailing, not counting aviation fuel. It is based solely on the fuel fingerprinting samples that we have discovered throughout the past 2 years. Our estimate is that we are losing a billion dollars a year in Federal tax.

The CHAIRMAN. That is in cocktailing.

Mr. STIFF. In cocktailing.

The CHAIRMAN. Now, let us go down the list. What about jet fuel incidents?

Mr. BARNHART. I think we are losing that much in jet fuel, if you just looked at the volume of jet fuel that is involved.

The CHAIRMAN. About a billion dollars uncollected taxes?

Mr. BARNHART. Oh, absolutely. I have said that, and more.

The CHAIRMAN. And you have got a pretty good feel that that is pretty accurate?

Mr. BARNHART. I believe so.

The CHAIRMAN. Yes.

Mr. BARNHART. I wanted to mention one other thing, Senator. There are other issues that are very significant, but we do not feel comfortable talking about them in a public forum and I would like very much to have a brief opportunity to outline them to you confidentially.

The CHAIRMAN. All right. We will make that happen.

Mr. BARNHART. Thank you.

The CHAIRMAN. You are very welcome.

Is there anything else, before we adjourn this hearing, anyone would like to say?

Mr. RHOADS. Mr. Chairman, I would like to second what Mary said about the communications. We feel like, at the law enforcement level, the IRS has their hands handcuffed about what they can let us know about tax information, even though we are charged with responsibilities.

They have so many disclosure regulations, that it is absolutely impossible to get the proper information. They want to tell us, but they cannot. They are forbidden to tell us by the disclosure procedures. So, you may want to look into that.

The CHAIRMAN. Mr. Brimacombe, perhaps you can talk about that a bit. Can there not be a way for IRS to give relevant information to another law enforcement officer, still respecting taxpayers' privacy, but on the other hand, cooperating?

Mr. STIFF. Currently, sir, we are limited. We can only share that information with revenue departments within the States. In a lot of the States, the fuel tax is a little bit unique.

In some States it is administered by the Department of Transportation and law enforcement agencies that are not part of the revenue department of that State, so we are precluded from exchanging information with those departments.

The CHAIRMAN. That is because of some regulations of some kind. Is there a public policy reason for not sharing with the Transportation Department, like with Mr. Rhoads in Mississippi?

Mr. STIFF. That, I could not address, sir.

The CHAIRMAN. But off the top of your heard, based on your experience, I mean, your own personal view?

Mr. BRIMACOMBE. I think it really gets down to our overall concern with taxpayer privacy. So when privacy laws were passed, they were passed in such a way to ensure that information we had on taxpayers were not shared just across the board, that there were specific ways and agencies we could share them with. I really think it just comes down to the privacy.

The CHAIRMAN. Well, I am sure that is the genesis. But I suggest, Mr. Rhoads, that you kind of look into this, too, and we would like to help out. If you see some area where the statute could be changed in a way that is fair to taxpayers and also helps you in your law enforcement efforts, boy, we would be interested. We want to help out, but sometimes we need your help, too. We cannot do it all ourselves.

Mr. BARNHART. I assure you, you will be taken up on that challenge.

The CHAIRMAN. All right. Good. We will get a meeting later, Mr. Barnhart, too, on this issue that you raised.

Mr. BARNHART. Please. Thank you.

The CHAIRMAN. All right. Senators may have questions that they will submit for the record, and I would like you to answer, please, within a week if you could. You made a lot of good points. We have this bright staff back here, and we have got to figure out what to do with all of this so we can do something that is effective.

Mr. BARNHART. They have been very, very helpful.

The CHAIRMAN. Good. Thank you.

The hearing is adjourned.

[Whereupon, at 11:40 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF RAY BARNHART

Mr. Chairman and Members:

I am Ray Barnhart, a former Administrator of the Federal Highway Administration during the Reagan years, a resident of Texas, and a man who is genuinely grateful to you today for holding this hearing.

Even though fuel tax theft was shown to be a major problem seventeen years ago, it continues to siphon billions of dollars from our federal and state transportation programs.

A very brief re-cap of the situation. You'll recall that motor fuel taxes weren't worth stealing until Congress, twenty years ago, enacted the '82 federal highway bill. For the first time in 23 years federal fuel excise taxes were increased, and they were increased dramatically: the gasoline tax was more than doubled, from 4¢ per gallon to 9¢, and the diesel tax almost quadrupled, from 4¢ to 15 ¢ per gallon. The ink had hardly dried on that law when organized crime moved into the fuel distribution business, for it immediately saw that it could reap literally billions of dollars by stealing those taxes!

Since so few dollars were involved when the taxes were only 4¢ a gallon, collecting those taxes was low on the priority list of federal and state revenue officials: they had bigger challenges to face with their limited budgets, such as ensuring the collection of the tens of billions of dollars of income taxes. Why fret over penny-ante problems?

At that time anyone could become a motor fuel distributor: just fill out a simple form, called a 637, stating you were in the fuel business, and promising – on your honor – to faithfully remit to the government treasuries the fuel taxes you'd collect on the governments' behalf from the service stations when you sold them the fuel. Accordingly, the Mafia-types immediately took advantage of the situation and implemented a number of schemes whereby they would keep those taxes for themselves, and with little danger of being caught in the process. Some of those tax schemes are briefly described on page 5 of the kpmg Consulting analysis.

In 1985, as FHWA Administrator I was shocked to learn how many Trust Fund dollars Treasury estimated we'd be able to distribute to the state departments of transportation the ensuing year. The tremendous revenue gain we'd anticipated from the '82 highway bill tax increases hadn't materialized! A review of the possible explanations led to but one conclusion: organized crime had entered the fuel distribution business, big time! I

asserted publicly that criminal enterprises were stealing as much as $ 1.7 billion dollars annually in federal fuel taxes, and that state governments were losing a comparable amount.

Subsequently, to close loopholes in the tax collection procedures, Congress moved the point at which the federal gasoline tax was levied from the distributor level to the terminal rack, which is one step removed from the refinery. This is where the fuel "breaks bulk" and one can determine if the fuel is to be used for a taxable or a tax-exempt purpose. Not surprisingly, the mob then curtailed its gas tax scams and switched to diesel fuel scams. To cope with this new fraud scheme, Congress then required that diesel fuel be taxed at the terminal rack as was gasoline. The first year after that change became effective Trust Fund revenue increased $ 1.32 billion.

Now that government had gotten serious about collecting gasoline and diesel taxes, the mob then developed scams involving home heating fuel. There are two major differences between home heating fuel and diesel to power trucks: (1) some additives, primarily for brand identification; and (2) an average of more than 40¢ per gallon in federal and state taxes. The crooks began bootlegging home heating fuel and selling it to truck stops as diesel, but keeping the taxes for themselves. To show how rewarding this type scam can be, one mob family in New Jersey was finally busted in the mid '90s. It owned 4 terminals that allegedly handled only home heating fuel for the Northeast. It also happened to own 7 truck stops in the state of Virginia. When after several years authorities finally had a solid case, they seized the 4 terminals, the 7 trucks stops - - and 57 tanker trucks. There was a steady stream of these trucks, each hauling 8,000 to 10,000 gallons of home heating fuel from New Jersey, and selling it as diesel fuel across state borders, 300 miles away in Virginia. A dishonest operator could – and still can – net as much as $ 4,000.00 by stealing the taxes due on a single truckload of fuel!

We've made much progress in coping with fuel tax theft during the past decade, but because of continuing weaknesses in our tax collection systems the problem is still massive. The fraud is multi-faceted, it occurs all across the nation and, while I can't document it because records are so incomplete, I'll stake my reputation on this statement: each year it means that billions of dollars are lost to federal and state transportation programs!

If you should think that's a reckless assertion, let me buttress my argument by briefly discussing just one more scheme of the many that exist.

You've been given a "Motor Fuel Excise Tax Revenue Leakage Analysis" that highlights some of the details regarding aviation jet fuel (starting on page 8 of the analysis). Additionally, you have a graph in color that dramatically shows what has transpired concerning jet fuel since the tragedies of September 11.

Following that frightful day, airline travel plummeted. Yet according to the Bureau of Transportation Statistics, as you can see from the graph, **through May of this year the commercial airlines actually used an average of more than 300 million gallons of jet**

fuel LESS per month than the amount of fuel allegedly supplied to them! You can see from the data accompanying the graph that a year ago, in March of 2001 – long before chaos hit the airline industry – even then the amount of jet fuel supposedly supplied to them was 317 million gallons MORE than what they reported using. Jet fuel scams, now becoming evident because of 9-11, have been on-going for years!

Where did that fuel go? I'm convinced that most of it, at least, ended up being bootlegged to truck stops and sold as diesel motor fuel. And without remitting the appropriate taxes to government agencies! Since it thus displaced regular taxable diesel fuel, the tax loss from jet fuel could amount to $ 160 million per month, dollars that should have gone to fund vital transportation programs.

How is this possible? Because while Congress has required that gasoline and diesel fuels be taxed at the terminal rack, it excluded aviation jet fuel from that provision. Like in the old days with gasoline and diesel taxes, fill out a form 637H, promise on your honor that you'll remit to Treasury any taxes on the fuel that you collect, and you, too, can become a dealer in jet fuel! If you cheat, beware! An overworked IRS agent may in a year or so get around to auditing your books!

Because aviation fuel is exempt from taxation at the terminal rack, organized crime continues to have free reign. I plead with you: revise the IRS Tax Code to close loopholes that facilitate tax theft, and MOVE THE INCIDENCE OF THE AVIATION JET FUEL TAX TO THE TERMINAL RACK!

Let me make this clear. In no way do I suggest that the major oil refiners, the vast majority of fuel distributors, or the airlines are parties to stealing taxes! There are, however, extremely clever Mafia-types and other dishonest individuals who grasp every opportunity to make a dishonest buck. Their scams can be stopped only if the Congress will enact meaningful laws and see that they're enforced.

Aviation fuel is especially vulnerable to tax cheats, much more so than scams involving gasoline, diesel, and home heating fuel. Why? Because with but a few exceptions, the burden of auditing and enforcing tax laws pertaining to jet fuel falls almost entirely on the U.S. Treasury agents!

Unlike on gasoline and diesel, the taxes state governments impose on jet fuel are relatively insignificant – if they exist at all. My state of Texas, for instance, with three major airlines (Continental, Southwest, and American), doesn't even levy a state tax on jet fuel; Montana has a 4¢ tax; Iowa taxes commercial jet at 3¢; New Jersey 2¢; California 1¢; etc. As a result, the revenue agencies in those states focus little attention on jet fuel auditing because the cost of doing so can't be justified by the dollars returned. Accordingly, it is most often left to federal officials to ensure the integrity of the tax collection process. The fundamental question is, are the feds equipped to cope with this massive undertaking?

Judge for yourself: there are approximately 140 federal fuel compliance officers in the entire nation who not only must ride herd on some 1,500 terminals that handle tens-of-billions of gallons of fuels, but also do on-road checks. Then there are an additional 300 audit-types that check thousands of individual companies, but those folks have to monitor not only motor fuels, but 44 other excise taxes as well.

And here's another of my major concerns. I understand through the grapevine that this IRS Division may be subject to a TWENTY-PERCENT REDUCTION in the coming fiscal year! "Hallelujah", the mob must be shouting, "another miniature Enron!"

Please do NOT allow that to happen. This IRS Division MUST be adequately financed if we are to put an end to these multi-billion dollar scams. I realize that it's popular with the public to damn tax collectors, but darn it, they're absolutely critical to the functioning of the country and to ensuring the integrity of our tax system. Additionally, two new and innovative programs, ExFIRS and ExSTARS, that have for months been under development, are now at the point of implementation. When that occurs, for the very first time it will be possible to determine how much fuel of each type will be sold in particular states. Because this knowledge is essential to getting tax theft under control, those programs must not be scuttled under the guise of "saving money." It would have the exact opposite result! I dare say that some of the federal initiatives that have been developed so far to fight fuel tax theft are among the most cost-effective in the history of tax enforcement, one of which returned $ 27.00 for each dollar spent.

Thus far we have but touched the tip of the tax evasion problems. We haven't even discussed the lack of control over fuel imports and supposed exports! Billions of gallons of fuel are imported and moved throughout the country by ships and barges, as well as by trucks moving across our borders. Gaps a mile wide! There are numerous federal agencies involved in those maritime shipments, each collecting data of one kind or another. But is there an effective way to ensure that any taxes due on those fuels are actually paid to the proper authority? There are thousands of barge shipments each year, with each barge handling anywhere between 400,000 gallons to one million gallons of fuel. As near as I can tell, the collecting of data is the end in itself, and with little or no coordination between the diverse authorities.

Which brings up another significant issue to conclude my testimony. Just as the FBI and CIA failed to communicate pre-9-11, in many instances because they were precluded by laws from doing so, in the same way federal authorities in the various agencies involved in motor fuel tax enforcement often cannot exchange information on corrupt individuals and organizations between themselves or with their state counterparts. It's appalling to hear a federal law enforcement person in one agency tell an agent from another comparable agency, when a particular crook's activity arises in conversation, that "we cannot discuss this issue." Or to have that fed assert that he cannot share information with a state law enforcement official about a known crook who has moved into the state and started operations there. Although I'm not a lawyer, I do recognize that problems of jurisdiction are complicated and must be handled delicately. Nonetheless, barriers that

prevent authorities from exchanging important information on illicit activities must be eliminated wherever possible.

Thank you, most sincerely, for the opportunity to discuss these important issues. And they are exceedingly important. The entire highway community in this nation .... the state DOTs, contractors, and suppliers, are up in arms over the proposed reduction in federal highway funding due to RABA. I'm convinced that at least half of that RABA shortfall is due to one thing: motor fuel tax theft, fuel taxes that don't find their way into the Trust Fund. The problem can readily be resolved IF you will give us the means to do so. Revising the IRS Tax Code, closing loopholes, and moving the aviation jet fuel tax to the terminal rack will be a major help. Once that's accomplished, or better yet simultaneously, I hope we'll turn our attention to accounting for the hundreds of millions of gallons of fuel that are imported into our country and that should be subject to our highway taxes.

One final statement, hopefully to generate future discussion and action. A few states have aggressively attacked the problem of their state fuel taxes being stolen. But despite the documented results achieved thus far with federal fuel taxes, where billions of dollars have been re-directed to the Federal Highway Trust Fund rather than going to the coffers of criminals, most states continue to give this situation short shrift. Michigan emulated the federal procedure of levying the state tax at the terminal rack and increased its revenue $ 38 million a year; Wisconsin gained $ 30 million, as did Oklahoma, and California increased its state fuel tax revenue by $ 65 million. My state of Texas, I regret to say, but I proclaim it FOR THE RECORD, is among the majority of states whose efforts in this regard are deplorable. Perhaps, through this Hearing, those states will finally gut up to their responsibilities.

Thank you.

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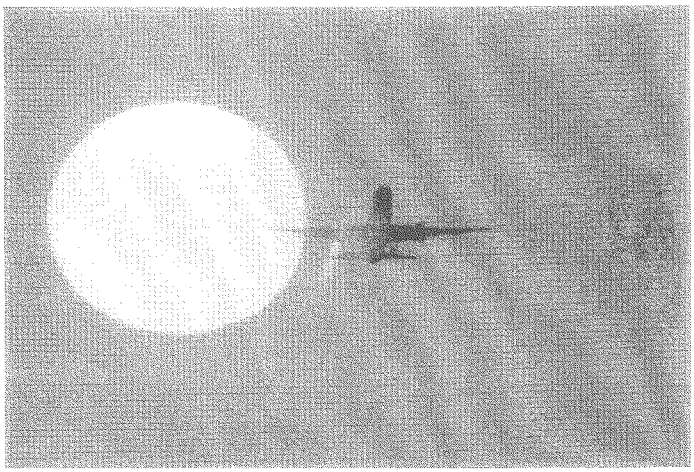
Jet Fuel Articles



2002-01-03 12:11:00 EST

***JET FUEL PRODUCTION RISING TO PRE-SEPTEMBER 11 LEVELS

The week's API report contained a notable piece of news. Just four months after the September 11 attacks, production of jet fuel by U.S. refiners is climbing back to normal levels.

The report shows national jet output at 1.524 million barrels per day, the highest figure since September 7th. The number rivals production levels reported by API in August, a month before the infamous attacks. Production rose almost 100,000 b/d for the week. It is lower than a year ago by some 70,000 b/d.

Higher production may reflect stronger December demand for jet fuel. Airlines are starting to report December traffic figures and the numbers look encouraging. Continental, for example, just reported record load factors for December 2001 that were higher than the prior year record. The record applied to domestic and international system-wide traffic.

Whether or not the boost in production is permanent or not remains to be seen. Jet fuel spot prices have been among the highest of any of the refined products, giving refiners lots of incentive to make fuel. Production has risen almost 200,000 b/d in the last six weeks.

On a regional basis, jet fuel production is higher than last year in the East and almost the same in the Midwest and on the West Coast. It continues to be noticeably below year-ago levels in the Gulf Coast. Based on last week's figures, however, jet output rose everywhere except on the West Coast.

Ben Brockwell, bbrockwell@opisnet.com

2002-06-26 09:42:10 EST
***GULF COAST JET PREMIUMS HIT NEW 2002 HIGHS

6/26/02 - Solid buying by several name-brand oil companies and a handful of trading houses has sent Gulf Coast cash premiums for jet fuel soaring. Over the last 24 hours jet premiums have jumped to their highest point of 2002 - a solid 1.5 cents over the August NYMEX. They have tripled in values this week.

Just a week ago jet barrels in the region commanded no premium to the futures market. As recently as June 3 barrels were discounted to the NYMEX by almost a penny. Most of 2002 has seen jet fuel in the Gulf trade at a discount to the NYMEX.

The sudden turnaround in is grounded in active buying by the refining sector, couple with a scarcity of sellers. It is ironic that so few sellers would be willing to move jet fuel. After all, the most recent demand figures from API - through May - continue to show jet usage off about double digit amounts.

Nevertheless, the surge in cash differentials in the Gulf is impacting other markets. Group 3 jet barrels, for example, had been discounted to the NYMEX by nearly a penny. That discount has shrunk to just 0.25 cents. There are no Gulf Coast barrels going into the Group.

New York jet premiums have risen to a solid 4 cents over the NYMEX. This too matches the highest premiums of 2002.

Last night's API report revealed jet stocks in the East to be 23 percent behind year ago levels. The deficit in the Gulf is a smaller 9 percent.

U.S. refiners did keep national jet fuel production over the 1.5 million b/d mark for the second straight week. This is the first back-to-back 1.5 million b/d figures since January.

Ben Brockwell, bbrockwell@opisnet.com

Independence Pipeline Ditched After Failing to Secure Customers

The final chapter in the long-running saga of the Independence Pipeline was reached Monday when its sponsors agreed to drop out of the project — which would have transported 916 million cubic feet per day of gas from Fort Defiance, Illinois, to Leidy, Pennsylvania — because it was unable to secure contracts with long-term customers.

"We're not going forward because of a lack of customer support," said El Paso spokesman Mel Scott. El Paso purchased original Independence sponsor ANR Pipeline during its merger with Coastal last year.

Independence and its tangential pipelines SupplyLink and MarketLink — sponsored by Williams' Transcontinental Gas Pipe Line (Transco) — were perhaps the most controversial pipeline projects in US history, considering the overwhelming opposition of landowners, environmental groups, and politicians living along its route.

Independence was designed to carry the case to Transco's Leidy hub, where the MarketLink project would carry the gas from Leidy into the northern New Jersey-New York marketplace.

SupplyLink was to carry gas supplies from Sandwich, Illinois, to ANR's Fort Defiance hub with the intention of moving Canadian gas supplies from the Alliance and Northern Border pipeline systems into the gas-starved US Northeast.

In filings with the Federal Energy Regulatory Commission (FERC), Independence and SupplyLink said they were unable to meet the customer contract requirements that the regulators imposed as a condition of their approval. In order for construction on the pipelines to proceed, FERC required that 68.2% of Independence's capacity be held by executed contracts, while SupplyLink needed executed contracts for 71.7% of its capacity *(OD Jul.13,'00,p1)*.

Ironically, both pipelines were scheduled to have a ruling made at today's FERC meeting on requests for extensions on the contract conditions, which would have expired on Jul. 12. The extensions would have given the pipelines until November 2004 to find the customers.

"Local distribution companies, electric generators, and marketers have all been unwilling or unable to commit to long-term service agreements," Independence said in its filing.

Independence backers had complained throughout the process that FERC's capacity contract conditions, which depended on 10- or 15-year contracts, ran counter to the direction of the market which was demanding more flexibility and shorter-terms for pipeline capacity contracts.

Further dampening Independence and SupplyLink's chances was the general slowdown in natural gas demand since the summer of 2000, when FERC approved the projects.

The onerous conditions that FERC placed on the two pipelines reflected the immense political pressure placed on FERC from then-New Jersey Gov. Christine Todd Whitman, numerous congressmen — both Republican and Democratic — and local political officials.

The landowner opposition against Independence and its related projects reached a new level of sophistication that portends future concern for the natural gas pipeline industry and for infrastructure projects in general. Specifically, the landowners, mostly farmers that claimed the pipeline would destroy their livelihood, formed associations to challenge the pipelines' efforts.

MarketLink eventually moved on without SupplyLink and Independence by securing approval from FERC to build in phases as supply was needed. The 156 MMcf/d first phase was finished in December 2001, while the 130 MMcf/d second phase will begin service in November, bringing incremental service into Pennsylvania, New Jersey, and New York.

Ⓟ **Christian Schmollinger**

Airlines Face Turbulent Skies as Jet Fuel Demand Still Taking Hit

Although air traffic volumes in the US have recovered gradually from the post-Sep. 11 lows, latest statistics from the Air Transport Association (ATA) confirm that airlines still face a long road to recovery, which is not good news to producers of jet fuel.

Earlier this year, the ATA suggested that the US airline industry — arguably the worst hit by last year's terrorist attacks — could bounce back to pre-Sep. 11 passenger volumes by the third quarter of this year. But as the second quarter draws to a close, that projection looks overly optimistic.

The airline industry moved quickly after the hijack airplane attacks on the US turned many people off flying. Though they slashed capacity utilization and ticket costs to match shrunken demand, they may face more darkness before the dawn.

Despite a small boost from Memorial Day weekend travel, revenue passenger miles in May still fell nearly 8% short of year-earlier levels along domestic routes, and international routes were even harder hit by that measure.

This year to date, domestic revenue passenger miles are about 9.5% below 2001, and international revenue passenger miles are 12.3% lower. But available seat miles have been slashed even more, which has actually helped boost load factors — the ratio of filled to available seats — to slightly above last year's level. But austerity measures aren't painless — airline ticket prices are currently about 15% lower than at this time last year, according to ATA, and US airlines aren't likely to turn a profit until late 2003 "at best."

Data confirm anecdotal evidence that more travelers are hitting the roads instead of flying domestically, and ATA points to the government taxes and fees, and the "hassle factor" as reasons why the recovery has been slower than anticipated.

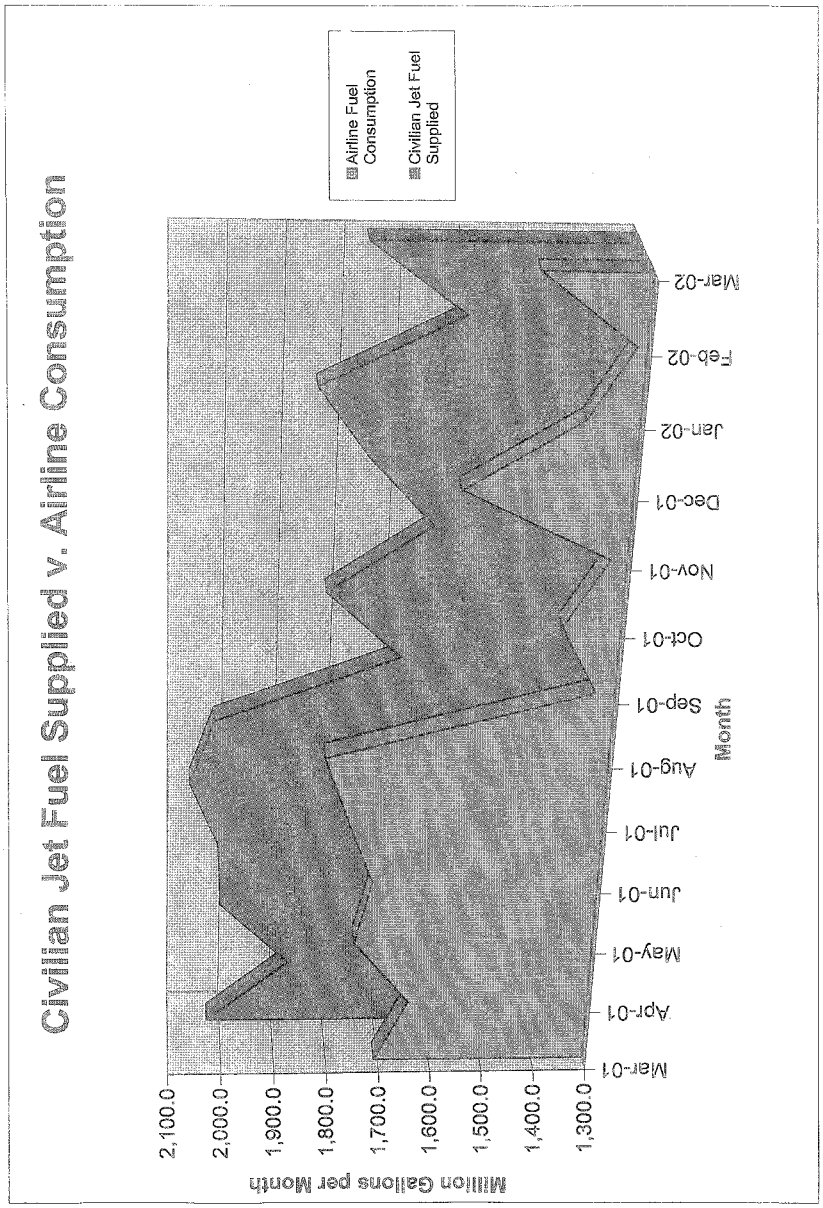
Not surprisingly, fewer planes in the sky have meant less jet fuel consumption this year. Just prior to the Sep. 11 attacks, OECD jet fuel demand was on average already about 1.5% below year-earlier levels, at about 3.5 million barrels per day, due to a slowing economy. And, with the exception of a brief spring break reprise in several countries, jet demand has trailed last year's levels by 10%-16% in most months since September.

North American jet fuel demand registered the full impact of the attacks first, quickly followed by Western Europe. Demand in Asia, where the large kerosene market can easily absorb excess jet supplies, has been more sporadic.

Latest US data still show jet fuel demand down some 11.5% on the year in May — similar to the rate of decline in most other months this year. US data suggest the decline in jet fuel consumption has been somewhat less than the actual drop in air miles traveled would suggest, probably because airlines have grounded or retired older, less efficient aircraft.

But, like the airline industry, OECD refiners know a crisis when they see one and were swift to rein in jet fuel production post Sep. 11, successfully averting any supply overhang. As early as September, OECD jet fuel production plunged more than 8% below the previous year, and continued to fall by double digits through the early part of this year.

Ⓟ **Katherine Spector**


Civilian Jet Fuel Supplied v. Airline Consumption
Airline Fuel Consumption
Civilian Jet Fuel Supplied
Million Gallons per Month
2,100.0
2,000.0
1,900.0
1,800.0
1,700.0
1,600.0
1,500.0
1,400.0
1,300.0
Mar-01
Apr-01
May-01
Jun-01
Jul-01
Aug-01
Sep-01
Oct-01
Nov-01
Dec-01
Jan-02
Feb-02
Mar-02
Month

TITLE	Products Supplied of Kerosene-Type Jet Fuel (a)	Refinery Production of Military Kerosene-Type Jet Fuel (b)	Civilian Jet Fuel Supplied	Conversion Factor	Civilian Jet Fuel Supplied	Airline Fuel Consumption	Difference
SOURCE	*[U.S. Energy Information Adminstration]*	*[U.S. Energy Information Adminstration]*	= Products Supplied - Military Production	FROM (Thousand Barrels / Month)	= Civilian Supplied x Conversion Factor	*[U.S. Bureau of Transportation Statistics].*	= Civilian Supplied - Airline Consumption
UNITS	(Thousand Barrels / Month)	(Thousand Barrels / Month)	(Thousand Barrels / Month)	TO (Million Gallons / Month	(Million Gallons / Month)	(Million Gallons / Month)	(Million Gallons / Month)
Mar-01	52,943	4,762	48,181	0.042	2,023.6	1,706.4	317.2
Apr-01	49,430	4,930	44,500	0.042	1,869.0	1,645.8	223.2
May-01	53,786	6,158	47,628	0.042	2,000.4	1,753.5	246.9
Jun-01	52,636	4,877	47,759	0.042	2,005.9	1,723.6	282.3
Jul-01	54,416	5,384	49,032	0.042	2,059.3	1,773.7	285.6
Aug-01	53,435	5,429	48,006	0.042	2,016.3	1,819.3	196.9
Sep-01	45,581	5,673	39,908	0.042	1,676.1	1,333.8	342.4
Oct-01	48,347	5,091	43,256	0.042	1,816.8	1,403.8	412.9
Nov-01	43,256	4,535	38,721	0.042	1,626.3	1,327.9	298.3
Dec-01	46,919	5,273	41,646	0.042	1,749.1	1,596.5	152.6
Jan-02	49,262	5,373	43,889	0.042	1,843.3	1,389.9	453.4
Feb-02	42,799	5,008	37,791	0.042	1,587.2	1,316.2	271.0
Mar-02	48,410	6,423	41,987	0.042	1,763.5	1,486.4	277.1

(a) EIA Table 2 - U.S. Supply, Disposition, and Ending Stocks of Crude Oil and Petroleum Products [Products Supplied = Refinery Production + Imports - Stock Change - Exports]
(b) EIA Table 29 - Refinery Net Production of Finished Petroleum Products by PAD and Refining Districts [U.S. Total]

MOTOR FUEL EXCISE TAX REVENUE LEAKAGE ANALYSIS

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MOTOR FUEL EXCISE TAX REVENUE LEAKAGE ANALYSIS

Executive Summary

Motor fuels excise tax evasion is a continuing problem. Constant monitoring and continued diligence are required in making and enforcing statutory and regulatory changes so that tax administration is more effective, efficient, and fair, while minimizing compliance costs to the greatest extent possible. This discussion document prepared by KPMG Consulting, Inc. for the Center for Balanced Public Policy describes various tax evasion techniques and makes a rough estimate of the potential scope of the problem. Documented evasion techniques include daisy chains, bootlegging, cocktailing/blending, fraudulent exemption claims, failure to file or filing false information returns, and the use of jet fuel in highway vehicles. We particularly focus on jet fuel because it is the only major transportation fuel supply not currently subject to federal excise tax at the terminal rack.

Using several federal data sources and supported by recent Florida experience, we estimate the federal revenue shortfall from jet fuel diversion alone may range between $1.7 billion and $9.2 billion over the next 10 years. State transportation tax collections may be suffering similar losses. As with most estimates of tax evasion, this estimate is necessarily approximate and based on certain assumptions that cannot be fully documented. It does indicate that ongoing revenue losses are a significant problem for tax administrators and honest business taxpayers facing competition from tax evaders.

We describe some of the many tax evasion techniques found in the literature, court cases, and press articles. While there have been significant revenue losses in the court cases we have identified, it is quite likely that much more evasion occurs than the amount caught and documented. We have not been able to develop enough information to prepare independent revenue estimates of losses resulting from these techniques, but the information that is available indicates that substantial losses continue to occur.

Florida began taxing aviation fuels at the rack on July 1, 1996, along with other changes. During the first year under the new system, Florida experienced a 21.4-percent increase in aviation fuels taxes. While it might be necessary to fine-tune Florida's approach if implemented at the national level to avoid any unintended consequences that could harm cash flows and affect compliance costs of commercial airlines and business aircraft users, such a policy has the potential to mitigate revenue losses and simplify fuel tax administration. In addition, while evidence suggests that taxing jet fuel at the rack could eliminate much of the ongoing federal revenue drain, the kinds of policy actions required to reduce or eliminate other forms of evasion are less clear.

Introduction

Motor fuel excise taxes are an important source of federal and state revenues and finance a large share of improvements in the nation's transportation system. Most federal motor fuel excise taxes are deposited in trust funds for this purpose. Some collections have gone into general revenues and a small portion is deposited in the Leaking Underground Storage Tank (LUST) Trust Fund. Federal and state tax rate increases over the years have correspondingly increased incentives for tax evasion with the 18.4-cents per gallon federal gasoline tax and 24.4-cents per gallon diesel fuel tax greatly exceeding profit margins on fuel sales at any point in the distribution system. While numerous legislative and regulatory steps have been taken by the federal and state governments, evasion remains a problem.

Monitoring federal excise tax collections and evasion is complicated by the variety and lack of coordination between federal data collection systems. The Energy Information Administration (EIA) tracks gallons produced, imported, exported, changes in stocks, and consumption. Using reports from the states, the Federal Highway Administration (FHWA) tracks gallons consumed in taxable and nontaxable use and tax collections. The Federal Aviation Administration (FAA) collects survey data on jet fuel costs and consumption of U.S. carriers, but not foreign carriers going to and from the U.S. The FAA also does not separately report U.S. carrier purchases within the U.S. and purchases overseas. IRS tracks federal excise tax collections, but not gallons consumed. IRS tables reporting excise tax refunds are inadequate for accurately determining the specific excise tax to which refunds are attributable or the quarter to which refunds apply. This difficulty is particularly acute when there is a tax rate change. Table 1 shows selected fuel excise tax collections reported on IRS Form 720 for fiscal years 1999 and 2000.[1]

Table 1

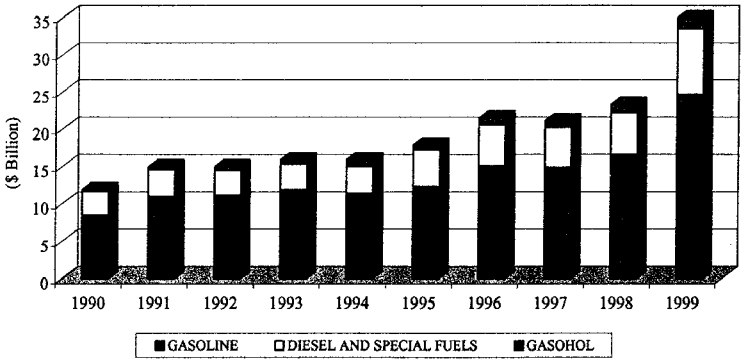
Federal Excise Taxes Reported by the IRS[2]
(Millions of dollars)

	Fiscal Years 1999	2000
Retail Excise Taxes		
Special Motor Fuels, total	24	20
Manufacturer Excise Taxes		
Aviation gasoline	58	58
Gasoline except for use in gasohol	21,237	21,041
Diesel fuel	7,896	8,230
Gasoline for use in gasohol	244	270
Gasohol	1,799	2,124
Aviation fuel, noncommercial	173	159
Aviation fuel, commercial	650	668
Kerosene (effective July 1m 1998)	78	80
Total	32,158	32,649

[1] The federal fiscal year runs from October 1 to September 30.
[2] *SOI Bulletin*, Spring 2001, Table 21, Internal Revenue Service, (Washington, DC: Department of the Treasury).

In FY 1999, $35 billion of motor fuel excise taxes was deposited in the Federal Highway Trust Fund.[3] This fund is used for developing and maintaining U.S. highways, mass transit, and other transportation related purposes. In FY 1999, excise taxes on the sale of gasoline, diesel and special fuels, and gasohol were about 90 percent of Federal Highway Trust Fund receipts.[4] Gasoline excise taxes account for about 60 percent of Federal Highway Trust Fund receipts.

Motor Fuel Excise Taxes Deposited in the Federal Highway Trust Fund, FY 1990-1999



Policy makers became aware of widespread motor fuel excise tax evasion schemes soon after the 1983 federal excise tax rate increase from 4 cents to 9 cents per gallon, and a further increase on diesel fuel to 15 cents in 1984. Since the mid-1980s, Congress and the states have enacted numerous statutory changes in attempts to reduce motor fuel tax evasion. Evasion was once estimated to be between 3 and 7 percent of all fuel taxes, and between 15 and 25 percent of diesel taxes alone.[5] Widespread motor fuels excise tax evasion in the early 1980s led to a series of federal statutory changes beginning with the Tax Reform Act of 1986 (see Appendix II). One

[3] FY 1998 trust fund deposits are understated and FY 1999 deposits overstated relative to historical experience because there was a one-time delay in transferring deposits.

[4] Federal Highway Administration, Status of the Federal Highway Trust Fund 1958-1999 (Table FE-210, available from http://www.fhwa.dot.gov/ohim/hs99/fuel.htm). FHWA defines special fuels as "diesel fuel and, to the extent they can be quantified, liquefied petroleum gases such as propane." In addition to motor fuels, certain other excise taxes are also transferred to the Highway Trust Fund, including $3.3 billion in FY 1998 and $4.0 billion in FY 1999.

[5] Federal Highway Administration, Department of Transportation. *Fuel Tax Evasion: The Joint Federal/State Motor Fuel Tax Compliance Project.* Report No. FHWA-PL-92-028. (Washington, DC: The Federal Highway Administration, June 1992), 18.

key change has been to generally impose federal fuels excise taxes upon removal from the terminal rack, including gasoline, undyed diesel, kerosene, and gasohol.

Motor Fuel Excise Tax Evasion Schemes

Various schemes have been used for evading excise taxes, including "daisy chains," bootlegging, cocktailing/blending, fraudulent exemption claims, failure to file or filing false information returns, and the use of jet fuel in highway vehicles.

Daisy Chains. The "daisy chain" creates a paper trail that makes it difficult for auditors to track the sale and taxation of the fuel. Typically, the paper trail shows that the motor fuel is taxed at some point in the chain and sold to the retailer tax-paid, but the tax is never remitted to the government. The entity in the chain with liability for the tax often disappears. The taxation of diesel fuel at the rack, dyeing, and expanded enforcement have reduced the use of daisy chains[6], but this progress is instructive in demonstrating how evaders have been able to move on to other techniques. Indeed, fuel tax evasion history is characterized by a series of policy changes and enforcement activities resulting in some evasion opportunities being curtailed only to be replaced, at least in part, by others. While evasion may never be eliminated as long as taxes are imposed on fuels, excise tax analysts generally believe evasion can be significantly reduced by taxing as much fuel as possible at the rack.

Bootlegging. Like other smuggling, motor fuels bootlegging occurs when a low tax jurisdiction is near a high tax jurisdiction. Such smuggling frequently occurs between states, costing states tax revenues and their share of the Federal Highway Trust Fund; however, bootlegging may also occur when motor fuels enter the country over the border. Similar problems may occur with fuel sold on Indian reservations.

Fraudulent Exemption Claims. Evaders frequently make fraudulent claims for the nontaxable fuel use, such as for home heating oil or off-road farming, to avoid excise taxes or to resell fuel at a tax inclusive price without remitting tax to the government.

For example, in April 1997, *US Oil Week* reported that prosecutors in Riverside County, California, charged two individuals in the motor fuel distribution business with multiple counts of state excise and sales tax evasion for supposedly forging farm exemption certificates for the purchase of tax-free clear diesel fuel. The defendants allegedly sold the tax-free diesel fuel to customers as tax paid.[7]

Failure to File or Filing False Information. Failure to file an excise tax return or filing a false excise tax return are common techniques used by evaders.

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[6] There have been a number of successful prosecutions of daisy chains since the 1980s. The IRS recently reported successes in prosecuting individuals in relation to operation "Red Daisy." More than two-dozen defendants have been convicted for their roles in a motor fuel distribution evasion scheme operating in the New York metropolitan area in the 1990s. One transaction defrauded the federal government and the State of New Jersey of more than $140 million of tax revenue on the sale of 500 million gallons of gasoline. The courts sentenced the eight defendants named in the report to a variety of terms of imprisonment and to restitution totaling over $2 million. See Criminal Investigation. "Excise Tax." *FY 2000 National Operations Annual Report.* (Internal Revenue Service, Department of the U.S. Treasury).

[7] "In the News." *Fuel Tax Evasion Highlights.* Volume 6, December 1997. Federal Highway Administration, Department of Transportation. (Available from http://www.fhwa.dot.gov/policy/hl97dec.htm.)

- On March 24, 1999, Delbert Delmar Clark III was indicted on 11 counts of excise tax evasion, totaling $209,764.23, for selling untaxed diesel fuel at a tax inclusive rate, without remitting the tax to the government. Clark pleaded guilty, and was sentenced to 15 months imprisonment and ordered to pay all taxes, penalties, and interest due.[8]
- On June 23, 2000, Keith A. Parry, operating out of Phoenix, Arizona, pled guilty to income tax evasion and was sentenced to 15 months imprisonment and ordered to pay the underreported taxes (over $800,000) relating to the preparation of false federal excise tax returns in an effort to defraud the federal government of taxes on the sale of jet fuel, diesel fuel, and gasoline.[9]

Cocktailing/Blending. This technique increases profits by extending diesel fuel with used motor oil and other distillates including pollutants, cleaning agents, and unfinished refinery products. There are two reasons in particular why this technique is attractive:

> *the substances used to extend the fuel were often not regulated so those quantities were not in any fuel tax reporting system; and ... in some cases the substances were regulated as waste materials so an unscrupulous person could get paid to dispose of the products and then blend them into gasoline and get paid again by the public.*[10]

A 1981 exposé on gasoline bootlegging by the Long Island newspaper, Newsday, recounted an incident where a cab driver pointed "...a gun at a station operator when the mixture caused the cab to stop running while still in the station."[11]

We understand that cocktailing/blending, also referred to as "below the rack blending" continues to the present and not only results in an ongoing revenue loss, but is also dangerous to society at large when hazardous waste is blended with taxable fuels. IRS' ExStars program is studying ways to prevent untaxed below the rack blending.[12] "Fingerprinting" is a method for tracing fuel from the retail outlet, back to the distributor and the terminal system, so that authorities may be able to learn where in the distribution chain the fuel was blended.

The following table originally published in U.S. Oil Week in 1996 illustrates various schemes used to evade taxes that are largely focused on cocktailing/blending.

[8] Criminal Investigation. "Excise Tax." *FY 2000 National Operations Annual Report.* (Internal Revenue Service, Department of the U.S. Treasury).
[9] Criminal Investigation. "Excise Tax." *FY 2000 National Operations Annual Report.* (Internal Revenue Service, Department of the U.S. Treasury).
[10] Ronald E. Raven, Ph.D, *Deliver Us From Evil: Governmental Responses to Reports of Fuel Tax Evasion* (Washington, D.C.: Federation of Tax Administrators, 1999), 21.
[11] Ibid, 24.
[12] "ExStars Briefing, February 24, 1999." (Available from http://www.petrolx.com/ExStars.html.)

"Fuel Tax Cons Rampant"[13]		
IRS district	**Alleged evasion type**	**Amount allegedly evaded**
Albuquerque	Blended transmix w/diesel, gasoline	$99,145(d); $100,026(g)
Atlanta	Used oil reprocessor indicted (Jerry Radney pled guilty OW 2/12; 6/26/95)	$2,500,000(d)
	63 other used oil cases	$1,000,000 +
	Bought fuel from airport at $0.20/gal., sold to T-stops	NA
Birmingham	Blended crankcase oil w/diesel	$2,000(d)
Brooklyn	Russian Mafia blended kerosene w/diesel	$100,000
	Russian Mafia blended kerosene w/diesel	$173,000
Buffalo	Three entities blended kerosene w/diesel	$48,000; $1,6000; $1,4000(d)
Burlington, Vt.	Blended 50% kerosene w/diesel	$2,000(d)
Chicago	Refiner used motor oil to produce diesel, kerosene	$644,406(d)
Greensboro	Blended crankcase oil w/diesel	$40,000
Houston	Refinery sold middle distillate oil as off-spec fuel	$1,586,140(d)
	Blended gasoline blendstocks w/gasoline	$326,800(g)
	Blended used oil w/off-spec diesel between two tanker trucks	NA
Indianapolis	10 entities blended kerosene w/diesel	
Laguna Niguel, Calif.	Blended light cycle oil, transmix, PO-70 w/diesel	$313,421(d)
	Blended transmix, light cycle oil w/diesel	$198,437
	Blended transmix, light cycle oil w/diesel	$139,806
	Blended waste products w/diesel	$1,000,000+
	Blended fuel oil w/diesel	$48,480(d)
Phoenix	Unregistered refiner fractionated transmix into diesel fuel, naptha; naptha blended w/gasoline	$1,000,000 (g/d)
	71 blending cases	$1,600,000
	Small refiner blended 70% taxable diesel w/30% oil	$500,000(d)
San Jose	Refinery produced middle distillate oil, charged excise tax; didn't remit	$15,000,000
	Blended atmospheric gas oil w/diesel	$350,000(d)
	Blended atmospheric gas oil w/diesel	$350,000(d)
Seattle	Bought diesel from boats under repair, blended w/barge strippings, bunker fuel	$50,000(d)
	Cleaned up oil spills, blended w/diesel, kerosene	$50,000(d)
		(d)=diesel; (g)=gasoline

[13] The above table has been reproduced, in-full, from U.S. Oil Week (Bob Gough, "Fuel tax cons rampant," *U.S. Oil Week*, (June 10, 1996): 18.)

Jet Fuel Use in Highway Vehicles. Unlike the federal taxation of gasoline and diesel fuel, excise tax is generally imposed on non-gasoline aviation fuel ("jet fuel") when sold by registered producers. Jet fuel is essentially the same as kerosene[14] (which is taxed at the diesel rate), but under current law is taxed at either 4.4 cents a gallon, in the case of commercial use, or 21.9 cents for non-commercial use.[15] Exempt removal of undyed jet fuel from the rack creates tax evasion incentives and opportunities that may result in the loss of not only federal and state aviation taxes, but more importantly diesel fuel excise taxes, because so-described "jet fuel" can readily be used in on-road diesel trucks.

While somewhat dated, a 1983 case illustrates jet fuel tax evasion opportunities. On August 17, 1983, the New York State Tax Commissioner issued Tenneco Oil Company a Notice of Determination of Tax Due Under Motor Fuel Tax Law alleging that Tenneco owed tax on jet fuel it sold untaxed to Doug-Long, Inc. An audit of Doug-Long, a registered distributor of diesel motor fuels, had revealed that from September 1981 to February 1983, of the 317,816 gallons of jet fuel Tenneco sold untaxed to Doug-Long, 116,367 gallons were sold at a truck stop operated by Doug-Long, or sold to heating oil jobbers. However, the Notice of Determination against Tenneco was canceled because the court ruled that Tenneco's sale to Doug-Long was not a retail sale, and therefore not subject to the taxes imposed on motor fuel. The court did conclude that tax was due on the sale of jet fuel as motor fuel from a registered motor fuel distributor. The finding did not directly result in the assessment of Doug-Long, and we have been unable to determine whether the state ultimately collected the tax.[16]

In a similar case, after a year-long investigation ending in August 1995, 23 defendants were charged with participating in an evasion scheme that involved purchase and blending of jet fuel with diesel fuel. This blended mixture was sold at service stations and truck stops in Southern California. As of December 15, 1995, six defendants had pleaded guilty.[17]

Jet fuel may leak into the motor fuel distribution system through a combination of the following events.

1. Jet fuel taxed as jet fuel and used as diesel fuel. When tax is paid on jet fuel but the fuel is used as diesel fuel for an on-road use, the Airport and Airway Trust Fund receives the benefit of the 4.3-cents per gallon tax (for fuel sold for commercial use), or the 21.8-cents per gallon tax (for non-commercial use), while the Federal Highway Trust Fund loses the 24.3-cents per gallon on-road diesel fuel tax. The 0.1-cent per gallon LUST Trust Fund is not affected.
2. Jet fuel not taxed and used as diesel fuel. When tax is never paid on jet fuel but it is used as on-road diesel fuel, the Airport and Airway Trust Fund receives no benefit and the Federal Highway Trust Fund and the LUST Trust Fund lose the 24.4-cents per gallon on-road diesel fuel tax.

[14] Jet fuel must meet certain additional specifications, but these do not affect its suitability for highway use.
[15] Jet fuel can be taxed at the 24.4-cents per gallon kerosene rate when removed at the rack, but is not taxed at the rack if certification is provided that it will be used as fuel in an aircraft. Commercial aviation users may register with the IRS and either pay a 4.4-cents per gallon tax when they purchase jet fuel from a producer (the commercial aviation tax rate) or purchase it tax free and self-assess tax when the fuel is used. Commercial aviation users paying the full tax rate are allowed to claim a refund or credit for tax in excess of 4.4 cents when the jet fuel is used.
[16] New York State Tax Commission. "In the Matter of the Petition of Tenneco Oil Company." *New York State Tax Reporter*, (CCH Incorporated: February 18, 1986.)
[17] "3 Plead Guilty to Bilking Government Out of Fuel Taxes," *The Los Angeles Times*, B4.

3. Diesel fuel is described and sold as exempt jet fuel, but does not meet jet fuel specifications and is used as highway diesel fuel. Here, the Highway Trust Fund loses the 24.3-cents per gallon diesel tax, and the LUST Trust Fund loses 0.1 cents per gallon.

Taxing aviation fuel at the rack would bring it into conformity with federal gasoline and diesel fuel taxes and would remove major tax evasion opportunities. As described above, the diversion of jet fuel for on-road use is only one of a number of fuel tax evasion schemes, but it is one where it may be possible to develop rough estimates of the current revenue drain and the corresponding revenue increases that could result from taxing it at the rack.

Using data from the Energy Information Administration (EIA), the Federal Aviation Administration (FAA), and IRS' SOI Division, we have estimated the national tax gap potentially attributable to jet fuel diverted for highway use. Because these tax gap estimates are based on differences in the fuel volumes reported in several federal data systems, these estimates may be understated or overstated due to sampling error and other inconsistencies and inaccuracies between data collection systems. These estimates assume jet fuel volumes reported by air carriers to the FAA are consistent with those reported to the IRS. To the extent this is not the case, it would contribute to a further revenue shortfall. In addition, we do not attempt to estimate any shifting of fuel to the 4.4-cent commercial tax from the 21.9-cent noncommercial aviation tax. Such transfers would also increase the revenue loss and these effects could be mitigated by taxing jet fuel at the rack.

The first section of Table 2 begins with EIA data on jet fuel supplied for domestic consumption expressed in thousands of barrels per day and removes tax-free military jet fuel production. These net figures are then converted into annual gallons supplied for commercial jet aircraft use.

The second section shows FAA jet fuel consumption data for domestic and international flights of U.S. carriers, which are reported on a fiscal year basis. These data are adjusted in the third section of Table 2 to approximate calendar years. General aviation data are collected in surveys on a calendar year basis and we had to estimate fiscal year effects.

Jet fuel used in commercial international travel is not taxable and must be removed. Domestic jet fuel purchases by foreign flag carriers are not available, but this is largely offset by foreign fuel purchases of U.S. carriers that are included in the data.[18] The difference between EIA data on net jet fuel gallons supplied and FAA data on jet fuel consumed represents a portion of the potential tax gap.

Because EIA measures product supplied as being equal to domestic production plus net imports (imports less exports), less the net increase in primary stocks, there may be small timing differences between when jet fuel leaves the refinery and when it is reported to the FAA as consumed. We understand a small amount of total jet fuel production is used in electric generation to meet air quality requirements and for fueling certain turbine generators. This will reduce the gap between EIA-reported jet fuel production and FAA-reported jet fuel consumption. Some jet fuel consumption reported by commercial carriers to the FAA is reported by refineries to EIA as kerosene or as No. 1 distillate production. This will increase the gap. It is also likely

[18] U.S. carriers report their total fuel consumption to the FAA, but foreign carriers do not. On net, there are slightly more arrivals on U.S. carriers from foreign destinations (using fuel purchased abroad) than U.S. departures on foreign carriers (using fuel purchased domestically). As a result, by subtracting FAA-reported international fuel consumption of U.S. carriers we may overstate domestic use and understate the estimated tax gap. Statistics collected by the Department of Transportation from domestic and foreign air carriers show that for the 1996-1998 period, 5.9 percent more passengers arrived from foreign destinations on U.S. carriers than departed from the U.S. on foreign carriers. See tables I-37 and I-38 in "National Transportation Statistics 2000," Department of Transportation.

that some jet fuel is lost between the refinery and aircraft fuel tanks, which could result in an overstatement of the tax gap.[19] On net, we do not know whether the potential tax gap is actually somewhat smaller or somewhat larger due to these reporting inconsistencies; however, we believe that any net adjustment would not affect our conclusion that significant volumes of jet fuel are being diverted for on-road use.[20]

[19] For example, if 0.25 percent of the EIA-reported 23,501 million gallons of jet fuel in 1999 were to have been lost before reaching the aircraft tank, the tax gap would be reduced by 59 million gallons, or 2 percent of the estimated 2,901 million gallon gap. If jet fuel were taxed at the rack, it is likely that these losses would be subject to federal excise tax.

[20] The EIA also collects data on jet fuel delivered to ultimate customers using Form EIA-782C. These data, which are collected from approximately 190 prime suppliers representing producers, importers, and inter-State resellers and retailers, show a gap averaging about 2.8 billion gallons per year over the 1995-2000 period and of about 3.3 billion gallons in 2000. Conversations with EIA staff indicate that they are not certain of the reasons for this reporting difference. They suggest that a portion of the gap could be attributable to direct importation of jet fuel by commercial airlines, which are not included in EIA's sample frame. They also cite a May 1996 Boeing Corporation paper indicating that part of the gap between jet fuel supplied by refineries and through imports and jet fuel consumption implied by annual seat miles (ASM) reported to the FAA exhibits a seasonal pattern. The Boeing paper reports that EIA-based demand is "the highest from the late fall through the middle of the winter, while the ASMs show that it should be the highest during the summer." See "Jet Fuel Data Status & Importance," Momenthy, A.M., Boeing Commercial Airplane Group, IATA Fuel Trade Forum, Johannesburg, May 1996, p. .3. Because much of the data used in the Boeing report reflects years before the dyeing regulations took effect, the extent of any jet fuel diversion into use as heating fuel, as implied by the report, is uncertain. EIA staff have not considered any issues associated with the potential diversion of jet fuel for on-road use.

Table 2

JET FUEL TAX GAP

	1995	1996	1997	1998	1999	2000
Energy Information Administration						
Jet fuel supplied (mb/d)	1,514	1,578	1,599	1,622	1,673	1,725
Less military jet fuel produced (mb/d)	176	168	144	142	140	151
Net commercial domestic supply (mb/d)	1,338	1,410	1,455	1,480	1,533	1,574
Domestic supply (mil. gal./year) [a]	20,512	21,675	22,305	22,688	23,501	24,196
Federal Aviation Administration (mil. gal./year)[21]						
Fiscal years						
Domestic carriers	12,652	13,022	13,429	13,754	14,243	14,742
International use	4,417	4,557	4,818	5,128	5,186	5,433
Total US carriers	17,069	17,579	18,247	18,882	19,429	20,175
General aviation	538	596	634	772	929	1,035
Total jet fuel	17,607	18,175	18,881	19,654	20,358	21,210
FAA data to reflect CY (using 75/25 allocation)						
Domestic carriers	12,812	13,187	13,660	13,877	14,402	14,824
international use	4,511	4,658	4,964	5,186	5,250	5,463
Adjustment for unreported foreign carrier use	0.8459	0.9100	0.9491	0.9620	0.9411	0.9411
Net international use	3,816	4,239	4,711	4,989	4,941	5,141
Total US carriers	16,628	17,426	18,371	18,866	19,344	19,966
General aviation	560	608	642	815	967	1,035
Total jet fuel	17,188	18,034	19,013	19,681	20,311	21,001
Estimated Tax Gap						
EIA gallons less FAA gallons	3,323	3,640	3,292	3,008	3,190	3,195
Percent gallons missing (gap/EIA)	16.2%	16.8%	14.8%	13.3%	13.6%	13.2%

[a] Thousands of barrels per day are converted to million of gallons per year using 42 gallons per barrel and 365 days per year, except in 1996 and 2000 when then are 366 days per year.

Over the 6-year period from 1995 through 2000, this gap averaged 14.6 percent of domestic supply. By growing the 2000 gap of approximately 3.2 billion gallons with the growth in real GDP as projected by the Congressional Budget Office, and by assuming an October 1, 2001 effective date for shifting the point of taxation to the rack, we can make a projection of the potential shortfall in Federal Highway Trust Fund and LUST Trust Fund deposits. The potential shortfall in Federal Highway Trust Fund deposits for the FY 2002 to FY 2011 period is $9.2 billion and the LUST Trust Fund deposit shortfall is $38 million. It is not necessarily the case that 100 percent of this shortfall could be recovered by taxing jet fuel at the rack.

Table 3 illustrates revenue loss projections assuming that diesel fuel taxes are being evaded at 24.4 cents per gallon. It is possible that only a 4.4-cent commercial aviation tax is being evaded. If that were to be the case, the net 10-year revenue shortfall would be reduced from $9.2 billion to

[21] Table 22. "FAA Aerospace Forecasts Fiscal Years 2001 – 2012," Federal Aviation Administration, FAA Plans and Policy, March 2001. http://api.hq.faa.gov/foreca01/Tabofcont.htm.

$1.7 billion. Similarly, to the extent the 21.9-cent per gallon noncommercial aviation tax is being evaded, the net revenue shortfall would be $8.3 billion.

Table 3

Potential Revenue Loss Resulting from Jet Fuel Diverted for On-Road Use[22]

(Dollars in millions)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
CBO real GDP growth			1.7%	2.6%	3.3%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	
Jet fuel diverted (mil. gal.)	3,190	3,195	3,249	3,334	3,444	3,554	3,668	3,785	3,906	4,031	4,160	4,293	4,431	
Loss to Highway Trust Fund ($0.243/gal.)	775	776	790	810	837	864	891	920	949	980	1,011	1,043	1,077	
Loss to LUST Trust Fund ($0.001/gal.)	3	3	3	3	3	4	4	4	4	4	4	4	4	
Fiscal year effects														
Highway Trust Fund				641	831	858	886	914	943	973	1,004	1,037	1,070	9,157
LUST Trust Fund				3	3	4	4	4	4	4	4	4	4	38
Total				644	835	862	889	918	947	977	1,009	1,041	1,074	9,195

Florida recently moved the point of taxation for aviation fuel to the terminal rack, along with other changes. In 1997, one year after Florida started taxing gasoline, diesel, and aviation fuel at the rack, the State's Department of Revenue analyzed excise tax collection data and found that the state experienced the largest gain in tax collections for aviation fuel. While no published analysis has directly linked the increase in tax collections with the change in treatment of aviation fuel, over the one-year period beginning July 1, 1996, when aviation fuel was first taxed at the rack, aviation fuel tax collections increased by 21.4 percent.[23]

This dramatic increase could be attributed to a number of factors. There could be a decrease in illegal blending with diesel fuel. It may also be that moving the tax collection point upstream decreases the potential for evasion simply because fewer and larger businesses are responsible for remitting tax to the government. Another portion of the dramatic increase in Florida could be due to kerosene being reported as aviation fuel in Florida. It could also be that previously unreported on-road fuel use is now being reported as taxable at the lesser aviation fuel tax rate, and is still used on the road.

[22] Estimates of diesel tax lost is the amount that would go to the trust funds if the entire gap between EIA reported volumes and FAA reported volumes is currently being diverted for on-road use. This loss could be significantly reduced by moving the collection point to the rack. The calculations assume this change would be effective on October 1, 2001. These estimates are before any offsets for income and payroll taxes used in computing net federal revenue effects. In making these estimates we assume these taxes will be extended at current rates, which is consistent with congressional score-keeping requirements. Under current law, the LUST Trust Fund financing rate goes to zero after March 31, 2005 and the diesel tax rate goes to 4.3 cents after September 30, 2005.

[23] State DOR analysts adjusted the data to remove the effect of tax rate changes and other features of the legislation that were unrelated to shifting the point of taxation. Florida defines aviation fuel as "...fuel used in aircraft, and includes aviation gasoline and aviation turbine fuels and kerosene." (*The 2000 Florida* Statutes, Title XIV, 206.9815.)

While the 21.4 percent gap experienced by Florida is significantly more than the 14.6 percent gap observed in the national data, other factors may have contributed to Florida's aviation fuel uplift, and not just the capture of aviation fuel previously diverted for on-road use. Nevertheless, the Florida experience indicates that large percentage fuels tax increases are possible.

Jet Fuel Use in Nonhighway Vehicles. Another opportunity for jet fuel-source highway tax evasion is via off-road use refunds.[24] While jet fuel can be taxed at the 24.4 cents a gallon diesel/kerosene highway tax rate when removed at the rack, it will not be taxed at the rack if certification is provided that it will be used as fuel in an aircraft. Clear jet fuel may be removed tax-free from the rack and certified for use in an aircraft, but resold through one or more below the rack brokers in a daisy-chain like scheme to honest ultimate vendors and described on resale documentation as clear, tax-paid diesel fuel. Ultimate vendors or off-road purchasers may subsequently file refund claims resulting in a federal revenue loss of up to 24.4 cents per gallon and comparable state losses without knowing that federal and state highway tax had never been paid thereon in the first place. Because ultimate vendors and off-road users may not be aware that what they believe is clear, tax-paid diesel fuel is actually untaxed jet fuel, and the ultimate vendor and end user invoices will describe the product as tax-paid diesel fuel. It would be very difficult for IRS to identify the abuse. This simple process may also be used simultaneously by unscrupulous intermediary resellers to avoid EPA prohibitions on distribution of high sulfur fuel for highway use. Jet fuel ASTM specifications for jet fuel sulfur content can be as high as 3,000 PPM - six times the sulfur level allowed by EPA for highway use. The use of comparatively lower viscosity jet fuel can result in damage to highway user vehicles' engines if too high a percentage of the jet fuel is used continuously in lieu of #2 diesel in a hot weather environment.

Conclusion

Motor fuels excise tax evasion is an ongoing problem requiring continual monitoring. As each new opportunity for abuse arises, revenue losses will be reduced if evasion is addressed through ongoing legislation, regulation, or increased enforcement activity. Based on our analysis, it appears that the diversion of jet fuel for highway use could be the cause of a significant, ongoing revenue shortfall.

Florida began taxing aviation fuels at the rack on July 1, 1996, along with other changes. During the first year under the new system, Florida experienced a 21.4-percent increase in aviation fuels taxes. While it might be necessary to fine-tune Florida's approach if implemented at the national level to avoid any unintended consequences that could harm cash flows and affect compliance costs of commercial airlines and business aircraft users, such a policy has the potential to mitigate revenue losses and simplify fuel tax administration. In addition, while evidence suggests that taxing jet fuel at the rack could eliminate much of the ongoing federal revenue drain, the kinds of policy actions required to reduce or eliminate other forms of evasion are less clear.

While the experience of Florida may or may not be representative of the revenue increase that would result from moving the point of jet fuel taxation to the rack, national statistics from the EIA and the FAA strongly suggest the existence of a large revenue drain today.

[4] Because we have no data on off-road vehicle use of jet fuel, the resulting revenue shortfall is not separated from the previously discussed evasion figures for on-road vehicle use of jet fuel.

In addition to reducing tax evasion resulting from jet fuel diversion, opportunities exist to increase tax revenues by addressing other schemes for evading federal and state excise tax collections.

Appendix I: Review of Evasion Literature

Public and private organizations have attempted to determine the extent of motor fuel excise tax evasion over the years. Indeed, the fuel tax evasion literature is extensive and this overview is not intended to capture all the work that has been done. While most estimates were prepared before federal regulations governing the current tax system were finalized, many of the tax evasion techniques described continue to be used.

National Economic Research Associates, Inc., February 1985

In 1985, the New York State Petroleum Council asked National Economic Research Associates, Inc. (NERA) to estimate the extent of gasoline excise tax evasion in the State of New York. In October 1992, New York moved the point of gasoline excise tax collection from the retailer to the distributor, but this move greatly increased the incentive to evade tax collection. NERA estimated gasoline excise tax evasion by comparing gasoline consumption to reported sales. NERA's first method extrapolated U.S. gasoline sales growth from 1982 to 1984 to New York. Their second method compared New York gasoline consumption with New York Department of Transportation traffic information and gasoline prices. Using the first method, NERA estimated that unreported gasoline sales were equal to 11.7 percent of reported sales in 1984, and 18.0 percent of reported sales in 1985. Using the second method, NERA estimated that unreported gasoline sales were equal to 14.5 percent of reported sales in 1984, and 20.9 percent of reported sales in 1985.[25]

National Economic Research Associates, Inc., January 1987

In 1987, another NERA study reported that federal gasoline tax evasion increased dramatically after 1983, and that evasion from 1984 to 1986 was approximately $500 million per year. NERA arrived at this evasion figure using two separate estimating methodologies. The first compared national consumption estimates to volumes upon which tax was collected to measure the tax gap. Using this method, NERA found little evasion from 1979 to 1982, but that evasion increased dramatically following the 1983 gasoline tax rate increase.[26]

> *The average difference between consumption and volume taxed over 1979-1982 was about 1.8 billion gallons (which could be attributable partly to exemptions), but the average annualized difference over 1984-1986 was in excess of 7.1 billion gallons. Thus the gap between (annual) consumption and taxed gallonage rose by over 5.3 billion gallons after the rate increase, strongly suggesting a sharp rise in evasion.*[27]

NERA'S second methodology regressed figures of taxed gasoline gallons on two consumption series (Energy Information Administration and the Federal Highway Administration) and compared these data to data on taxed gasoline gallons to measure the tax gap. Using both

[25] Dunbar, Frederick C. *Gasoline Tax Evasion in New York: Statewide Estimates.* (Washington, DC: National Economic Research Associates, Inc., February 25, 1985.)
[26] Addanki, Sumanth, Yuval Cohen, and Frederick C. Dunbar. *Gasoline Tax Evasion.* (Washington, DC: National Economic Research Associates, Inc., January 21, 1987), 2.
[27] Ibid, 5.

methodologies, NERA estimated that approximately $500 million of gasoline tax revenue was evaded annually.

NERA also evaluated previous state gasoline tax law changes to determine whether moving the incidence of taxation affected state revenue collections. NERA reported that when New York State moved the incident of taxation from the wholesaler to the point of importation, taxable gallonage increased 18 percent above the 1.6 percent nationwide average increase for the same period (1995 and 1996.)[28]

The Joint Federal/State Motor Fuel Tax Compliance Project, 1992

This comprehensive 1992 report discussed motor fuel tax evasion problems, and concluded, based upon prior studies, congressional testimony, and investigations, that "...the current level of gasoline tax evasion is between 3 and 7 percent of gallons consumed, and that the level of diesel fuel tax evasion is between 15 and 25 percent of gallons consumed."[29] This study was the first comprehensive discussion of the issues surrounding fuel excise tax evasion.

General Accounting Office, 1996

In *Diesel Fuel Excise Tax Change*, the GAO reported that diesel tax collections increased by $1.2 billion, following the Omnibus Budget Reconciliation Act of 1993 change that moved the diesel tax collection point to the terminal.

> *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.*[30]

This represented an increase of diesel fuel excise tax collections of 17.5 to 20.4 percent.[31]

[28] Ibid, 15.
[29] Federal Highway Administration, Department of Transportation. *Fuel Tax Evasion: The Joint Federal/State Motor Fuel Tax Compliance Project.* Report No. FHWA-PL-92-028 (Washington, DC: The Federal Highway Administration, June 1992), 18.
[30] General Accounting Office. *Diesel Fuel Excise Tax Change.* GAO/GGD-96-53. (Washington, DC: U.S. General Accounting Office, 1996), 4.
[31] Using FY 1993 and numbers from the Federal Highway Administration, Table FE-210, we calculated the evasion loss range as a percentage of FY 1993 excise tax collections.

Council on State Governments and the Council of Governors' Policy Advisors, 1996

In addition to reviewing the literature on previous attempts to quantify fuel excise tax evasion, *Road Fund Tax Evasion: A State Perspective* estimated the loss of motor fuels taxes using two methods. First, the authors created three surveys to measure the perception of evasion and the magnitude of the problem, and to collect information on strategies states are discussing and implementing.

> *Principal revenue administrators estimated that the revenue from motor fuels taxes (gasoline and diesel fuels) would be increased by 6.53 percent, on average. The state-by-state percentage revenue gain as provided in the survey was multiplied by the motor fuel taxes currently collected, to derive the $1.2 billion estimate provided...*[32]

Unfortunately, supporting information in the report is limited in that it does not separate the evasion estimate into the gasoline and diesel components or the state-by-state components.

The authors' second method developed a statistical model comparing the estimated demand for motor fuels to excise tax revenue collections. The step-wise regression model estimated demand for each state using three equations with the following inputs: gallons of fuel per resident; gallons of fuel per driver; and gallons of fuel per vehicle. This approach yielded a revenue loss of $952 million.[33] The study did not provide the state-by-state estimates, the gasoline and diesel components of the revenue loss, or the percent of evasion that $952 million represents (on an U.S. aggregate or a state-by-state basis).

To check their two estimates, the authors used estimated fuel evasion percentages from prior studies:

- The Federal/State Motor Fuel Tax Compliance Project – 3 to 7 percent of all fuel taxes; 15 to 25 percent of diesel taxes.
- Congressional Testimony – $1.1 billion lost to the Federal Highway Trust Fund.
- Virginia Study – New York equals 18 to 40 percent; California equals 1.3 to 2.2 percent; Virginia equals less than 10 percent.

This method resulting in a fuel excise tax evasion loss of approximately 7.8 percent of collections ($1.5 billion).[34,35] However, the authors do not indicate how they derived their $1.5 billion figure or the gasoline and diesel shares.

[32] Council of State Governments and the Council of Governors' Policy Advisors. *Road Fund Tax Evasion: A State Perspective.* (Lexington, KY : Council of State Governments & Council of Governors' Policy Advisors, 1996), 55.
[33] The report did not state the percent of excise tax collections that $952 million represents, but using the relationship between the revenue loss and percentages of the first method described, this estimate would equal approximately 4.9 percent of excise tax collections.
[34] Council of State Governments and the Council of Governors' Policy Advisors. *Road Fund Tax Evasion: A State Perspective.* (Lexington, KY : Council of State Governments & Council of Governors' Policy Advisors, 1996), 55-56.
[35] The report did not state the percent of excise tax collections that $1.5 billion represents, but using the relationship between the revenue loss and percentages of the first method described, this estimate would equal approximately 7.8 percent of excise tax collections.

Steve Baluch, Federal Highway Administration, 1996

Stephen Baluch's 1996 study describes how the effectiveness of enforcement activities can be measured. For example, taxes assessed upon audit and the examination of returns, or the losses associated with criminal investigations can provide quantifiable data on evasion activities. For example, after Pennsylvania conducted a series of truck stop raids beginning in 1992, officials observed that taxable gallons increased by 4.2 percent in the first year.[36] In addition, the impacts of legislative changes can be observed, although it is difficult to separate the types of legislative changes.[37] Baluch stated that although federal statutory changes in the last 15 years have decreased the evasion levels, the potential for large revenue losses still exists.

> *Since enactment of the dyed fuel program, at least 60 percent of the estimated evasion losses are now being recovered, an extremely favorable result considering that the FHWA fuel dye and marking report to Congress concluded that recovering 50 percent of the estimated losses would be optimistic. And yet, even if diesel fuel tax evasion has been reduced from a range of 15 to 25 percent of the taxable product to a range of 3 to 7 percent, that still represents several hundred million dollars of revenue yet to be recovered. And with a comparable range for gasoline, where evasion may actually be increasing again because of the greater difficulty of evading diesel fuel taxes, the total federal evasion losses may still amount to nearly $1 billion, which leaves a substantial potential revenue target for future compliance efforts, although the relative cost and effort to recover it would likely increase.*[38]

Raven, Ronald E., Ph.D., Federation of Tax Administrators, 1999

Ronald Raven's work is a comprehensive compilation of the events surrounding the changes in the taxation of motor fuels. He chronicles attempts by state and federal officials to address motor fuel tax evasion, as well as various schemes used by evaders. Raven reviews prior motor fuel evasion literature, and describes a number of court cases and investigations of the more notorious fuel tax evaders. This detail illustrates the magnitude of the evasion problem, as well as the necessity for governments to attack the creativity of the fuel tax evaders. His analysis focuses on the actions of Congress, the states, the Department of Justice, the Internal Revenue Service, and the Federation of Tax Administrators, as well as private parties, to combat the evasion of motor fuel excise taxes. After describing tax systems developed by federal and state governments to date, Raven describes an excise tax collection model that would meet the requirements of the main actors. This model, the *Federal "Sponge" Model*, would establish a uniform tax rate at the federal level that would apply to all states and Native American reservations and would be allocated to states in the same manner as the International Fuel Tax Agreement (IFTA). State governments would collect taxes and conduct audits, while the federal government would gather information and provide refunds.

[36] Baluch, Stephen J. "Revenue Enhancement Through Increased Motor Fuel Tax Enforcement." Washington, DC: Federal Highway Administration, Department of Transportation, 1996, 71.
[37] Ibid.
[38] Ibid, 72.

Appendix II: Post-1986 Gasoline and Diesel Excise Tax Legislative Changes[39]

Major Motor Fuels Excise Tax Legislative Changes Since 1986	
Gasoline	
1987	Effective January 1, 1987, the tax rate increased by 0.1 cent per gallon [to 9.1 cents per gallon.] [Enactment of the LUST tax.]
1988	The Tax Reform Act of 1986 moved the taxing point upstream from the wholesale level to the terminal or refinery level. This was intended to reduce the tax administration burdens on fuels outlets and IRS tax collection and enforcement costs. [Effective January 1, 1988]
1989	The Technical and Miscellaneous Revenue Act of 1988 permitted wholesale distributors to sell gasoline on a tax-exempt basis and to claim the refunds for sales for (1) export, (2) use by state and local government, (3) use in [foreign trade in] aircraft or vessels, or (4) certain nonprofit educational organizations. This provision was intended to lessen administrative burdens of excise tax refund procedures for exempt users.
1990	Effective September 1, 1990, the tax rate decreased by 0.1 cent per gallon [to 9.0 cents per gallon.] [Expiration of the LUST tax.]
1990	The Revenue Reconciliation Act of 1990 raised taxes by 5.1 cents per gallon [to 14.1 cents per gallon] to raise revenue for the Highway Trust Fund and for deficit reduction. [Effective December 1, 1990]. [LUST tax was not in effect from September 1, 1990 to December 1, 1990]
1991	The Revenue Reconciliation Act of 1990 imposed tax upon (1) removal from any refinery or terminal, (2) entry into the United States, or (3) sale to any unregistered person (unless there has been a prior taxable removal or entry), whether or not taxes have been previously paid. Removals or entries are not taxed for bulk transfers to terminals. A refund (without interest) may be obtained if a taxpayer establishes that the gasoline was previously taxed. This was intended to discourage selling of tax-paid gasoline within a terminal and to collect excise tax on all fuel when is dispensed over the terminal rack. [Effective July 1, 1991.]
1992	No legislative changes took effect.
1993	Effective October 1, 1993, the tax rate increased by 4.3 cents per gallon [to 18.4 cents per gallon].
1994-5	No legislative changes took effect.
1996	Effective January 1, 1996, the tax rate decreased by 0.1 cents per gallon [to 18.3 cents per gallon]. [Expiration of the LUST tax.]
1997	Effective October 1, 1997, the tax rate increased by 0.1 cents per gallon [to 18.4 cents per gallon]. [Reinstitution of the LUST tax].
1998-2000	No legislative changes took effect.

[39] Legislative changes (except for bracketed text) from 1987 to 1991 are reproduced from "Table IV.1: Major Motor Fuels Excise Tax Legislative Changes Since 1986," General Accounting Office. *Status of Efforts to Curb Motor Fuel Tax Evasion.* GAO/GGD-92-67. (Washington, DC: U.S. General Accounting Office, 1992), 26.

Major Motor Fuels Excise Tax Legislative Changes Since 1986[39]	
Diesel	
1987	The Tax Reform Act of 1986 allowed a retailer to elect to buy diesel fuel tax-paid, thereby moving the excise tax liability up to the wholesale level. This change was intended to reduce the tax administrative burden on fuels outlets and tax collection and enforcement costs for IRS. [Effective April 1, 1987.] [LUST tax of 0.1 cent increased tax rate to 15.1 cents effective January 1, 1987.]
1988	The Revenue Act of 1987 mandated movement of the taxing point up in the distribution system from the retail level to the wholesale level. Also, most tax-exempt users beyond the wholesale level were required to buy fuel tax-paid, then apply for a refund. This requirement was intended to reduce opportunities to evade payment and achieve more efficient administration and collection of tax and to eliminate a competitive advantage enjoyed by vertically integrated segments of the gasoline industry. [Effective April 1, 1988.]
1989	The Technical and Miscellaneous Revenue Act of 1988 reversed some of the 1987 act changes by allowing some tax-exempt motor fuel users such as farmers, off-road users, and boaters, to buy diesel tax-free. This reversal was intended to lessen the administrative burden of the excise tax refund on exempt users of diesel fuel. This action, in effect, reversed some of the 1987 act changes by allowing more entities to purchase products tax-free. [Effective January 1, 1989.]
1990	The Revenue Reconciliation Act of 1990 raised taxes by 5.1 cents per gallon [to 20.1 cents per gallon] to raise revenue for the Highway Trust Fund and deficit reduction. [Effective December 1, 1990]. [Effective September 1, 1990, the tax rate decreased by 0.1 cent per gallon.]
1991-2	No legislative changes took effect.
1993	Effective October 1, 1993, the tax rate is increased by 4.3 cents per gallon [to 24.4 cents per gallon.]
1994	The Omnibus Budget Reconciliation Act of 1993 moved the taxing point up the distribution system from the wholesale level to the terminal rack level. The Act also mandated that diesel fuel sold tax-free for exempt purposes was to be dyed. [Effective January 1, 1994]
1995	No legislative changes took effect.
1996	LUST tax expires. [Effective January 1, 1996.]
1997	LUST tax is reinstated. [Effective October 1, 1997.]
1998	Effective July 1, 1998, kerosene is officially considered a diesel fuel and taxed at the diesel fuel rate.
1999-2000	No legislative changes took effect.

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27 August 2002

The Honorable Max Baucus, Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C., 20510

Dear Mr. Chairman:

In your letter dated July 31, 2002, you asked me to respond by August 30 to two questions concerning fuel tax evasion: (1) What is the single biggest issue on evasion; and (2) What is the most important thing that Congress can do about it?

The magnitude of the tax theft (as estimated by those of us who have been fighting this issue for years, as well as by the IRS) makes it obvious that our existing audit/enforcement procedures are inadequate and obsolete. Because there are so many tax evasion opportunities available it would be presumptuous of me, and misleading, to suggest that a single solution can be evolved to solve all the problems. Instead, it is my opinion that preventing tax theft must be an evolutionary process; i.e., Congress will have to enact multiple reforms in order to gain control of the situation. This approach is necessary because tax evasion stratagems vary considerably in complexity; some can be readily addressed, but others will require the involvement and cooperation of multiple federal and state authorities, many of which aren't even aware that a problem exists, as well as private-sector petroleum interests.

It is therefore recommended that Congress use the following criteria to determine which new theft countermeasures should be initiated, and the order in which they should be undertaken.

1. Realistically, considering the extant IRS structure, what can be implemented immediately without undue interruption of normal business activity, and without imposing significant additional administrative or financial burdens on legitimate businesses?

2. What is fair and will generate the greatest revenue gain, both now and in the future?

3. What will result in the most desirable cost/benefit ratio?

4. What best will serve all geographic areas of the nation, and will have the least negative impact on federal and state governments?

Analyzed according to those criteria, I believe the priority for Congressional action should be as follows.

FIRST: IMPOSE THE FEDERAL TAX ON JET FUEL AT THE TERMINAL RACK.

Inasmuch as the federal taxes on gasoline, diesel fuel, and kerosene are already at the terminal rack, moving aviation fuel to the rack will bring about uniformity, simplify the reporting process, and thus enhance IRS's ability to more efficiently execute its audit and enforcement responsibilities. The rules regarding tax exemption for commercial airlines must also be streamlined and simplified, and penalties for the diversion of jet fuel to highway use without the payment of applicable highway taxes must be severe and enforceable.

Preventing the diversion of jet fuel to highway use is the easiest to solve. The IRS already has an existing base system/procedure in effect, i.e. taxing at the rack, the dyed fuel rule, and ExSTARS. It must be pointed out that under current IRS regulations, aviation fuel used by commercial airlines in domestic flights (commonly referred to simply as jet fuel within the industry) carries a federal tax of 4.4 cents per gallon, while the same fuel used in general aviation is taxed at 21.9 cents per gallon. Aviation fuel (jet) used in international flights, whether by domestic airlines or foreign-based, is exempt from taxation. (Highway-use diesel fuel, of course, bears a federal tax of 24.4 cents per gallon, which includes the .1 cent underground storage tank fund.) With modest rule changes and reliance on pre-existing administrative precedents and processes, as well as enhanced penalties for non-compliance, the IRS should be able to more effectively restrict the sales of tax-exempt and low-tax aviation (jet) fuel at the nation's 1,500 fuel supply terminals to FAA regulated commercial airlines.

NOTE: The EPA has mandated that by the year 2008, highway diesel fuels must contain a sulfur level not to exceed 15 parts per million. The process of desulfurizing diesel, known as hydro-treating, reduces viscosity, lowers density, and *neutralizes color*. Accordingly, the ultra low diesel fuels will all tend to be clear and look just like aviation jet fuel. Inasmuch as there apparently is no intent to reduce the sulfur content of jet fuel, however, while they will *appear* to be identical they will NOT be the same fuel in part because of the different sulfur levels.

Further, because of the higher costs involved in transportation and storage of the multiple types of distillates (diesel/jet/kerosene/heating oil/etc.), it seems inevitable that refiners will gravitate toward producing a single-low sulfur product that can be used for on-road and off-road purposes, as well as for home heating fuel. With no ability to visually distinguish these fuels from each other and from jet, from an enforcement perspective the only difference between them will be the federal tax rate: 24.4 cents per gallon for road-use diesel; 21.9 cents for non-commercial aviation; 4.4 cents for commercial aviation; and no tax at all on off-road diesel as well as on home heating fuel. This will create an enforcement nightmare for the IRS unless some kind of chemical markers can be developed to add to the fuels based upon their intended usage.

Accordingly, the Congress should consider directing the IRS to immediately undertake an expedited research project to develop invisible but detectable chemical markers - non-detrimental to either the fuel or engines - that can be injected into the un-taxed and low-taxed aviation fuel at the time it is removed from the supply terminal by transport truck. These will undoubtedly take months, if not years, to develop, but such could be effective deterrents to the diversion problem, and would be similar to the "tax or dye" rule for off-road diesel. In the meantime, the IRS can require the posting of a "Not For Highway Use" legend on terminal-issued bills of lading for jet fuel. Developing similar markers for home heating fuel and tax-exempt diesel may also help deter scams. The off-road diesel dye mandate rule has worked effectively since 1994, but apparently efforts are now being made to illegally remove the dye or negate it downstream from the terminal.

SECOND: REQUIRE THAT ALL ENTITIES FILING MORE THAN TWENTY-FIVE FUEL TRANSACTIONS WITH THE IRS PER MONTH DO SO ELECTRONICALLY.

When fully operational, the ExSTARS reporting system will be invaluable to federal and state governments in combating fuel tax evasion. However, the system will flounder and prove ineffective unless electronic reporting is mandated. Even though its implementation has only just begun, according to the IRS approximately 40 percent of the 10-to-14 million monthly filings are submitted on paper documents, meaning that 4-to-5 million of them must be manually transcribed

each month in order for the system to be of use. This is an impossible task, and corrective legislation is imperative if the potential benefits of ExSTARS are to be realized.

THIRD: ENSURE ADEQUATE FUNDING FOR THE IRS SMALL BUSINESS- SELF EMPLOYED DIVISION.

The integrity of the fuel tax collection system is dependent upon two things: (1) an efficient IRS Division; and (2), practicable and enforceable laws, which include meaningful penalties for non-compliance. With but approximately 440 employees nationwide to monitor some 1,500 fuel supply terminals, audit thousands of fuel distributors, perform roadside inspections, and ensure that the federal trust funds actually receive the multi-billions of dollars annually that are due them, it would be irresponsible to under-fund this important Division; adequate funding must be assured.

In years past, some highway interests have objected to using federal Highway Trust Fund revenue to finance the IRS fuel tax enforcement initiatives, arguing that such is an inappropriate use of revenue that supposedly is dedicated solely for transportation purposes. That argument, in my opinion, is foolish and shortsighted. Under the highway bill soon to expire, roughly only $ 30 million from the Trust Fund will have been directed to the IRS. The record shows that the investment in improving IRS's audit and enforcement activities has been a major factor in recovering literally billions of dollars for the Trust Fund - hence for transportation improvements - that previously were being stolen. During that same time frame, highway agencies have literally expended hundreds of millions of Trust Fund dollars on restoring abandoned railroad stations, building recreational hiking and bicycle paths, and paying for other "enhancement" projects. While many of these are worthwhile, financing them in large measure has been made possible by the very IRS activities about which those highway interests complain! The nation's highway programs would be well served if Congress were to *double* the dollars directed to IRS for fuel tax enforcement programs. Investing $ 60 million dollars each year is a small price to pay for preventing the theft of billions. The IRS, of course, should be accountable to the FHWA, on an audited basis, for the Trust Fund dollars it expends.

FOURTH: JURISDICTIONAL CONSTRAINTS THAT PREVENT THE SHARING AND EXCHANGE OF PERTINENT INFORMATION BETWEEN LAW ENFORCEMENT AUTHORITIES MUST BE RECONCILED.

Although the Finance Committee might find this issue to be technically outside of its jurisdiction, because the problem directly impacts the ability of federal agencies to cope with scams that siphon revenue from Trust Funds, it would be most constructive if Finance were to urge the appropriate Senate Committee or Committees to resolve such conflicts.

It is a fact that in many situations federal and state officials currently are precluded from sharing vital information concerning illegal activities not only with each other, but with their counterparts in state governments as well. Safeguards to protect individual privacy rights must of course be incorporated into any changes in laws and regulations. The appropriate officials from Treasury, Customs, Coast Guard, Defense, Transportation, FBI, Homeland Security, etc., must be brought together with state counterparts to evolve solutions to the jurisdictional problems that hinder effective enforcement of fuel tax laws.

FIFTH: TRACK AND ACCOUNT FOR THE MARITIME MOVEMENT OF FUELS.

Although little attention has yet been given it, fraud involving barge shipments of fuel is potentially equal to or even greater than those identified thus far with diesel and jet fuels. Tremendous volumes of fuels are imported into the US from foreign nations, and huge amounts are exported as well. At the present time there is absolutely NO mechanism to track the hundreds of millions of gallons of fuel involved in such shipments. Thousands of barges, each capable of transporting anywhere from 400,000 gallons of fuel to one million gallons, travel the coastal areas and on inland waterways. If, for instance, 10 million gallons of jet fuel are loaded on barges at a U.S. refinery and designated as being for export to a port outside of the U.S., there is no system in place to verify that the shipment actually reaches the indicated destination. The product, perhaps actually being jet fuel, could after leaving the loading dock be re-labeled "solvent" with false papers, then delivered to a point on the Mississippi or along the Intercoastal Canal, and be off-loaded without paying the applicable taxes. Potentially, the amount of lost tax dollars involved is huge.

To counteract maritime scams will require the development of a system comparable to ExFIRS that covers fuel imports and exports. Such an undertaking will take considerable time and effort to develop. Obviously, any system will involve numerous federal agencies, such as the Coast Guard, Customs, and the Department of Defense. Compounding the problem is the fact that foreign-flagged vessels will be involved. This is not just a theoretical problem, but one that in fact has been encountered. We dare not delay any longer in seriously examining this issue.

Should you have any questions, or need further clarification, please contact me. Thank you for the opportunity to comment on these important issues.

Sincerely,

Ray Barnhart
Chairman of the Board of Trustees
Center for Balanced Public Policy

Tax Scams and Schemes

Fuel Tax Fraud

Statement of

Joseph Brimacombe

Deputy Director of Compliance,
Small Business and Self Employed Operating Division,
Internal Revenue Service

Before the
Senate Finance Committee

July 17, 2002

IRS
Department of the Treasury
Internal Revenue Service
www.irs.gov

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 (IRS) activities to address them.

Background:

The IRS is responsible for administration of more than 40 separate excise taxes, including motor fuel. Motor 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. Six separate excise taxes are imposed to finance the Federal Highway Trust Fund program. Three of these taxes are imposed on highway motor fuels.

Motor fuel taxes on gasoline, diesel fuel and kerosene accounts for more than 90 percent of trust fund receipts. Motor fuel is taxed when it moves out of the bulk transportation and storage network – a refinery, pipeline, barge, or terminal – and into tanker trucks/rail cars at the terminal rack. At this point, gasoline is taxed and diesel fuel/kerosene is either taxed, or dyed if it is intended for nontaxable purposes. The position holder, usually the owner of the fuel as it passes the terminal rack, is liable for payment of the tax. All persons, owning taxable motor fuels before tax is paid, must be registered with the IRS. Additionally, terminal facilities 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 Form 720, taxpayers itemize their liability, for example, reporting the number of gallons of each type of fuel and the tax due, and claims of nontaxable use of the fuel. Any balance due or overpayment is settled at the time Form 720 is filed. Highway motor fuels are taxed as follows: 1) gasoline at a rate of 18.4 cents per gallon; 2) diesel fuel and kerosene at 24.4 cents per gallon; and 3) special motor fuels, such as propane, at 18.4 cents per gallon, generally. Gasohol, a mixture of ethanol and gasoline, is taxed at rates ranging from 13.1 to 15.379 cents per gallon, depending on the concentration of ethanol in the mixture.

Tax receipts deposited in the Highway Trust Fund Account totaled $31.5 billion in FY 2001 -- $26.9 billion to the Highway Account and $4.6 billion to the Mass Transit Account.

Compliance Problems

Federal and state excise tax rate increases over the years have increased incentives for tax evasion, with the tax significantly exceeding the profit margin of the product. The corresponding revenue losses are a significant problem for tax administrators and honest business taxpayers facing competition from tax evaders. Since these tax evaders are constantly trying new methods/schemes of

evasion, maintaining the flow of receipts into the Highway Trust Fund requires ongoing and vigilant compliance by federal and state authorities.

When taxpayers do not voluntarily meet their tax obligations, the IRS must use its enforcement powers to collect the taxes due. However, we simply do not have the resources to attack every case of non-compliance. Therefore, we must apply our resources to where non-compliance is greatest while still maintaining adequate coverage of all other areas.

The IRS identified and is addressing critical areas of excise tax non-compliance. These include: the continued misuse of dyed diesel fuel; "bootlegging" to evade payment of taxes at a higher rate; "smuggling" to evade payment of any and all taxes; "cocktailing" to illegally reduce the effective tax rate; and the diversion of aviation jet fuel to highway use to illegally evade motor fuel taxes. 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 persists despite the numerous legislative and regulatory steps taken by federal and state governments. The IRS currently has approximately 140 Fuel Compliance Officers (FCOs) to monitor 1,400 terminals, all fuel wholesalers, thousands of retail motor fuel outlets, and U.S. border crossings. Additionally, these personnel are charged with conducting periodic inspections of on-road vehicles on highways throughout the country.

The FCOs continue to uncover fuel misuse. For example, since the start of the fiscal year beginning October 1, 2001, the IRS FCOs have assessed over 250 penalties totaling over $500,000 for misuse of dyed diesel fuels. 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.

Motor fuel "bootlegging" is a second significant problem. This form of tax evasion occurs when a low tax jurisdiction is near a high tax jurisdiction and taxpayers scheme to evade payment of taxes at a higher rate, "bootlegging" the fuel to a lower-taxed rate jurisdiction. It frequently occurs between states – 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 per gallon, taxpayers may illegally bootleg the fuel to North Carolina where the tax rate is 24.2 cents. The pennies-per-gallon difference is huge in an industry where over 30 million gallons are transacted daily.

A third critical compliance problem is smuggling of motor fuel. This involves the illegal introduction of fuel into the United States to evade payment of any and all excise taxes. This problem is alleged to occur at border crossing points and

points of entry for ocean-going vessels. There are 55 border crossings between the United States and Canada and Mexico. More than 9 million trucks cross these borders into the United States each year. Currently, illegal smuggling activity can only be detected by conducting border checks. This includes 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. The 140 FCOs must perform all fuel compliance activities throughout the country, including periodic border checks. These border checks are constrained by both limited resources and potential disruption of international traffic due to the time required for each truck inspection under the existing processes. In addition to the border crossing points, the U.S. Army Corps of Engineers reports there are over 300 facilities, throughout the United States, capable of receiving fuel products from water-borne traffic.

Another critical compliance problem is the use of adulterated fuel through "cocktailing" or blending of the product. This tax evasion technique increases profits by increasing the volume of motor 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, so therefore these quantities are not in any fuel reporting system. Second, in some cases the substances are regulated as waste materials, providing an unscrupulous individual an opportunity to get paid to dispose of the product(s) and then blend them into motor fuel and get paid again. This tax evasion technique results in an ongoing revenue loss and also may be dangerous to the public when hazardous waste is blended with taxable fuels.

Since Congress passed legislation taxing kerosene, the diversion of aviation jet fuel to highway use to avoid motor fuel taxes has become an increasing compliance problem. Unlike the federal taxation of gasoline and diesel fuel, aviation fuel is generally not taxed at the rack. Jet fuel is taxed at 4.4 cents per gallon for commercial use and 21.9 cents per gallon for non-commercial use. Exempt removal of undyed jet fuel from the rack creates tax evasion incentives and opportunities that result in loss of federal and state aviation taxes as well as diesel fuel excise taxes because the "jet" fuel can readily be used in on-road diesel trucks.

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, and most recent, was the development and implementation of the Excise Files Information Retrieval System (ExFIRS). The ExFIRS system is made up of a number of subsystems that will: 1) support the collection of motor fuel industry operational information and automated analysis of this information; and (2) aid in identification of the areas with highest risk for non-payment of excise tax liabilities, therefore offering higher potential for return on investigative and enforcement activities. One of the most critical subsystems to ongoing compliance efforts is the Excise Summary Terminal Activity Reporting System (ExSTARS).

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, third parties report approximately 80 percent of the personal income received by taxpayers.

Recognizing that compliance with the excise tax laws of this country would be greatly enhanced by a similarly constructed excise information matching system, Congress, in response to industry concerns, mandated the development of such a system in 1998.

ExSTARS is the information reporting system that was created. It enables the IRS to track all fuel transactions that occur within the fuel industry's bulk shipping and storage system. It provides tracking capabilities of fuel from the pipeline system to the point of taxation for the Federal Excise Tax at the terminal rack. This information will then be matched by the IRS to fuel sales transactions reported by taxpayers and to verify their tax liabilities reported on the quarterly Forms 720.

ExSTARS has a comprehensive database tracking the distribution and terminal inventory levels of all fuel in the United States. The system also tracks all disbursements across the terminal rack and the state destination of the fuel after it leaves the terminal. We recently demonstrated ExSTARS' reporting and tracking capabilities to outside stakeholders, including representatives from industry and state taxing agencies. Feedback from this group stated the capabilities of the system exceeded their expectations. Representatives of the Federal Highway Administration reviewed the system and stated the system will assist in their program needs. The benefits of this system will also be extended to each state's compliance programs when ExSTARS is made available at the state level later this year.

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 21st Century.

ExSTARS was initially implemented in April 2001 and set information reporting requirements on the 1,440 terminals registered to transact fuel sales in this country, as well as the pipelines and barge carriers that transport the fuel from the refineries to the terminals. The IRS is currently receiving information reports on 10- to- 14-million fuel transactions monthly. Approximately 60 percent of these are filed electronically. The IRS is currently processing both the paper and electronic documents – transcribing all summary data into the system. However, we are finding it both impractical and cost prohibitive to transcribe the supporting detail information on the paper documents. Yet, this detail data transcription is critical to state compliance activities. Therefore, the IRS worked with the industry to extend filing requirements. This extension was provided to facilitate electronic filing and allow each affected taxpayer the opportunity to be compliant using EDI filing.

Other Key Internal Revenue Service Compliance Strategies

While ExSTARS will enhance compliance efforts, instances of willful non-compliance will continue to require IRS intervention. In several of these areas, the IRS is developing sophisticated and state of the art technologies to address excise tax evasion techniques, such as smuggling, bootlegging, and cocktailing.

For example, the IRS developed "fuel fingerprinting" technology to combat fuel tax evasion occurring "below the rack" – particularly bootlegging, smuggling, and adulterated fuel through "cocktailing" or blending of the product. Fuel fingerprinting 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. This technology allows for the detection of untaxed aviation fuel being used as highway motor fuel. Fuel fingerprinting also detects "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. Fuel fingerprinting provides a more efficient and comprehensive method to monitor compliance compared to traditional audit techniques. This technology has been tested in all fifty states allowing us to refine baseline fingerprint data for matching purposes. We are currently negotiating nationwide implementation with the National Treasury Employees Union (NTEU).

In another example, the IRS is also developing state of the art technology to identify smuggling of motor fuel at U.S. border points of entry and ocean-going vessels and barge traffic over intercoastal waterways. Under existing processes, illegal smuggling activity can only be detected by physically detaining a truck at

the border, reviewing the manifest, extracting a sample from the cargo tank, and analyzing the sample to determine if the substance matches the description on the manifest. The IRS worked with the Department of Energy's Pacific Northwest National Laboratory (PNNL) to design, develop, and test a new technology called an Acoustical Identification Device (AID) that uses hand-held sonar technology to identify the liquid contents of sealed containers, such as tanker trucks. Concurrent with this effort, PNNL is working with the United States Customs Service to use the same technology for other purposes, such as drug interdiction.

The IRS also responded to findings and concerns regarding the exempt removal of undyed jet fuel from the rack for use in on-road diesel trucks. Through use of its fuel fingerprinting technology, the IRS identified instances of jet fuel being sold as diesel fuel in retail outlets and in highway diesel trucks. The IRS will continue to define the scope and magnitude of this abuse.

Each of the compliance concerns outlined thus far involve diesel fuel. However, bootlegging, smuggling, and cocktailing can be used for gasoline tax evasion schemes as well, but our efforts to explore and address this problem have been constrained by resources and a limited ability to mitigate safety hazards involved in handling and shipping samples of the more volatile gasoline.

Additionally, in recent years, the IRS expanded its compliance efforts by making the Form 637 Registration Program – that allows a taxpayer to engage in tax-free transactions -- the cornerstone and first step in compliance. When the IRS issues a 637 Registration, we are in effect telling everyone who deals with the registrant that we have made a determination that the registrant can be relied on to collect and pay the proper amount of Federal Excise Tax. The IRS conducts periodic compliance checks with taxpayers to ensure that the taxes are collected consistent with the statutes and to account for any and all transactions involving a tax exemption. By strengthening this up-front compliance activity, downstream compliance problems can be minimized. One area that continues to pose a challenge is the detection of illegal distribution of fuel involving water-borne traffic. Currently, a terminal is required to be registered with the IRS in order to receive and store tax-free fuel. Fuel owners will only store fuel in IRS registered terminals. Therefore, a failure to register will result in loss of business. Recent regulations have required the registration of pipelines and barges. However, there is no tax or economic penalty for failure to comply.

Conclusion

Mr. Chairman, in conclusion, I believe that we are making progress in our goals to ensure that federal motor fuels taxes are reported, paid, collected, and made available to the Highway Trust Fund. 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.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SMALL BUSINESS/SELF-EMPLOYED DIVISION

AUG 2 0 2002

The Honorable Max Baucus
Chairman, United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510
Attn. Bob Merulla, Editor, &
Carla Martin, Chief Clerk

Dear Mr. Chairman:

I am writing to follow up on questions asked at the July 17 Senate Finance Committee hearing concerning motor fuel taxes. Thank you for the opportunity to provide further clarification on this issue.

Question 1:

How many IRS enforcement officers are there nationwide who have the authority to make immediate arrests for violations of motor fuel tax laws? Here is a scenario:

- An IRS employee learns that a truck is unloading jet fuel into storage tanks at a truck stop where it will be sold as diesel fuel. What can the employee do, and how soon can charges be pursued against the individual bootlegging the fuel?

Answer:

For the upcoming fiscal year 2003, we project having 215 Excise Tax Agents available to conduct audits, 637 Registration Compliance Checks, and identify non-filers of excise tax returns. These agents are responsible for the enforcement of over 40 separate excise taxes including the motor fuel tax laws. In addition to the Excise Tax Agents, the IRS currently has approximately 140 Fuel Compliance Officers (FCO's) to monitor 1,400 terminals, all fuel wholesalers, thousands of retail motor fuel outlets, and U.S. border crossings. These personnel are also charged with conducting periodic inspections of on-road vehicles on highways throughout the country.

None of our enforcement personnel have arrest authority. We do not have authority to take immediate action in any scenario. FCO's have authority to inspect any location that may have fuel stored and to take samples of the fuel to determine if someone has tampered with the fuel – such as diluting the dye concentration. If a FCO discovers a suspicious sample, he or she will advise the owner of the fuel that we will test the fuel to verify the presence of dye. If an individual is using dyed fuel for a taxable purpose, such as in the propulsion tank of a highway vehicle, the IRS will propose a penalty of $10.00 per gallon or a minimum of $1000 per violation. The sample is scientifically tested using standardized methods to detect the presence of dye. After conformation that dye is present in the sample, the IRS will send the owner of the fuel a penalty assessment notice for the improper use of dyed fuel. The owner of the fuel then has the right to appeal this assessment to our Appeals Office. If our Appeals Office upholds the assessment, we then mail a collection notice to the owner of the fuel and take necessary action to collect the penalty. This entire process can take several weeks from start to finish.

In the scenario of a truck unloading jet fuel into a storage tank at a truck stop, we can not take any immediate action. Because an individual can readily substitute jet fuel for on road diesel fuel or kerosene, we cannot immediately determine that this transaction is improper. First, we must establish whether any Federal Excise Taxes have been paid on this fuel. Unlike gasoline and undyed diesel fuel, jet fuel can be removed from a terminal tax free for aircraft use. If the jet fuel is diverted to highway use, the full 24.4 cents per gallon highway tax is required to be paid. Because we have no means to automatically track the jet fuel, we must rely entirely on taxpayers' voluntary disclosure that the fuel has been diverted and payment of tax.

In the scenario described above, we would have to trace the fuel upstream from the truck stop to the owner of the fuel being delivered. This requires a time intensive review of the invoices and inventory records of the fuel owner to establish that he or she has not paid the proper tax. Once we establish that the tax has not been paid, we will assess the tax against the proper person.

Question 2:
It appears that IRS audits to ensure that distributors of gasoline and diesel fuels have actually remitted the appropriate taxes to federal government are after-the-fact; that is, an audit may not take place for months or even years, thus enabling the dishonest person to steal huge amounts of tax dollars before the theft is discovered. How timely are those audits? How often are distributors audited?

Answer:
The timing of audits is a concern. We do not start most audits until several months after a possible taxable transaction has occurred and this time delay can allow a taxpayer to pyramid their liability. We believe ExSTARS will provide information that will enable us to identify taxpayers that should be audited more quickly. However, due to the fact that jet fuel can be removed from a terminal tax free for aircraft use, ExSTARS contains limited information on aviation jet fuel distribution. To trace the use of aviation jet fuel, we have to audit the 637-H registrants, which are permitted to buy aviation fuel tax free. Each transaction conducted by the 637-H registrant has to be inspected to determine if the fuel was actually used for aviation purposes and the proper rate of tax paid for the use of the fuel.

We have a total of 524 taxpayers that are 637-H registrants. From September of 1999 through May of 2002, we examined 134 taxpayers that hold a 637-H registration. The average direct examination time (actual hours incurred by an Excise Tax Agent) for this examination was 180 hours or over 4 ½ weeks. As you can see, the process is time consuming – but with the existing tax structure, it is the only way we can identify misuse of aviation jet fuel.

Question 3:

For more than a decade the federal gasoline and diesel taxes have been imposed at some 1500 terminal racks, but aviation jet fuel has continued to be taxed at the distributor level. How many non-airline distributors of jet fuel are there that the IRS must audit, and how many IRS employees are dedicated to doing that work?

Answer:
We have a total of 524 taxpayers that have a 637-H registration and 18 of these taxpayers have a registration as an airline. For FY2003, we plan to have 215 agents working on all Excise Tax Programs including the examination or returns, the 637 Registration Program, and the identification of non-filers of excise tax returns. We do not have agents

dedicated to examining one type of return. We anticipate that out of the 215 agents designated for the entire Excise Program, we will expend the equivalent of 100 staff years examining returns. We currently have 137 637-H taxpayers under examination and expect these examinations to carry over into FY2003. Based on our historical average time expended on this type examination, we will use the equivalent of over 12 staff years completing these cases in FY2003. At this time, we do not have an estimate of how many additional 637H registrants we will examine next year.

Question 4:

When it was discovered in the mid-1980s that fuel tax fraud was commencing on a significant scale, many individuals disputed that such scams existed. History has shown the reality of those scams, to the extent of billions of dollars. Today, while folks like some of those testifying at this hearing assert that fraud is still a major problem, others tend to dismiss it as insignificant. Based upon the IRS's knowledge and experience, Mr. Brimacombe, is fuel tax fraud of major concern today?

Answer:

Federal and state excise tax rate increases over the years have increased incentives for tax evasion, with the tax significantly exceeding the profit margin of the product. The corresponding revenue losses are a significant problem for tax administrators and honest business taxpayers facing competition from those who evade paying the tax. Because these individuals are constantly trying new methods/schemes of evasion, maintaining the flow of receipts into the Highway Trust Fund requires ongoing and vigilant compliance by Federal and State authorities.

The IRS identified and is addressing critical areas of excise tax non-compliance. These include: the continued misuse of dyed diesel fuel; "bootlegging" to evade payment of taxes at a higher rate; "smuggling" to evade payment of any and all taxes; "cocktailing" to illegally reduce the effective tax rate; and the diversion of aviation jet fuel to highway use to illegally evade motor fuel taxes.

FCO's continue to uncover fuel misuse. For example, since the start of the fiscal year beginning October 1, 2001, the IRS FCOs have assessed over 250 penalties totaling over $500,000 for misuse of dyed diesel fuels. 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.

A third critical compliance problem is smuggling of motor fuel. This involves the illegal introduction of fuel into the United States to evade payment of any and all excise taxes. Due to the complexities involved and the limited resources the IRS and other agencies have, we have discovered only a few cases. This problem occurs at border crossing points and points of entry for ocean-going vessels. There are 55 border crossings between the United States and Canada and Mexico. More than 9 million trucks cross these borders into the United States each year. Currently, we can only detect illegal smuggling activity by conducting border checks. This includes 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. The 140 FCOs must perform all fuel compliance activities throughout the country, including periodic border checks. These border checks are constrained by both the limited resources and the potential disruption of international traffic due to the time required for each truck inspection under the existing processes. In addition to the border crossing points, the U.S. Army Corps of Engineers reports that over 300 facilities, throughout the United States, are capable of receiving fuel products from water-borne traffic.

Another critical compliance problem is the use of adulterated fuel through "cocktailing" or blending of the product. This tax evasion technique increases profits by increasing the volume of motor 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, so therefore these quantities are not in any fuel reporting system. Second, in some cases the substances are regulated as waste materials, providing an unscrupulous individual an opportunity to get paid to dispose of the product(s) and then blend them into motor fuel and get paid again. This tax evasion technique results in an ongoing revenue loss and also may be dangerous to the public when hazardous waste is blended with taxable fuels. We use fuel fingerprinting to test samples of diesel fuel taken from truck stops and terminals. These tests indicate the presence of petrochemicals other than diesel fuel in enough samples to

convince us that cocktailing is a problem resulting in significant revenue losses. Although gasoline is readily susceptible to cocktailing, we have not optimized a testing procedure for gasoline. This is due to resource constraints and the need to overcome safety hazards/concerns with the handling of gasoline samples.

Since Congress passed legislation taxing kerosene, the diversion of aviation jet fuel to highway use to avoid motor fuel taxes has become an increasing compliance problem. Unlike the federal taxation of gasoline and diesel fuel, aviation fuel is generally not taxed at the rack. Jet fuel is taxed at 4.4 cents per gallon for commercial use and 21.9 cents per gallon for non-commercial use. Exempt removal of undyed jet fuel from the rack creates tax evasion incentives and opportunities that result in loss of federal and state aviation taxes as well as diesel fuel excise taxes because individuals can readily use the "jet" fuel in on-road diesel trucks. We have several active cases involving the diversion of jet fuel.

Thank you again for the opportunity to respond to your questions. Please contact me at (202) 283-2200 if further clarification or assistance is needed.

Sincerely,

Joseph R. Brimacombe
Deputy Director, Compliance Policy

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

Thank you Chairman Baucus for holding this hearing. As you know this is the fourth of our Committee's hearings focusing on our concern for "Schemes Scams and Cons" played on the American taxpayers.

Today we will be hearing witness testimony regarding fuel tax fraud. I am not talking about just moving around a few numbers on a tax return. Today we will be discussing millions of gallons and billions of dollars of missing fuel and missing tax dollars. This problem not only robs the U.S. Treasury it also robs the American Taxpayer.

We rely on these tax dollars to fund not only the Highway Trust Fund, which is charged with constructing and maintaining our national transportation system, which includes our highways and public transportation systems. In addition, this also robs money from our Airport Trust Fund.

In light of September 11, the safety and soundness of maintaining our nation's transportation infrastructure is now more than ever of the utmost importance. These issues are not just tax fraud—not only are we concerned with the tax loss, but where else is this money going—is it being used to fund terrorism? Yesterday this Committee also had a hearing on Homeland Security and it has become obvious that a sound system of monitoring transportation and collecting tax on these fuels will ultimately create a safer environment for Homeland Security.

We need to know where all of this fuel is going. What makes us think that if we cannot find the fuel to collect the tax, that we could find the fuel to stop the terrorists acts. A missing barge could hold sixty tanker truck loads of fuel, that's about $200,000 in federal and state excise taxes left uncollected. But what is even more disconcerting is that the same missing barge and its sixty tanker trucks of fuel could be used like the bomber used fertilizer and fuel in Oklahoma City. That cannot happen.

Today I hope our witnesses will review the problems, report on the state of enforcement and make recommendations on how to stop fuel tax fraud and put the tax money back in the trust funds.

STATEMENT OF
MARY E. PETERS, ADMINISTRATOR
FEDERAL HIGHWAY ADMINISTRATION
UNITED STATES DEPARTMENT OF TRANSPORTATION
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
HEARING ON
SCHEMES, SCAMS, AND CONS: FUEL TAX FRAUD
JULY 17, 2002

Mr. Chairman and Members of the Committee, thank you for scheduling this hearing to focus attention on the continuing problem of fuel tax evasion. My predecessors have come before you on a number of occasions over the past two decades to report on the extent of this problem and discuss ways to improve compliance with Federal motor fuel excise tax laws. With your assistance, we have made significant progress in addressing fuel tax evasion. Today, I would like to provide an overview of the Federal Highway Administration's (FHWA) fuel tax evasion program, including measures taken to reduce the incidence of fraud and some significant problems that remain.

As you well know, the Highway Trust Fund (HTF) finances virtually the entire Federal investment in our Nation's highways, as well as a major portion of Federal transit programs. The HTF itself is supported by the users of the highway system through payment of Federal excise taxes on gasoline, gasohol, and diesel fuels, on sales of large trucks, trailers, and truck tires, and the special highway use tax on heavy trucks. By far the most significant portion of revenues is derived from fuel taxes—projected at roughly 88 percent of revenues into the HTF over the next 10 years. Evasion of fuel taxes represents a significant loss of funding to every State, not just to those States in which the evasion occurs, since each State receives a share of every Federal-aid highway dollar. Loss of motor fuel taxes poses a serious threat to both Federal and State programs. The impact of such losses is even greater coming at a time when we have experienced a reduction in growth of HTF revenues, while demands on highway capacity reach unprecedented levels and replacement and rehabilitation costs for aging infrastructure increase.

Background

Fuel tax evasion exists because illicit profits on sales of untaxed fuel can dwarf profits made on legitimate sales. To illustrate, profit on a gallon of fuel is usually just a few cents but, if taxes can be evaded, profit can be as much as 45 cents per gallon higher (24.4 cents Federal diesel tax per gallon plus 20 cents average State tax). Thus, one truckload of fuel could potentially yield about $3600 in additional profits if both Federal and State diesel taxes are evaded (45 cents x 8000 gallons). Furthermore, the fuel tax compliance problem is exacerbated by the complexity of motor fuel distribution processes.

Substantial revenue losses caused by motor fuel tax fraud, involving organized crime, were first discovered in the New York metropolitan area in the mid-1980s. Ray

Barnhart, then Administrator of the Federal Highway Administration, was alerted to the problem when fuel tax revenues did not increase as expected following gasoline and diesel tax increases after 1982. Subsequent investigations revealed a nationwide problem, which threatened the integrity of both the Federal HTF and State highway and transportation funds.

The Internal Revenue Service (IRS) and FHWA began working together to combat fuel tax evasion by supporting changes in tax collection procedures and promoting enforcement activities. Examination of the problem indicated that imposing a tax at a higher point in the distribution chain offered the greatest potential for eliminating fraud, mainly by reducing the number of taxpayers. The highest point in the distribution chain is the refinery, but the fuel use is not determined at this level. An overwhelming number of refund requests for exempt uses would be filed if the point of taxation was at the refinery level.

Exhibit 1 (See Attachment 1, Fuel Distribution System) illustrates the basic fuel distribution process. Although there can be variations in the process (See Attachment 3, Model of the Fuel Distribution System showing variations), in the basic system fuel moves from the oil refinery in bulk shipment, by pipeline, ship, or barge, to a terminal. A terminal is a storage and distribution facility. The terminal "rack" refers to the mechanism used to dispense motor fuel products from the terminal into tank trucks or rail cars. The expression "above the rack" is sometimes used to refer to the bulk transfer system that is made up of all of the facilities for the movement and storage of gasoline and diesel fuel from refinery to terminal. The bulk transfer system includes terminals, pipelines, barges, ships, and domestic refineries. Under current law, generally motor fuel is not subject to Federal highway taxes at the bulk shipment level. However, State fuel taxes may be imposed at the bulk level, or at any level in the distribution system.

When fuel leaves the terminal by truck or rail, it must pass through the rack and at this time the use of the fuel is determined and the Federal taxes are imposed, unless the fuel use is determined to be tax exempt. Some exempt uses for diesel fuel and kerosene include school buses, construction equipment used off-road, farming, and home heating. At this point in the distribution system, tax-exempt diesel fuel and kerosene are dyed red. However, aviation-grade kerosene may be removed from the terminal without taxes being imposed and without being dyed, if certain conditions are met. All removals of gasoline at a terminal rack are taxable.

From the terminal, the fuel goes to the wholesale distributor, sometimes to intermediate storage, then to the retailer, and finally the consumer. Fuel may also go directly to the retailer from the terminal.

Tax Reform Act (TRA) of 1986 (P.L. 99-509, 100 Stat. 1951). Progress was made in gasoline tax enforcement under the TRA of 1986 which moved the point of gasoline tax collection from the wholesale level to the rack level at the point of removal from the terminal, refinery, or point of import, and also strengthened licensing and bonding requirements on registrants for activities involving excise taxes. The point of taxation change reduced the number of gasoline taxpayers from about 8,000 to 1,000, considerably simplifying payment tracking. However, the point of taxation for diesel fuel was not moved to the rack and diesel fuel tax evasion remained a continuing and growing problem. By the early 1990s, FHWA estimated that the combined Federal and State fuel tax evasion losses approached $3 billion annually.

Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA) (P.L. 102-240, 105 Stat. 1914). To address the ongoing evasion problem, Congress, in fiscal year (FY) 1990, approved initial HTF funding for the Joint Federal/State Motor Fuel Tax Compliance Project (the Joint Project). However, it was funding provided in ISTEA, $5 million annually through 1997, which allowed the nationwide expansion of the fuel tax evasion program. Under section 1040 of ISTEA, $3 million were allocated to the States for participation in regional motor fuel tax enforcement task forces and $2 million were provided to the IRS to supplement its fuel tax enforcement efforts. The mission of the Joint Project was to ensure that collection of motor fuel taxes was a priority for Federal and State tax enforcement agencies. From the Joint Project's inception, FHWA promoted a return-on-investment approach, through intergovernmental action, including investments in the operations of other agencies. Success was measured in part by increases in HTF revenues. Enforcement activities, such as audits and criminal prosecutions, are estimated to produce assessments for violations of State and Federal taxes in the range of $10 to $20 for each dollar spent on these programs. However, not every assessed dollar is actually collected, especially in the case of criminal assessments.

The Joint Project is directed by a Steering Committee, chaired jointly by the FHWA and IRS, and composed of representatives from the lead States of the nine task forces, and numerous ad hoc participants, including the U.S. Department of Justice, American Association of State Highway and Transportation Officials (AASHTO), American Petroleum Institute, Federation of Tax Administrators and others. With funding administered by FHWA, the Joint Project supports fuel tax enforcement activities of the IRS and States and facilitates the exchange of information among enforcement agencies. Forty nine States and the District of Columbia now participate in one or more of the Joint Project's nine task forces.

Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66, 107 Stat. 312). Two provisions in the Omnibus Budget Reconciliation Act strengthened enforcement of diesel fuel taxes and resulted in substantial revenue gains. The Federal point of taxation for diesel fuel was moved up to the terminal rack level consistent with gasoline, and any untaxed (exempt) diesel removed from the terminal was required to be dyed red. Using the terminal rack point of taxation substantially reduces the number of entities responsible for collecting and remitting diesel fuel taxes, making enforcement simpler and less costly. Dyeing makes it more difficult to use exempt diesel on-road. Those caught with red-dyed fuel in highway vehicles are subject to a minimum $1,000 fine. In the first year under the new law, Federal diesel fuel tax revenues increased over $1 billion, with about $700 million of the increase attributed to improved compliance. States that have adopted legislation conforming point of taxation and dyed fuel provisions with Federal requirements have also seen substantial improvements, in some cases double-digit percentage increases in diesel fuel tax revenue.

Transportation Equity Act for the 21st Century (TEA-21) (P.L. 105-178, 112 Stat. 107). TEA-21 continued support for fuel tax compliance projects and also gave States the option of using up to ¼ of 1 percent of their Surface Transportation Program (STP) funds for such projects. However, under TEA-21, the focus of the fuel tax compliance program under the Joint Project shifted from encouraging cooperation among the States and the Federal government in addressing tax evasion issues, to developing and maintaining a Federal automated fuel tracking system.

Under section 1114 of TEA-21, the IRS was directed to develop a Federal and State motor fuel information reporting system that could track the movement of fuel and determine if the proper tax is paid. The majority of TEA-21 tax compliance funds were dedicated to IRS development and implementation of the Excise Files Information Retrieval System (ExFIRS), with the IRS receiving $31 million and States sharing $4 million, over the six year period of the Act. The ExFIRS system is made up of a number of subsystems that will support the collection of motor fuel industry operational information; support automated analysis of this information; and aid in identification of the areas with highest risk for non-payment of excise tax liabilities (therefore offering higher potential for return on investigative and enforcement activities). Perhaps the most important of the subsystems is the Excise Summary Terminal Activity Reporting System (ExSTARS), which is designed to track all petroleum movements, in and out, through approved terminals, and to capture destination State information when the product is removed through the terminal rack. The IRS reports that the ExFIRS system is nearing completion.

As a result of the change in priorities, funding to the States for tax compliance projects has been reduced each year to the point where, in FY 2002, States received $8,146 ($16,292 for task force lead States), approximately an 84 percent reduction from the $50,000 ($100,000 for task force lead States) they received each year under ISTEA. And not every State is receiving funds. However, the method of distribution ensures that the limited funds are going to those States whose unobligated balance of tax evasion funds has dropped below a minimum threshold. Unfortunately, the reduction in HTF funding for State compliance projects has taken place at the same time that many State agencies are experiencing erosion of other tax enforcement resources as part of broader budget cutting efforts.

Furthermore, the TEA-21 option for States to use STP funds for motor fuel tax compliance projects has had limited success. Between FY 1998 and FY 2002, close to $85 million in STP funds potentially could have been used for fuel tax evasion projects, but only $8.8 million have been used for such purposes by 18 States. The majority of States have not obligated STP funds for fuel tax evasion because the State DOTs have set priorities for these funds years before receiving them. Tax compliance projects, which normally are administered by State revenue or enforcement agencies rather than State DOTs, must compete with other eligible State DOT projects for use of the STP dollars. While this funding option has given some State revenue and enforcement agencies the opportunity to invest in more costly items, such as State automated fuel tracking systems, and hardware and software for program support, most have been unable to benefit from the option.

FHWA continues to support and promote the Joint Project and State tax compliance initiatives by acting as a clearinghouse for enforcement information at both Federal and State levels; by supporting Federation of Tax Administrators training for motor fuel auditors in basic and advanced audit techniques; by contributing to the development of a training course on enforcement/criminal investigations techniques for State motor fuel tax enforcement agents; and by investigating areas with potential for new evasion schemes such as imported finished motor fuel products. Recently, we provided a Spanish-language version of the brochure "Attention Truckers: No Dyed Fuel

on the Highway," so that truck drivers from Mexico sharing our transportation system will know about our laws and penalties for using untaxed diesel fuel on-road.

Fuel Tax Evasion Today

While legislative changes have made substantial inroads in the motor fuel tax evasion problem, fuel tax evasion persists nationwide. There are still a variety of ways in which fuel taxes may be evaded or underpaid, and fraud schemes have quickly adapted to take advantage of the remaining loopholes.

Daisy Chain. An operation of this sort was more popular before the dyeing of diesel fuel and the change to a terminal rack point of taxation. It involves multiple paper transfers of fuel among fictitious companies to conceal the party liable for remitting the tax, which is in fact never remitted. By the time auditors unravel the transactions, the company that allegedly paid the tax will have disappeared without leaving assets. A Daisy Chain could often siphon off millions of tax dollars in a few weeks of operation. Schemes involving false information filing continue to operate today and, as discussed below, are believed to be ongoing in the jet fuel distribution system.

Bootlegging. Fuel is smuggled across State, Tribal, or international borders without paying the taxes due, meaning losses in Federal or State taxes, or both. Bootlegging is particularly a threat to State fuel tax collections, usually occurring where a high-tax State borders a low-tax State.

One type of bootleg operation may be accomplished using fuel barges that move untaxed fuel through inland waterways or along the coast. The barges will tie up where a portable pump can be used to pump fuel into trucks. The terminal rack, the point of taxation, may be bypassed completely or a portion of the revenue that should have been collected may be lost. In the latter case, because barges are not completely pumped dry at the terminal, diversion of a part of the fuel shipment to be offloaded may not be detected by the terminal.

Noncompliance Involving Imports of Foreign Finished Product. According to the U.S. Department of Energy's Energy Information Administration 1998 import data, 437.5 million barrels of finished petroleum products are imported into the U.S. annually. This number is projected to grow each year. Increased reliance on foreign products is a result of increased demand and the reduced number of working domestic refineries (from 315 in 1980 to 151 in 2000).

The importation of finished motor fuel products is an area of potential motor fuel tax evasion concern that, to date, has not been adequately addressed. Ideally, shipments of imported fuel should be capable of being tracked from their entry into the U.S. waters to their destination terminal. Domestic source barges also require oversight to prevent purported exports from re-entering the U.S. unreported. A variety of agencies collect data from entities importing motor fuel into the U.S. While each agency requires specific forms to be completed, coordination of the data from each of the forms does not occur. This lack of data coordination, and the lack of coordinated agency efforts, may allow fuel to enter the U.S. unreported. In addition, this permits loopholes that may allow high-

sulfur fuel shipments to proceed undetected to points within the U.S. where the fuel may be off-loaded illegally.

In conjunction with the Joint Project, FHWA is currently studying the finished motor fuel importation process. Our focus is on truck and rail shipments across the Canadian and Mexican borders; barge movements; seaports; and fuel moving through foreign trade zones. Washington State officials, for example, believe that cheating is increasing on gasoline brought in from Canada. Exported fuel does not have to pay Canadian gasoline tax. Companies may be bringing in tax-free fuel for retail sale without paying Federal or State fuel taxes and without proper import licensing.

Complex processes and overlapping responsibilities for tracking foreign fuel shipments suggest that closer scrutiny may be warranted to address homeland security concerns as well as tax evasion potential. For instance, the maneuver known as "lightering" can complicate tracking of fuel shipments and could create vulnerabilities. "Lightering" refers to the off-loading of fuel, in many cases of foreign origin, from a seagoing vessel into barges, to lighten the vessel sufficiently to allow its passage into a shallow seaport.

Below the Rack Schemes/Jet Fuel Tax Fraud . So called "Cocktailing" refers to the blending of tax-paid fuel with untaxed products to extend the supply, resulting in loss of State and Federal taxes on the extended gallons. Additives can include jet fuel, petroleum waste products, and even hazardous waste materials, leading to potentially dangerous emissions and damage to motor vehicle engines in addition to the revenue losses.

The potential for aviation fuel to find its way onto the highway system untaxed has recently become a particular concern. Under the current IRS code, "H" registrants (importers or producers (including wholesale distributors) of aviation fuel) can purchase clear, tax-free jet fuel for resale. Because jet fuel can be used in diesel engines "as is" or can be blended with diesel for use on-road in trucks, exempt removal of clear jet fuel from the terminal rack provides evasion opportunities that can result in the loss of both Federal and State highway diesel fuel tax revenues. The Leaking Underground Storage Tank (LUST) Trust Fund may suffer a loss as well.

Jet fuel can enter the motor fuel distribution system primarily in one of three ways: (1) *Jet fuel is taxed at the jet fuel rate but used as diesel fuel.* The tax rate on jet fuel is either 4.4 cents/gallon (commercial) or 21.9 cents/gallon (general aviation). Purchasing the fuel tax-paid at either of the aviation rates, and using the fuel on-road, results in a loss of 24.3 cents/gallon to the Federal HTF. The Airport and Airway Trust Fund receives a small windfall and the LUST trust fund is not affected. (2) *Jet fuel is not taxed and is used as diesel fuel.* Purchase of tax-free jet fuel and its subsequent use on the highway results in losses to the Highway and LUST trust funds, while the Airport and Airway Trust Fund receives no benefit. (3) *Diesel fuel is sold as exempt jet fuel (e.g. for military use) but does not meet jet fuel specifications and is used on-road as diesel fuel.* The HTF loses 24.3 cents/gallon; the LUST trust fund loses .01 cents/gallon. The Airport and Airway Trust Fund is not affected.

Exhibit 2 (See Attachment 2, Production/Consumption graph) provides a comparative illustration of trends in jet fuel production and consumption from July of 2001 to March of this year, and suggests there is a considerable quantity of jet fuel

remaining after taxable airline consumption. Some of the difference represents tax-free exports or use in foreign commerce. Because jet fuel is currently the only major transportation fuel not taxed at the terminal rack level, tracking fuel and revenues is difficult. Florida, the only State to tax aviation fuels at the rack, reported a 21.4% increase in aviation fuel taxes collected in the first year under the new system.

A study prepared in December 2001, by KPMG Consulting, using data from the Energy Information Administration at the Department of Energy (DOE), FHWA, the Federal Aviation Administration (FAA), and the IRS, estimated that potential revenue loss from jet fuel diversion could range as high as $9.2 billion for the FY 2002 through FY 2011 period. This estimate was arrived at in part because of the difference in volume of fuel production and volume of airline consumption.

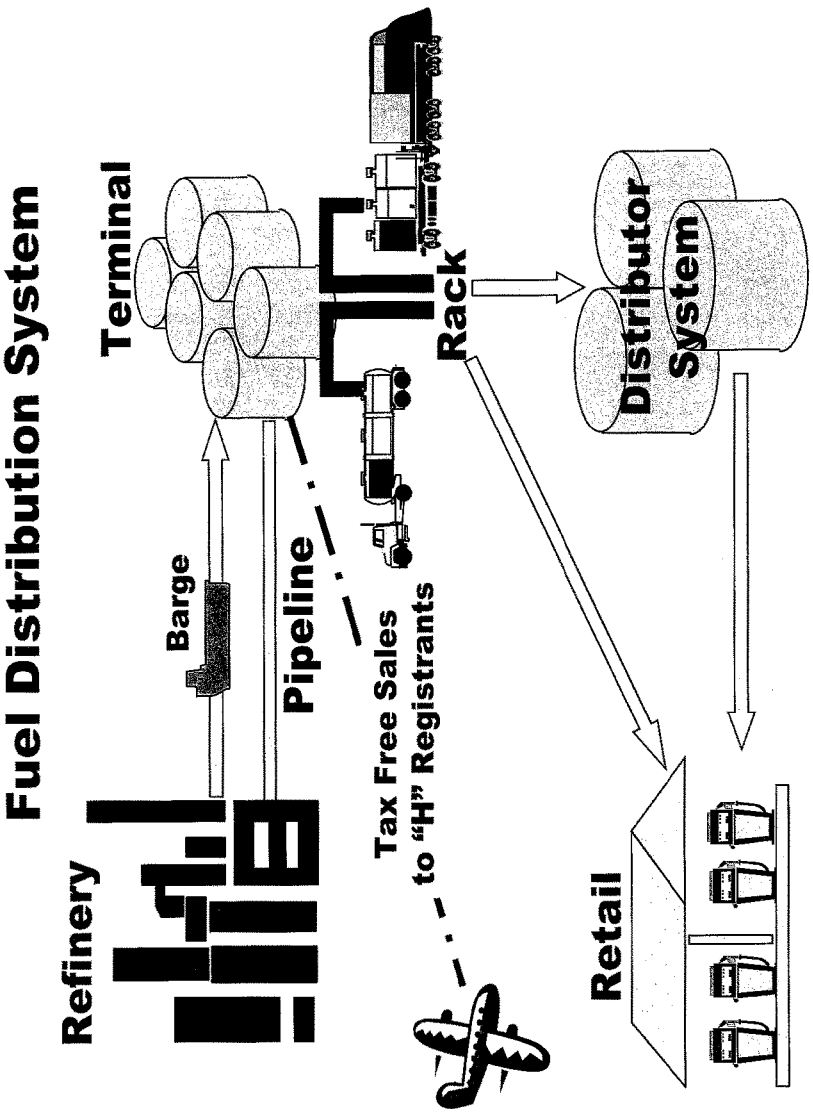
Conclusion

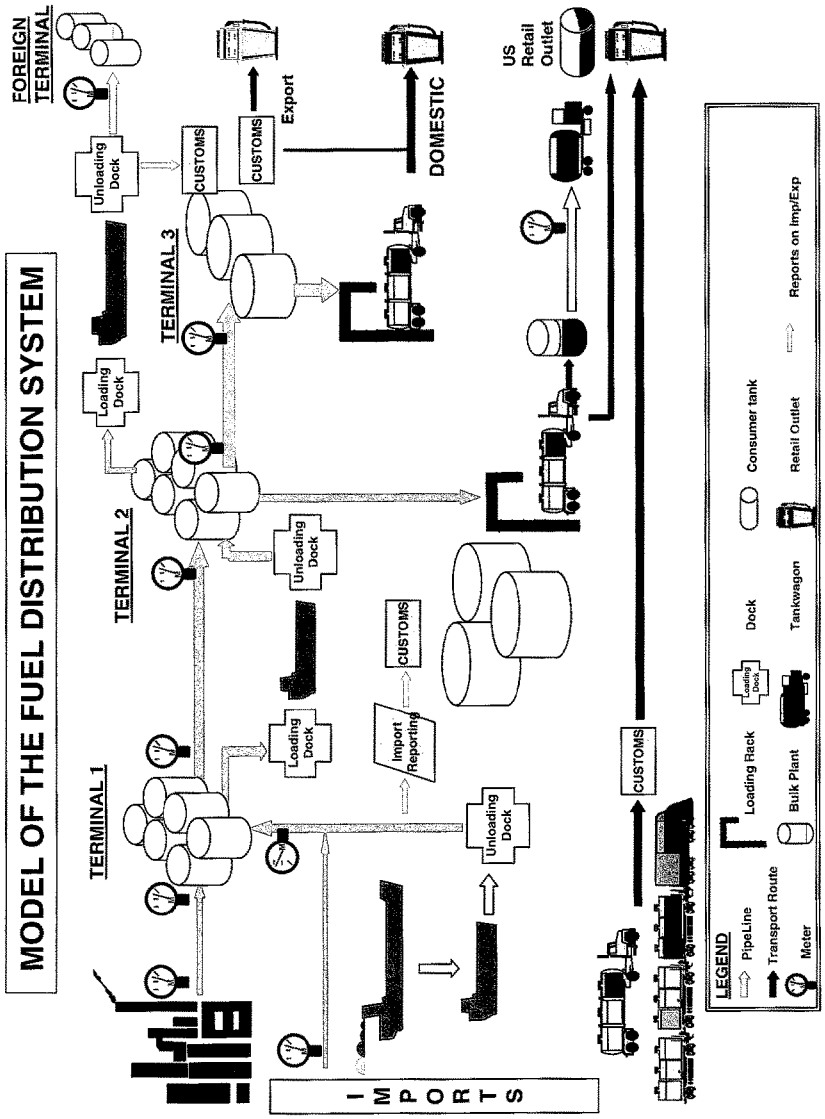
In shaping the Administration's reauthorization bill, Secretary Mineta has committed to maximizing the safety and security of surface transportation for all Americans, even as the Department seeks to enhance mobility, reduce congestion, and facilitate growth in the economy. If we are to realize these goals, we must strive for the greatest return possible on each dollar invested in transportation. Furthermore, we must ensure that the American people are not cheated out of the dollars that, by law, they are entitled to have invested in their surface transportation systems.

An ongoing commitment to motor fuel tax enforcement is needed to continue the progress already made in combating fuel tax evasion. Although it is difficult to precisely quantify the revenue gains attributable to reduced evasion, reports from specific enforcement actions indicate that we are getting a good return on the money that has been invested to improve fuel tax compliance. Increased tax compliance means increased revenues.

FHWA will continue, through the Joint Fuel Tax Compliance Project, promoting enforcement activities and developing new strategies to encourage compliance. We believe that working together with our partners to ensure collection of the revenues that fund our programs is an integral part of our role as stewards of Federal-Aid Highway Program investments.

Mr. Chairman and Members of the Committee, this concludes my statement. I again thank you for the opportunity to testify today and I will be pleased to answer any questions you may have.

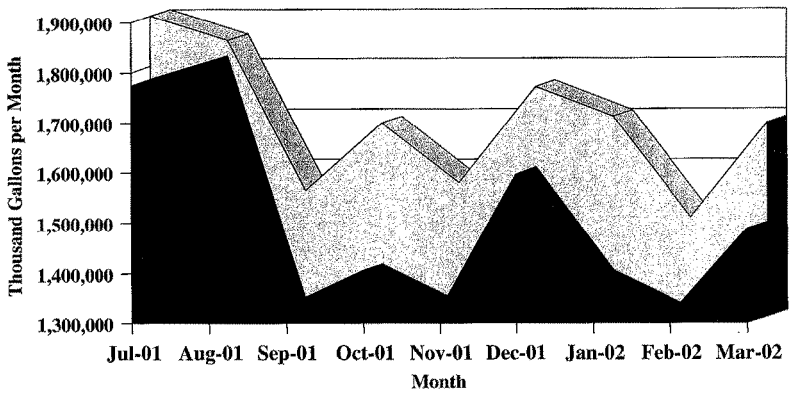

Fuel Distribution System
Refinery
Barge
Terminal
Pipeline
Tax Free Sales
to "H" Registrants
Rack
Distributor
System
Retail


MODEL OF THE FUEL DISTRIBUTION SYSTEM
FOREIGN TERMINAL
TERMINAL 1
TERMINAL 2
TERMINAL 3
Unloading Dock
Loading Dock
CUSTOMS
Import Reporting
Export
DOMESTIC
US Retail Outlet
IMPORTS
LEGEND
PipeLine
Transport Route
Meter
Loading Rack
Bulk Plant
Dock
Tankwagon
Consumer tank
Retail Outlet
Reports on Imp/Exp

U.S. Refinery Net Production – Commercial Kerosene-Type Jet Fuel (E.I.A.)

v.

Airline Consumption (B.T.S.)



QUESTIONS FOR THE RECORD
FROM THE FHWA ADMINISTRATOR'S APPEARANCE BEFORE THE
SENATE FINANCE COMMITTEE
JULY 17, 2002

Question: Does the Federal Aviation Administration have a program similar to the tax evasion program administered by FHWA?

Answer: No. The FAA does not have a program similar to the evasion program administered by FHWA. However, various state and Federal agencies are increasingly conducting spot checks across transportation modes to look for inappropriate uses of jet fuel.

Question: If the FAA does not have a program similar to the evasion program administered by FHWA, do you think they should? When AIR-21 gets reauthorized next year, should Congress create a similar type of program?

Answer: The FAA, as part of the reauthorization process, is currently looking at the magnitude of the jet fuel tax evasion problem and various ways to address it. The determination as to whether the FAA should administer a similar program will be largely based on whether it is cost beneficial (i.e., whether the increase in tax revenue would outweigh the enforcement costs), and whether the Department of the Treasury would concur with the establishment of such a program.

Jet fuel poses a unique challenge because it is the only major transportation fuel that is not taxed at the terminal if purchased for sale as aircraft fuel. This arrangement requires users of the fuel to voluntarily submit the appropriate taxes that they owe to authorities. Since jet fuel, when combined with the right additives, can be used as a substitute for diesel and other types of on-road motor fuel, an incentive exists to evade taxes. This situation is exacerbated by very low or non-existent state tax rates on jet fuel. A solution to reducing tax evasion without hurting lawful users, especially the commercial airlines, has not yet been determined.

Question for the Record from Senator Baucus

QUESTION: You have described in your testimony the money that FHWA gets to administer the evasion problem. Is it enough? Do states get enough of the money to create evasion programs?

ANSWER: Over the life of TEA-21, the IRS will receive $31 million to establish and operate an automated fuel reporting system to improve tax enforcement and the States will share $4 million in allocated tax compliance funds for evasion programs.

States may use the Federal tax compliance funds for a number of purposes including participation in regional task forces and task force activities such as joint audits and investigations, and to reimburse State travel costs for motor fuel tax examination and criminal investigation training.

While there may not be sufficient allocated tax compliance funds for items such as auditor and investigator salaries, equipment purchases, or automation/computerization activities, states have the option of using up to 1/4 of 1 percent of their Surface Transportation Program (STP) funds for these purposes. However, tax compliance projects, usually managed by State revenue departments, must compete with other eligible State highway projects for approval and to receive funds and, in many cases, State DOTs have set priorities for these funds many years before receiving them. Thus, the majority of States' revenue/enforcement agencies have been unable to benefit from this funding option.

The States that have been able to use their STP funds for motor fuel tax compliance projects have used them in a number of different ways to supplement tax compliance program funds. Since the enactment of TEA-21, 19 State revenue agencies have received STP funds for tax compliance efforts. At least three States (Arkansas, California, Tennessee) are developing automated tracking systems that will accommodate State needs. Two other States (Ohio, West Virginia) have purchased vehicles for on-road enforcement efforts. Georgia and Indiana have expanded their audit and enforcement programs.

FHWA will continue, through the Joint Fuel Tax Compliance Project, to work with all of the States to promote enforcement activities and develop new strategies to encourage compliance.

In preparation for reauthorization of the surface transportation programs, we are looking into the balance of investments that will produce the greatest improvement in the surface transportation system, including investments into the tax compliance systems.

MISSISSIPPI DEPARTMENT OF TRANSPORTATION FUEL TAX ENFORCEMENT

By Wayne Rhoads

The Mississippi Highway Department was changed to the Mississippi Department of Transportation (MDOT) in 1992 by an act of the Mississippi Legislature. MDOT now includes not only highways, but also other modes of transportation such as; Rails, Ports, Aeronautics and Public Transit—making it truly multimodal. In that same legislation, weight enforcement and fuel tax enforcement became the responsibility of MDOT. The "on the road" fuel tax enforcement duties consist of spot checks on all highways and/or waterways of Mississippi for proper documentation (import notice, bill of lading, licensed distributor, etc.), dyed diesel checks and investigations of any illegal fuel being transported into the state.

In January of 2001 our Enforcement Division started stopping every fuel tanker traveling through Mississippi to fill out a brief survey and MDOT Fuel Tax Form. This step allowed MDOT Officers to become familiar with the transporters of fuel and their drivers. MDOT expected criticism about this new procedure, but after 6 months, we didn't receive one negative phone call. We found that most of these drivers are very professional and cooperative. After the events of September 11, MDOT had to heighten awareness concerning all fuel tanker trucks traveling through our state. MDOT officers were familiar with what trucks were traveling in their areas and were able to spot strange and unusual tankers off the normal routes.

In late 2001, we found some interesting things going on concerning jet fuel that was being imported into Mississippi from Louisiana. Many state municipalities that have no jetport were reported as destinations on the import notices received at MDOT weigh stations. Further investigation concluded that about 30,000 gallons of jet fuel a month were imported into various municipalities that had no jetports. We sent out a notice to all our officers to sample diesel vehicle fuel tanks in these areas and we found crystal clear fuel, which looked like jet fuel being used on the roads. We even found a few jet fuel tankers parked behind truck drivers' favorite restaurants and along remote highways equipped with gas operated pump hoses and nozzels. These cases are still under investigation.

We started researching our state jet fuel consumption, and found that the largest volume of jet fuel was used during October of 2001. This led to another statewide alert concerning jet fuel. In February and March of 2002 we began sampling the fuel tanks again and found more clear fuel. Apparently word got out about the cases involving the use of untaxed fuel on the highway. As a result, the jet fuel consumption for April dropped by 1.9 million gallons while the taxed Diesel went up 1.9 million.

Mississippi has the Mississippi River on one side and the Tennessee Tombigbee River on the other, as well as several miles bordered by the Mississippi Gulf Coast. This makes Mississippi a prime location to transport large amounts of fuel by barge. Some of our investigations have revealed potential barge off-loading sites. These areas are places where a barge and an 18-wheel tanker truck can come in close range to load the tanker truck with a pump from the barge. This process bypasses the terminal and the Federal point of taxation. After finding a few of these sites along the Mississippi River and the Tennessee Tombigbee River, we coordinated a detail with the US Coast Guard, Corp of Engineers, Mississippi Bureau of Narcotics, and the Mississippi Department of Wildlife and Fisheries, to check for registration, documents and drugs on the Tennessee Tombigbee River. MDOT is now working on a way to systematically monitor of our river systems. We want to know who's shipping what, where they are shipping it and is it really what's declared on the documents.

The need for a joint Federal State Enforcement Task Force became evident. On April 18, 2002, the first meeting was held for the Southeastern United States. Law Enforcement officials from many branches of state and Federal government as well as the Corp of Engineers and the IRS attended this meeting. To be effective in Fuel Tax Compliance this type of task force meeting needs to be held around the nation to communicate and educate our Law Enforcement Officials about the Fuel Tax evasion schemes currently happening nationwide. Some things to consider which could help:1). Do away with any tax-free purchases of jet fuel at the rack.2). Develop funding for "on the road, water and rail enforcement" pertaining to fuel tax compliance. 3).Eliminate all disclosure regulations prohibiting the IRS from communicating with any law enforcement agencies involved with fuel tax investigations.

ANSWERS TO SENATE FINANCE COMMITTEE QUESTIONS TO WAYNE RHOADS

Q. Wayne, as I understand it, there aren't many out there like you. That is to say that it is usually the departments of revenue in states who are responsible for ensuring fuel tax compliance. You work for the Department of Transportation. In your opinion, which is more effective—having the Department of Revenue or the Department of Transportation responsible for ensuring that all fuel taxes are paid in state?

A. Most states fund their Department of Revenue from what is known as general fund money. This general fund is supplied by sales and income tax collected in that state. This fund actually runs state government. It funds all state agencies such as Public Health, Education, Welfare, Mental Health, Environmental, Public Safety, and oh I almost forgot Revenue. (Bear in mind that each state is different.) The Department of Transportation usually is a "special fund" agency. This simply means that they have their own separate source of funding—state and federal fuel tax—set aside by law to construct and maintain an adequate, and safe, multi-modal transportation system. So if you look at this as a business, the most important issues for a Department of Revenue would be to keep the state properly funded. Remember this is where they get their funds also.

On the other hand the life blood of the Department of Transportation (DOT) is their funding. They have to project the needs for different transportation systems as for as 20 years in advance. When you try to set up forecasts on when you can construct or maintain the system, revenue is the driving factor. I believe that if you allowed the department who receives the benefit from the funding to collect, audit, and enforce the tax laws which create the funding you'll have a better chance 1) of collecting and reporting every dime that is due and 2) to be able to push needed legislation through the legislative process to control fuel tax evasion and 3) have a more professional and effective enforcement program.

In Mississippi, our Tax Commission actually is charged with the duty of collecting, auditing and making assessments of fuel tax. The Department of Transportation is charged with the responsibility to enforce the fuel tax laws. These laws mainly deal with reporting of fuel being transported, proper documentation while fuel is being transported, and looking for blended fuel or untaxed fuel on the roads. In this way the Mississippi Department of Transportation has some involvement in the process and can have an effect on the revenue collected. Although a more prefect world would be for the DOT to be totally charged with the responsibility of fuel tax collection, as Montana DOT has done. This would probably also work at the federal level, but the turf wars may leave a lot of scars. This is not to say that the people at the state and federal revenue agencies are not good competent employees, but if they where moved under an agency that saw them as the keepers of the purse, they might be treated with a little different attitude. When new ideas about products and changes in technology are developed which make fuel tax compliance more than just an honor system, they'll have a better chance of acquiring them.

In my opinion, the most effective answer is that the state and federal Departments of Transportation would have more of an incentive to collect all the taxes and this would streamline the whole process of budgeting, forecasting of future projects and legislating changes needed for fuel tax compliance. If however, this would be too big a bite to chew at first shot-- at least get the DOT'S involved in fuel tax enforcement while in transport (on the road).

Q. Wayne, as your investigations have taken you around the state of Mississippi, what kind of additional manpower and equipment would have helped you if you had it?

A. The manpower needed would be about six full time uniform officers stationed at strategic locations throughout the state to monitor transportation of fuel by barge, rail and truck. We would need two investigators that could work undercover surveillance. We would need to fully equip and mark six cars, have two unmarked cars for investigations as well as computers, communication equipment, and extra funds for travel and flexible night time shifts. Mississippi has two major river systems—the Tenn/Tom and the Mississippi River. The Mississippi River has 150 million tons of fuel transported on it every year and the Tenn/Tom River has about 381 thousand tons transported on it each year. The Mississippi DOT Enforcement has legal authority to board the vessels, check for proper documentation, and take samples of fuel being transported on these rivers. This type of enforcement activity would benefit fuel tax compliance for the whole country. This type of regular monitoring would require funds for contracting aerial surveillance every quarter to check for possible off loading sites and for purchasing boarding vessels to board barges.

M. D. O. T.
Fuel Tax Investigation And Enforcement
MISSISSIPPI
DEPARTMENT OF TRANSPORTATION
VIRTUTE ET ARMIS
LAW ENFORCEMENT
Previous
Next

Documentation
Import Notices
Fuel Type: Gas, Diesel or Dyed Diesel
Origin: Where the fuel came from.
Destination: Business & City
Bill Of Lading Number
Import Notice Number
Owner Of Fuel; Distributor
Transport Company
Previous
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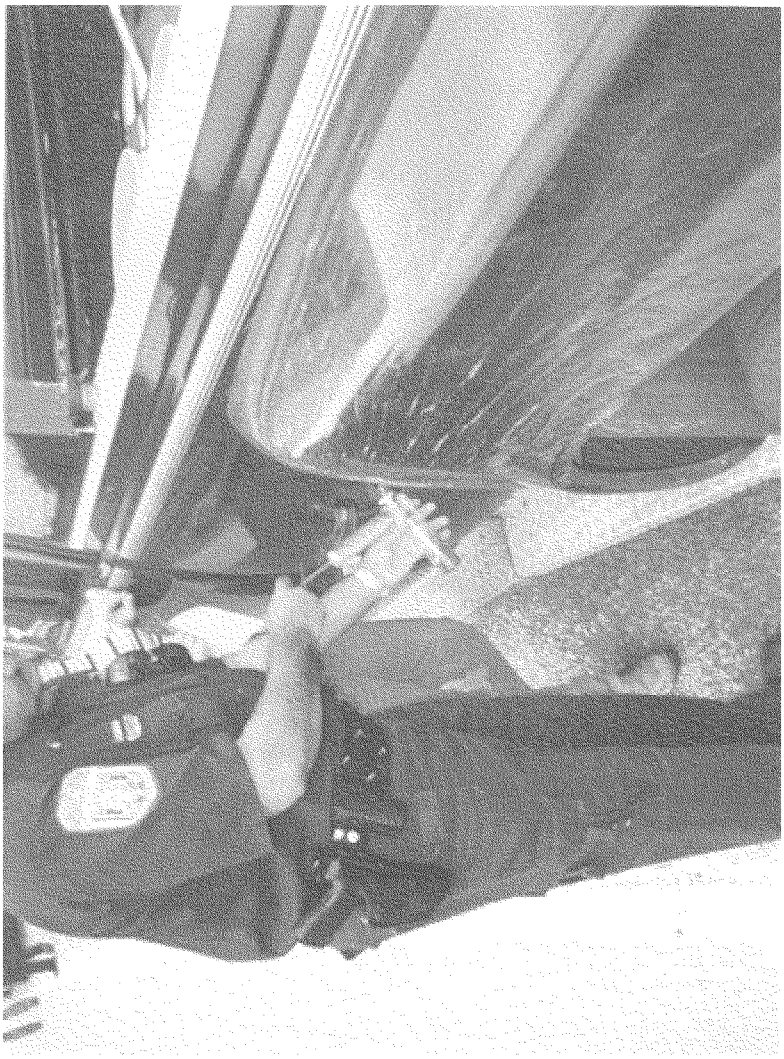
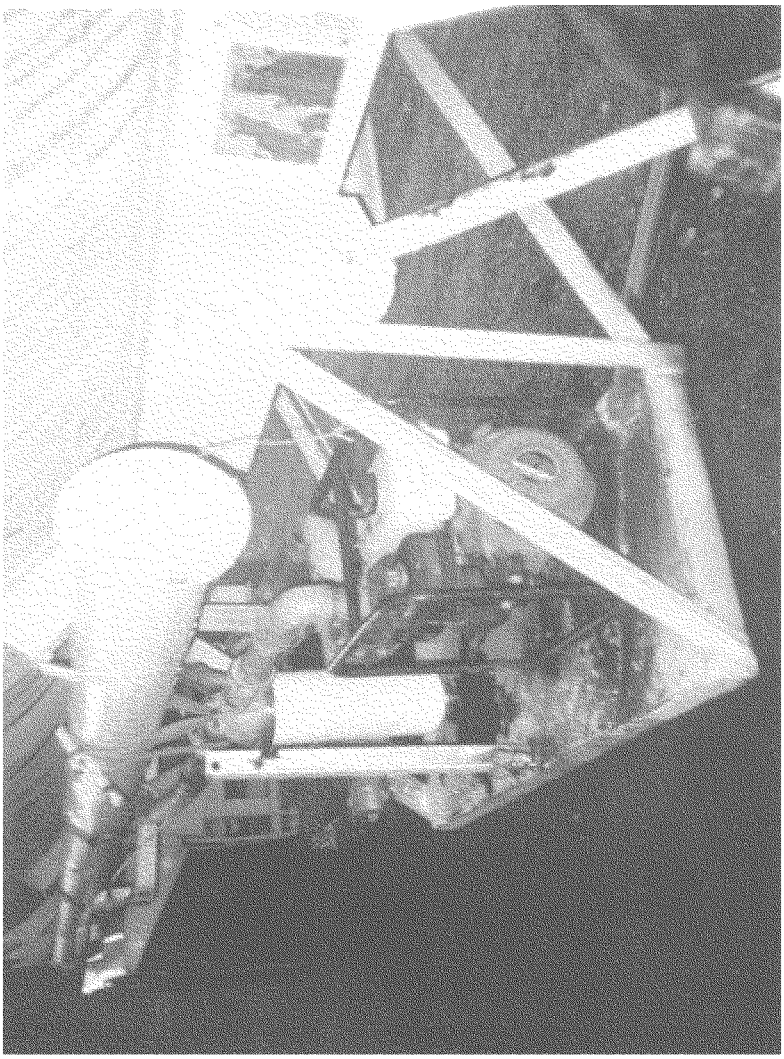
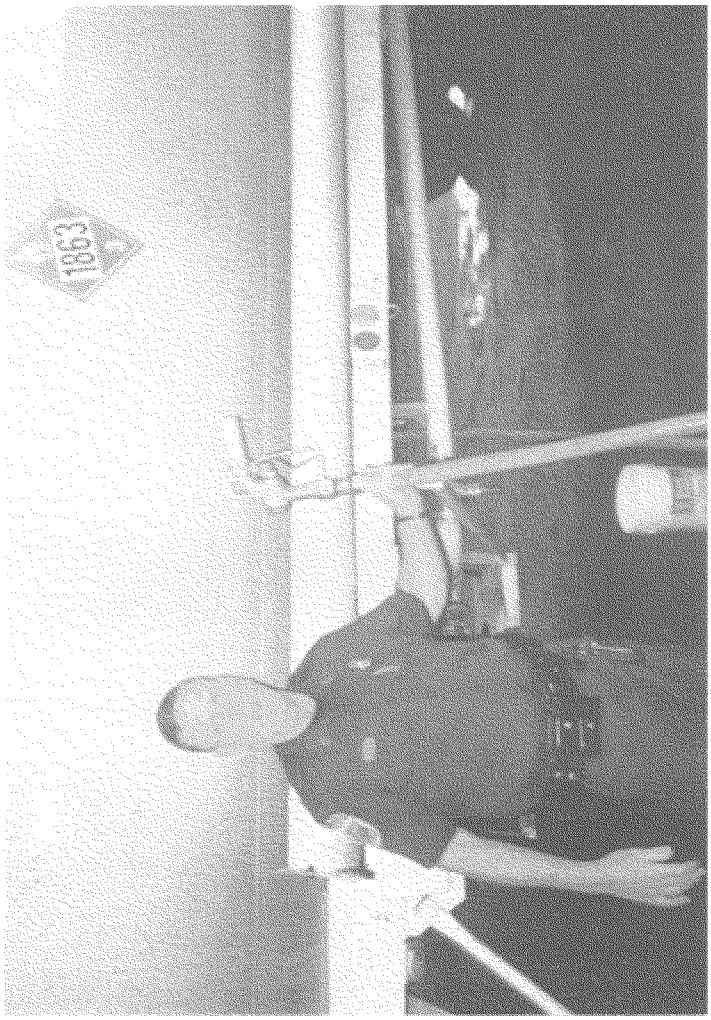






Using Other Fuels in a Ram Diesel

For the "inline" P7100 pump ('94 to 98.5 12 Valve engines). *P7100 pumps are internally lubricated by engine oil.*
These fuels are "OK": #1 & #2 Diesel, 1K & 2K Kerosene, Jet-A, Jet A-1, JP-5, and JP-8.
NOT OK under any circumstances: Jet-B, JP-4, and Cite

The "rotary" VE pump (pre '94) and electronic VP-44 (98.5+ 24 valve) *VE and VP-44 pumps are fuel lubricated.*
#1-D Diesel or #2 Fuel Oil (diesel) only
Alternate fuels listed for the P7100 pump may be used in the VE pump if if 5% lube oil is added.

The P7100 inline pump is internally lubricated by engine oil, while the VE and VP-44 pumps are fuel lubricated. The "lighter" fuels, such as Kerosene, Jet-A, and JP-5/8, don't lubricate enough.

Note: there have been some reports of sticking plungers in some early P7100 pumps. There are many commercial fuel additives which contain a pump lube - to avoid plunger trouble, consider using an additive when the engine is running on an alternate fuel.

Fuel Tidbits from the Bradley Bits - a news bulletin for Bradley Fighting Vehicles

JET A-1 fuel is essentially identical to JP-8 except it does not have three additives required in JP-8: a fuel system icing inhibitor, a corrosion inhibitor, and a static dissipater additive. Hot JP-8 fuel reduces the life of fuel pumps on some diesel engines, so avoid using JP-8 or Jet A-1 extensively in hot heather, and keep the fuel tank as full as possible to reduce fuel temperature.

Diesel fuel #2 and water separate completely; JP-8 fuel and water do not. JP-8 becomes cloudy when contaminated with water; and the cloudier the fuel, the more severe the contamination. The Ram fuel/water separator will not be able to remove suspended water from JP-8 or Jet A-1.

Some Questions answered by Josh Berman of Cummins:

> Dodge says to run #2 diesel under most conditions. In "arctic" conditions (<10 °F), others
> recommend 50% #2, and 50% K1 OR #1 diesel. Is the 1st statement true? I know the second
> is because its in the owners & service manuals.

Blending is better than running on fully on #1 or K1, because it will keep your power output closer to that of running on #2 Diesel.

> What if any problems will be caused by extended operation on other than #2
> diesel? I'm more concerned about short duration needs... ie out in a rural
> area and unable to find diesel, but can find a K1 pump.

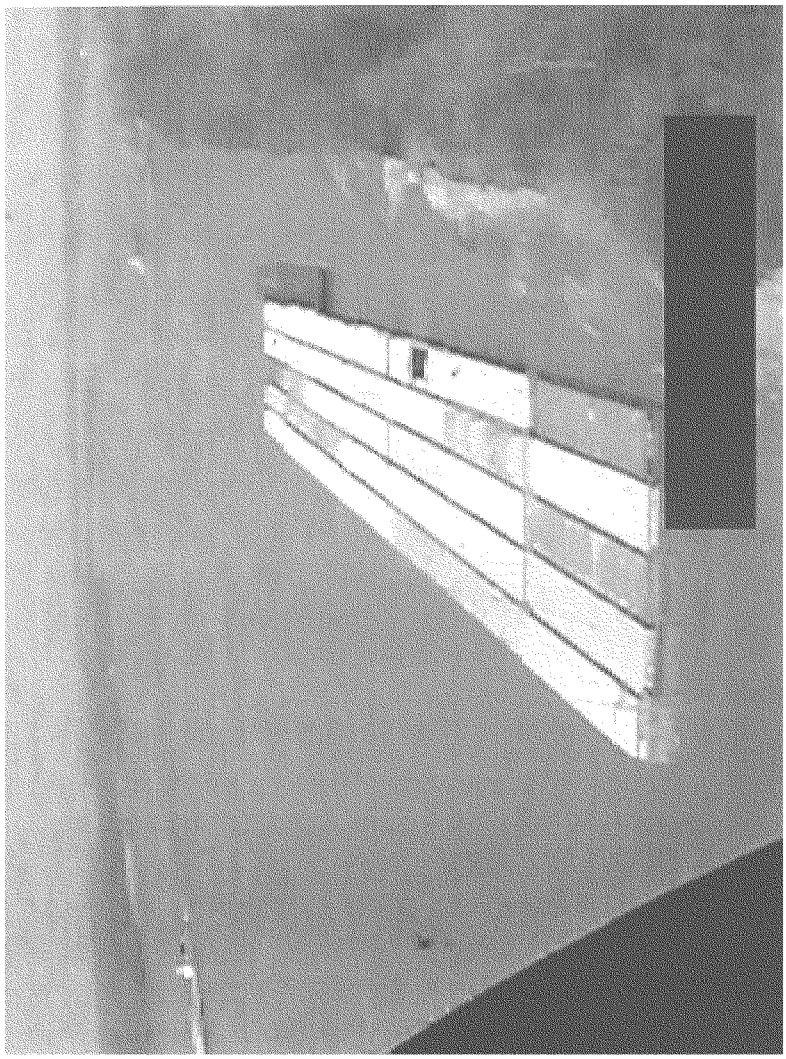
STATE TAX COMMISSION
SPECIAL FUEL TAX COLLECTIONS SPECIAL FUEL DISTRIBUTORS
FISCAL YEAR ENDING JUNE 30, 2002

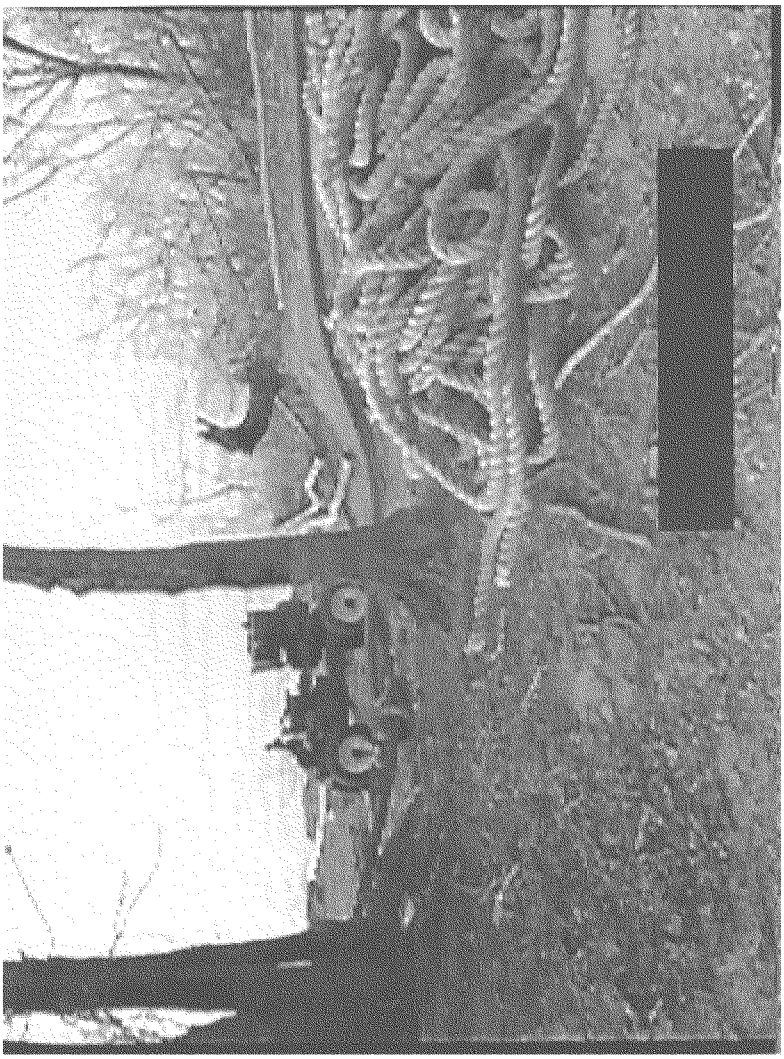
2001	'Dyed Diesel & Kerosene '5.75 Cents		Fuel Oil '5.75 Cents		Undyed Diesel Fuel '18 Cents		'Jet Fuel '5.25 Cents		'Dyed Diesel Fuel '12.25 cents		Penalty	Government Exemptions	Credit Undyed DF	Authorized Credits	Total
	Gallons	Tax	Gallons	Tax	Gallons	Tax	Gallons	Tax	Gallons	Tax					
July	12,591,435	$ 724,007	1,676,888	$ 96,421	44,716,263	$ 8,048,927	2,481,225	$ 130,264	167,697	$ 20,543	$ (11,536)	$ 68,361	$ 46,646	$ 41,779	$ 8,851,841
August	14,103,905	$ 810,975	(1,707,764)	$ (98,196)	43,712,627	$ 7,868,273	2,187,180	$ 114,827	435,493	$ 53,348	$ 3,400	$ 85,996	$ 21,735	$ 8,296	$ 8,636,599
September	11,756,316	$ 675,988	(37,482)	$ (2,155)	46,314,735	$ 8,336,652	2,240,823	$ 117,643	513,441	$ 62,896	$ 4,378	$ 86,529	$ 28,199	$ 28,875	$ 9,051,800
October	14,588,078	$ 838,815	2,959,467	$ 170,169	47,550,865	$ 8,559,155	3,434,265	$ 180,299	329,488	$ 40,362	$ 2,771	$ 122,539	$ 50,128	$ 67,312	$ 9,551,593
November	11,847,905	$ 681,254	(2,944,111)	$ (169,286)	51,348,787	$ 9,242,782	1,645,041	$ 86,365	493,681	$ 60,476	$ 3,164	$ 111,874	$ 33,032	$ 29,483	$ 9,730,366
December	10,532,408	$ 605,614	2,572,397	$ 147,913	41,261,517	$ 7,427,073	1,555,050	$ 81,640	269,129	$ 32,968	$ 5,551	$ 100,063	$ 28,291	$ 21,153	$ 8,151,252
2002															
January	6,134,151	$ 352,713	(2,544,054)	$ (146,283)	45,941,977	$ 8,269,556	1,743,632	$ 91,541	132,883	$ 16,278	$ 1,768	$ 102,632	$ 10,579	$ 16,699	$ 8,455,664
February	6,318,189	$ 363,296	3,507	$ 202	44,567,810	$ 8,022,206	2,931,114	$ 153,883	335,498	$ 41,099	$ 4,068	$ 86,619	$ 20,556	$ 53,047	$ 8,424,532
March	7,191,673	$ 413,521	9,859	$ 567	43,383,133	$ 7,808,965	2,241,107	$ 117,658	47,190	$ 5,781	$ (2,306)	$ 105,968	$ 72,813	$ 59,456	$ 8,105,949
April	8,282,340	$ 476,235	775,220	$ 44,575	45,246,778	$ 8,144,420	279,794	$ 14,689	213,265	$ 26,125	$ 47	$ 104,397	$ (31,633)	$ (8,977)	$ 8,642,305
May															$ -
June															$ -
Total	103,346,400	$ 5,942,418	763,927	$ 43,926	454,044,492	$ 81,728,008	20,739,231	$ 1,088,810	2,937,765	$ 359,877	$ 11,306	$ 974,977	$ 280,346	$ 317,122	$ 87,691,900

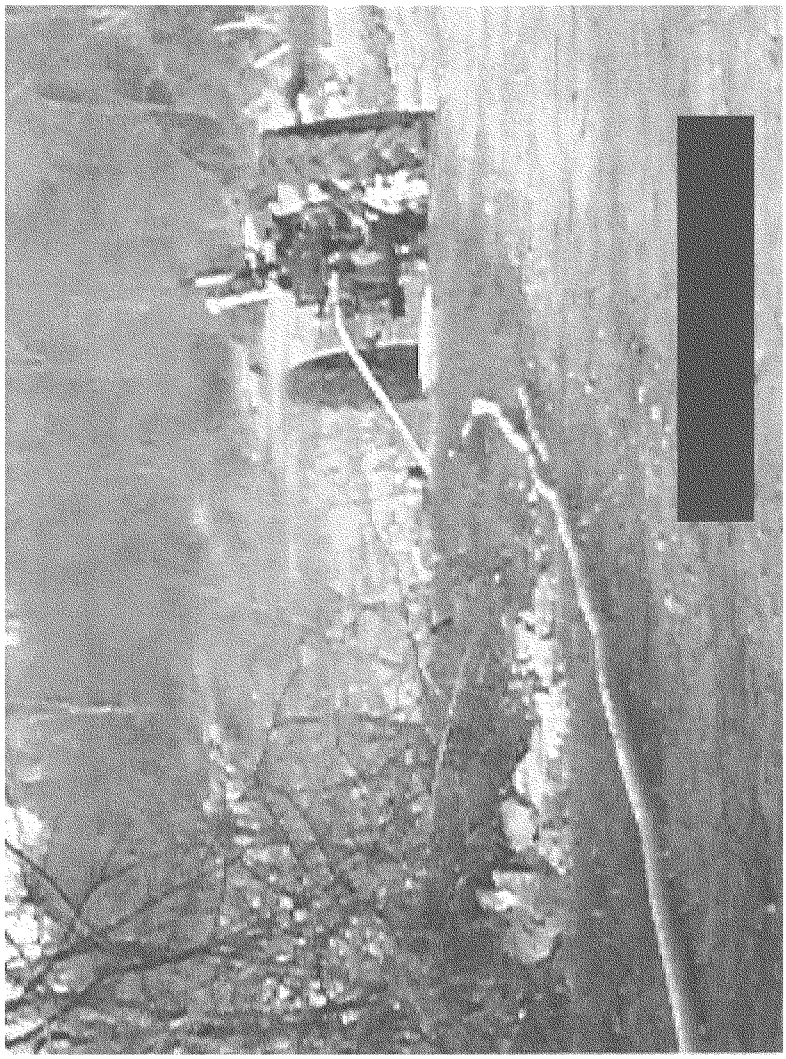
GALLONS OF JET FUEL SOLD IN ALABAMA
JUNE 2001 THROUGH MAY 2002

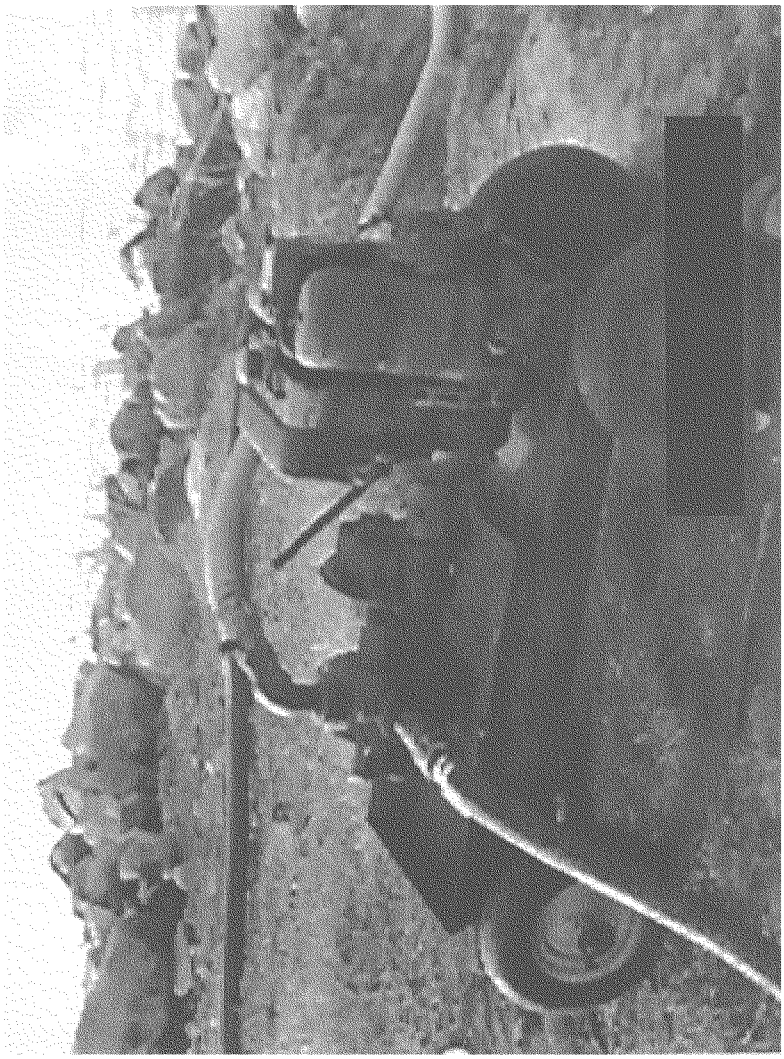
June 2001	**5,784,498**
July 2001	**4,346,989**
August 2001	**4,768,838**
September 2001	**4,693,072**
October 2001	**3,561,683**
November 2001	**6,126,299**
December 2001	**1,161,375**
January 2002	**4,560,284**
February 2002	**4,183,645**
March 2002	**4,418,806**
April 2002	**5,453,119**
May 2002	**9,781,662**

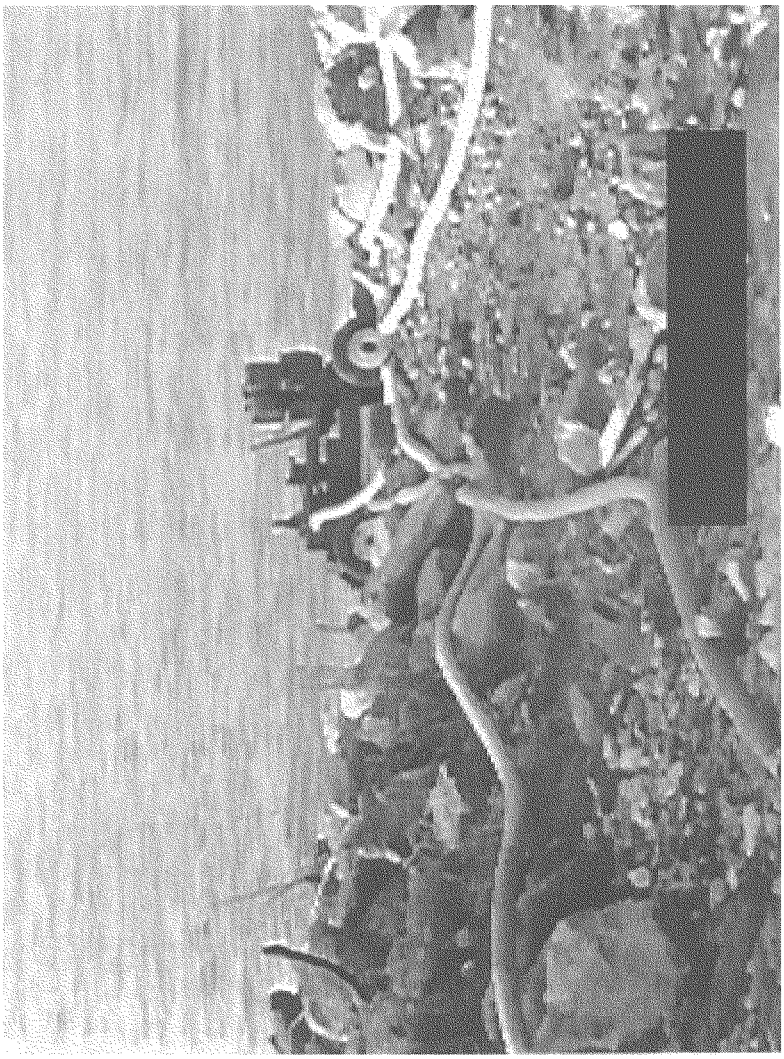

U.S. COAST GUARD











Testimony of David L. Skinner, Fuel Tax Compliance Coordinator, Florida Department of Revenue, before the U. S. Senate Finance Committee, July 17, 2002

Tax on Jet Fuel - Florida's Experience

On January 1, 1994 there were significant changes to the federal tax law on diesel fuel. In Florida, a working group was established, (called the "Industry/DOR Fuel Tax PIT Crew"), to review Florida's fuel tax system and make recommendations for improvements. The working group was comprised of representatives from the Florida Petroleum Council (representing major oil companies), the Florida Petroleum Marketers and Convenience Store Association (representing the marketers and distributors), the Florida Department of Revenue, and other stakeholders. At that time, Florida's motor fuel, special fuel and aviation fuel taxes were imposed at points in the distribution chain that were below the terminal rack. It soon became apparent to the group that Florida's fuel taxation system could be much more efficient and less burdensome on the industry if we could synchronize the state law with the federal law.

There were many difficult issues to be resolved:

- The marketers' loss of "float" if they had to pay the tax up front.
- The marketers' loss of collection allowance.
- The major oil companies' risk of bad debt losses.
- The retailers' shrinkage and evaporation allowances.
- How to handle temperature gains and losses.
- How to handle exports to other states.
- How to handle imports from other states.
- How to handle changes in destination or split loads.
- How to handle terminal rack exchange agreements between major oil companies.
- How to collect Florida's complicated system of local option taxes on gasoline.
- How to handle refunds or credits for off road exemptions if tax was pre-collected at the rack.

One by one these issues were resolved through a very cooperative process of negotiations between the three principal parties, and in consultation with other affected stakeholders. It was a remarkable experience as all the parties came together with a common interest to make the Florida system more efficient while at the same time minimizing the burden for the industry and building in provisions that would help to prevent tax fraud and evasion. The industry members fully understood that if tax cheats were allowed to prosper, their business would be hurt.

One major issue was the last to be resolved - the kerosene/jet fuel issue. The parties knew that this product, while not normally subject to highway taxes, could easily be blended with diesel fuel and used by tax cheats to evade highway taxes. The federal government had not yet resolved the issue, but there were changes under consideration that would impose federal highway tax on undyed kerosene at the terminal rack. (This federal change ultimately took effect July 1, 1998.)

The group had learned that as much as 90% of the kerosene stored in Florida's terminals was refined to meet the specifications for aviation jet fuel. The decision finally reached by the group was to recommend to the Florida Legislature that kerosene be included with jet fuel and aviation gasoline in Part III of the motor fuel tax statutes. The tax would be imposed at the terminal rack, same as motor fuel and diesel fuel, but at the aviation fuel tax rate, 6.9 cents per gallon. If the kerosene was dyed at the terminal rack to the same specifications as the off-road diesel fuel, it could be sold tax-free.

This would allow the aviation fuel taxes to be placed on the same reporting form with the motor fuel tax and diesel fuel tax and be paid by the same position holders in the terminals who were responsible for the payment of motor fuel and diesel fuel taxes. Special provisions were made to allow tax-free sales of kerosene for home heating with an ultimate vendor credit or refund for the distributor, much the same as with diesel fuel sold to farmers. In Florida, unlike the federal system, these ultimate vendors would be

responsible for paying any local option taxes due on gasoline sales, and thus could take a credit on their return against those taxes instead of having to wait for a refund.

The statutory language for all these changes was drafted by various members of the group, and presented to the 1995 Florida Legislature. The Executive Vice President of the Florida Petroleum Marketers and Convenience Store Association, G. Alan Whidby, took the lead in securing a sponsor for the bill and lobbying it through the Legislature. The group's recommendations were adopted into law with very little change and the new motor fuel tax laws took effect on July 1, 1996.

A year after the law changed, we analyzed the effects on revenue collections. We were expecting significant increases in diesel fuel tax collections, as had been experienced by the federal government and several other states that had moved their taxation points. We also expected improvements in the collections of local option fuel taxes which had previously been paid at the retailer level, but now were being paid at the wholesaler level. What we did not anticipate was the large increase in collections of aviation fuel tax.

After adjusting for pending refunds, we found that our aviation fuel tax had increased by 21.4% over the prior 12 month period. Until the recent tragedy of September 11th, aviation jet fuel has continued to increase. While the reasons for the increase are not clear, there are several possibilities.

One very likely reason is that some customers are paying the 6.9 cents per gallon aviation fuel tax on kerosene, but are not claiming the allowable refund. If the aviation fuel tax is NOT paid or if it is refunded, the purchase price of the kerosene is subject to Florida's sales and use tax – up to 7% of the purchase price, unless there is a specific exemption. Therefore, if the kerosene sells for $1.00 per gallon or more (excluding taxes) the sales tax would actually be more than the aviation fuel tax. (There are exemptions from the sales and use tax for farming and home heating.)

Another possibility is that there was some tax evasion by distributors of aviation fuel before it was moved to the terminal rack. Furthermore, jet fuel and/or kerosene could be illegally blended and used as highway fuels, with the crooks simply absorbing the cost of 6.9 cents per gallon in order to profit from non-payment of the 26.4 cent state and 24.4 cent federal highway taxes. We have not seen any direct evidence of this in Florida.

To some extent, the economic growth in the 1990's may have been a factor. After the first year, the aviation fuel gallons reported on tax returns continued to grow by .5% in FY 1997-98, 5.5% in FY 1998-99, 5.6% in FY 1999-2000, and 3.1% in FY 2000-01.

The reported gallons of aviation fuel in Florida since September 11th clearly reflect the decrease in consumption that has been reported by the airlines.

Collection Month	Applied Month	Prior Year Gallons	Current Year Gallons	Percent Change
10/01	Sept. 2001	76,186,744	52,791,907	-30.7%
11/01	Oct. 2001	83,539,587	66,435,504	-20.5%
12/01	Nov. 2001	89,346,300	88,242,676	-1.2%
1/02	Dec. 2001	101,471,596	72,139,152	-28.9%
2/02	Jan. 2002	103,586,849	84,498,340	-18.4%
Totals		**454,131,076**	**364,107,578**	**-19.8%**

In Florida there are several locations that store duty-free supplies of jet fuel under U. S. Custom Bond, which is eligible for tax-free use in qualified foreign flights. Florida recognizes that this bonded jet fuel is exempt from its aviation fuel tax, thus bonded aviation fuel is not included in the figures noted above.

Imposing the tax at the terminal rack does create some problems. The most significant problem is seen when there are exempt uses for the fuels. If the tax has been pre-paid by the user, there must be a means of claiming a refund or credit against other taxes.

In Florida we have tried to solve this by allowing an ultimate vendor credit in certain circumstances, to be claimed against other tax liabilities or as a refund to the vendor. The sale could be made tax-free to the consumer, and the vendor could claim the credit or refund if the taxes were already paid to a supplier.

For kerosene, this credit is allowed when there is a direct delivery for home heating, a sale of 5 gallons or less through a so called "blocked pump", or a sale in pre-packaged containers of 5 gallons or less. In this manner we were able to avoid causing a hardship on consumers using kerosene for home heating.

For jet fuel, there is a provision that allows an airline which has met certain employment thresholds in Florida to be exempt from the aviation fuel tax. In a similar fashion, their supplier would sell aviation fuel to them tax-free and take an ultimate vendor credit on their tax return.

Overall, the difficulties in making the change in our tax law for aviation fuel were minor compared to the other major changes for gasoline and diesel fuel. The tax reporting forms were completely revamped and the aviation fuel taxes were combined on the same forms with motor fuel tax and diesel fuel tax. The feedback I have heard from industry has been generally positive, and I am unaware of any particular problems stemming from the movement of the aviation fuel tax to the terminal rack in Florida.

COMMUNICATIONS

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE

These comments are submitted on behalf of the American Petroleum Institute (API) and its members for inclusion in the record of the July 17, 2002 Senate Finance Committee Hearing on fuel tax fraud. API represents approximately 400 companies involved in all aspects of the oil and gas industry including exploration, production, transportation, refining and marketing.

API members historically have supported efforts to curb evasion of motor fuel taxes where there was credible evidence of significant evasion activity. Our position is that evasion of these taxes creates a competitive disadvantage for honest taxpayers and undermines the legitimate distribution of petroleum products to the public.

In addressing evasion issues, Congress should first rely on IRS to curb evasion of motor fuel taxes through its enforcement activities. IRS should look to improved surveillance and auditing practices, including more stringent registration requirements, if necessary to curtail tax fraud. If having taken these steps, Congress finds it necessary to modify the present collection system in order to curtail evasion of motor fuel taxes, then API would support such modification, as it has in the past.

For example, when the points of collection of the gasoline tax, and later the diesel tax, were moved to the terminal rack, API supported those legislative changes and worked closely with Congressional staffs and trade organizations to develop the statutory language. Similarly, API supported legislation subjecting kerosene to excise tax in order to curb evasion of the diesel fuel tax. In each of these instances, there was solid evidence of extensive evasion activity that IRS was unable to curb through its enforcement of existing laws.

API understands that a proposal has been made to move the point of collection of aviation fuel to the terminal rack to curtail alleged widespread evasion of tax on such fuel. However, as yet there is no credible evidence of substantial evasion of tax to support this change. To our knowledge, except for anecdotal evidence of isolated instances of evasion, the primary support for allegations of aviation fuel tax evasion is a study dated December 17, 2001, which has been submitted for the record of this hearing, and prepared by KPMG Consulting Inc. for the Center for Balanced Public Policy.

API has reviewed that study and has concluded that the analysis utilized therein is materially flawed. The study relies on data from a variety of data sources to support its conclusion that there is excise tax leakage of aviation fuel taxes; however, there is a lack of coordination between these separate data sources. This lack of coordination makes it difficult, if not impossible, to make credible comparisons of information reported to the various sources. The study fails to take into account any of the differences between those various data systems.

For example, the study compares aviation fuel production data reported by refiners to the EIA with aviation fuel consumption data reported by US carriers to the FAA. Based on that comparison, the study estimates the tax gap attributable to jet fuel which is alleged to be diverted to highway use. The study fails to account for the substantial amount of aviation fuel that is reclassified to diesel or kerosene in the pipeline or at the terminal level (with appropriate excise taxes being collected and remitted when due). Such reclassification occurs for a variety of reasons. For example, aviation fuel is used to improve the cold weather properties of diesel fuel and heating oil. The study also fails to recognize that the production data reported by refiners to EIA includes aviation blendstocks and aviation fuel that is produced for export to foreign countries. These three components of the production data reported by refiners to EIA (reclassification, blendstocks and exports) could account for most of the difference between the higher level of aviation fuel production reported by refiners to EIA and the lower level of aviation fuel consumption reported

by domestic carriers to FAA. Yet, the study fails to account for any of these differences.

There are other differences between the various data systems that the study relies on to support its contention of aviation fuel tax evasion, but none of those differences is explained in the study.

Further, the study expressly provides that its estimates are based on certain assumptions that cannot be fully documented. Given the level of uncertainty expressly stated within the body of the study, it should not be relied on as credible evidence of widespread aviation fuel tax evasion.

In the absence of credible evidence of significant evasion of taxes on aviation fuel that is unlawfully diverted into the diesel fuel market, API's position is that Congress should rely on IRS to address such evasion through its enforcement of existing laws. Any legislative modification at this time would be premature.

As stated above, API has historically supported efforts to curtail evasion of the motor fuel tax laws when there was sufficient evidence of evasion. Accordingly, API recommends that Treasury Department conduct a study of the incidence of evasion of tax on aviation fuel and issue a report of its findings. The recently implemented ExSTARS reporting system should be a reliable data source for such study.

If such study finds significant evasion activity related to aviation fuel that IRS cannot adequately address through enforcement activities, API will vigorously pursue a legislation solution, including moving the point of collection of tax on aviation fuel to the terminal rack. We note, however, that our members have concerns over the technical aspects of any refund or credit mechanism that might be included in a legislative proposal, due to the complexities of the aviation fuel distribution system and the different tax rates that apply to commercial and general aviation fuel. Thus, API takes the position that any refund claims regarding aviation fuel should be made by the ultimate purchaser and not by the terminal position holder or ultimate vendor, who may not know whether the ultimate purchaser is exempt from tax or if the fuel is used in a tax-reduced or tax-free manner.