REPORT TO THE CONGRESS ON EVASION OF THE FEDERAL GASOLINE EXCISE TAX

Office of Tax Policy
U.S. Department of the Treasury

December 1987

THE SECRETARY OF THE TREASURY
WASHINGTON

January 6, 1988

Dear Mr. Chairman:

Section 1703(g) of Public Law 99-514, the Tax Reform Act of 1986, provides that the Secretary of the Treasury "shall conduct a study of the incidence of the evasion of the gasoline tax."

Pursuant to that Section, I hereby submit the "Report to the Congress on Evasion of the Federal Gasoline Excise Tax."

I am sending a similar letter to Congressman Dan Rostenkowski, Chairman of the Committee on Ways and Means.

Sincerely,

James A. Baker III

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The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Enclosure

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1. INTRODUCTION AND SUMMARY

I. BACKGROUND OF THE STUDY

This report has been prepared in response to section 1703(g) of the Tax Reform Act of 1986 (P.L. 99-514), which requires the Secretary of the Treasury to conduct a study of the evasion of the Federal gasoline excise tax. Section 1703(a) of the Act amended the law to provide for the collection of the Federal gasoline excise tax at the refinery or terminal level rather than at the wholesale or retail level. Congress altered tax collection procedures and mandated this study because of concerns with the failure to comply with the Federal excise tax on gasoline, particularly organized, willful tax evasion.

Since the change in the point of tax collection becomes effective on January 1, 1988, this report cannot compare the tax collection experience under the amendment with experience under current law. Instead, the report uses data from a number of sources that, reasonably interpreted, permit an estimate of the annual revenue loss to the Federal government from the evasion of the gasoline excise tax under current collection procedures.

II. PRINCIPAL FINDINGS

The report finds that the Federal government is currently losing excise tax revenue of about $250 million a year from noncompliance with the Federal excise tax on gasoline. Approximately $100 million a year of the revenue loss is estimated to be attributable to willful, organized evasion of gasoline excise taxes, which is described in Chapter 3 of this report. Ordinary tax audit procedures usually cannot detect these types of evasion schemes. Without a change in tax collection procedures, recouping these losses through tax enforcement would be very costly, would be intrusive and burdensome for law-abiding taxpayers, and still would not be fully effective. Moreover, competitive pressures produced by such schemes themselves engender further evasion. Thus, changes in tax collection procedures designed to end organized evasion are needed to prevent ever-increasing losses.

The report concludes that the best means of eliminating organized evasion of the Federal gasoline tax is to move the point at which taxes are collected upstream, in the manner enacted by section 1703 of the Tax Reform Act of 1986. Such a change has been estimated to increase excise tax receipts by $300 million in fiscal year 1988 and $200 million a year thereafter, for a total of

$1.1 billion over the five fiscal year period, 1988 through 1992. Thus, the change will eliminate about 80 percent of the estimated noncompliance with the Federal gasoline excise tax.

III. ORGANIZATION OF THE REPORT

Chapter 2 of the report describes the current gasoline excise collection system and administrative practices. Chapter 3 cites recent disclosures involving criminal schemes designed to evade the gasoline excise tax. Chapter 4 discusses actions taken by State governments to reduce gasoline tax evasion and the extent to which such actions have improved tax compliance. Chapter 5 summarizes the Federal revenue loss from noncompliance with the excise tax and the amount that will be recouped under the statutorily mandated changes in tax collection procedures. Finally, Chapter 6 discusses why the opportunity for tax evasion will continue until there is a change in the point at which the tax is imposed, such as collecting the tax at the refinery or terminal level as provided by section 1703(a) of the Tax Reform Act of 1986.

2. LAW AND ADMINISTRATIVE PRACTICES

Under section 4081(a) of the Internal Revenue Code as currently in effect, an excise tax of 9.1 cents per gallon is imposed on gasoline sold (or used) by producers and importers of gasoline.[1] In fiscal year 1986, Federal gasoline excise tax receipts totaled $9.0 billion.

The legal incidence of the gasoline excise tax is on the producer or importer, who is required to file a quarterly excise tax return. Taxpayers must make monthly deposits of tax in any month if they are liable for more than $100 of taxes. Monthly deposits are due by the last day of the month following the month in which liability is incurred. If a taxpayer is liable for over $2,000 of taxes for any month of a calendar quarter, the taxpayer must make semi-monthly deposits in the following quarter. Generally, these deposits are payable by check and are due by the 9th day following the close of each semi-monthly period. Independent refiners, however, may pay the tax by the 14th day following the close of the semi-monthly period if the payment is made by wire transfer.

I. ADMINISTRATION OF THE GASOLINE EXCISE TAX

A. Background and Law Prior to January 1988

Prior to 1959, the term "producer" generally meant a refiner or importer of gasoline. The excise tax was imposed upon the refiner or importer at the time gasoline was sold to a wholesaler or distributor. The tax was not imposed on sales to other producers. In the case of vertically integrated companies, the sale by the producer, and hence the payment of tax, did not occur until the gasoline was sold to a dealer for sale to an ultimate consumer. If a wholesaler, distributor, or jobber purchased gasoline from a producer, however, the wholesaler, distributor, or jobber was required to reimburse the producer for the tax upon purchase, although the wholesaler, distributor, or jobber could not recoup that cost until it sold the gasoline to a subsequent purchaser.

In the Federal Highway Act of 1959 (P.L. 86-342), Congress amended the statute to provide that the term "producer" includes a wholesale distributor. A wholesale distributor is generally an entity which sells gasoline to producers, dealers, or to users who purchase in bulk quantities and deliver into bulk storage tanks. The 1959 change, by delaying the time at which the tax was paid, reduced the competitive advantage of integrated companies over independent gasoline wholesalers, distributors, and jobbers. In 1984, Congress further amended the law to provide that the term "wholesale distributor" includes "chain retailers" having 10 or more gasoline stations under common management.

In order to qualify as a "producer," a wholesaler must register with the Internal Revenue Service (IRS) by filing Form 637 with the District Director requesting a registration number. Once a wholesaler obtains a registration number, it may purchase gasoline from a refiner or importer tax free (since the refiner or importer is treated as having sold the gasoline to another producer) and may sell gasoline tax free to any other wholesaler holding an IRS registration number.

Certain types of consumers of gasoline are statutorily exempt from payment of the tax. For example, State and local governments (including governmental entities such as school districts) are exempt from the tax, and they are permitted to purchase gasoline tax free. These exemptions have been interpreted to extend to organizations, such as volunteer fire departments and rescue squads, fulfilling a governmental function. In addition, the Energy Tax Act of 1978 (P.L. 95-618) established an exemption from the gasoline excise tax (then 4 cents per gallon) for gasoline that is blended in a mixture which contains at least 10 percent qualified alcohol (ethanol or methanol). Such a mixture is commonly called "gasohol" and often is marketed as octane enriched unleaded gasoline. Currently, gasohol qualifies for a 6.05 cents per gallon exemption from the 9.1 cent excise tax.

IRS has several responsibilities in connection with the gasoline excise tax. In addition to registering producers and wholesalers, IRS processes applications for exemption (Form 637) from the tax. IRS is also responsible for collecting and accounting for tax payments and for receiving the quarterly excise tax returns (Form 720).

B. Changes in the Tax Reform Act of 1986

Section 1703 of the Tax Reform Act of 1986 (the "Act") changed the point at which the Federal gasoline excise tax will be imposed. Tax collection was moved to a point earlier in the distribution chain. The Act amended sections 4081 and 4082 of the Internal Revenue Code so that, effective January 1, 1988, the excise tax will be imposed upon removal from the refinery or, if earlier, upon sale of gasoline, gasoline blend stocks, and products commonly used as additives in gasoline. For imported gasoline, the tax is imposed upon removal from the custody of customs. The new law provides an exception which permits tax-free bulk transfers of gasoline, gasoline blend stocks, and gasoline additives to registered and bonded terminals. In such cases, the terminal operators are liable for collection and payment of the tax upon removal from the terminal. The Act permits the Secretary of the Treasury to prescribe regulations for the registering and bonding of such terminal operators.

Collection upon removal from the terminal will help assure that all distributors and dealers that remove gasoline from the terminal will be purchasing tax-paid gasoline. In addition to assuring collection of the Federal tax, this change will help to give the honest dealer a fair chance to compete against those evading excise taxes. As explained in Chapter 3, under the current system a dealer may have to choose between purchasing gasoline from a suspect source or leaving the business.

C. Change Included in H.R. 3545

H.R. 3545, as approved by the House on October 26, 1987, included a provision to permit registered wholesale dealers who post a bond, or other proof of financial responsibility, to purchase gasoline from either a refinery or a bonded terminal without payment of tax. The point at which the tax is actually imposed (removal from the refinery or bonded terminal) would have remained unchanged. The bill would have provided that the Secretary of the Treasury would set the standards for the posting of a bond or providing proof of financial responsibility. H.R. 3545 would have required that the standards be sufficiently strict to prevent recurrence of the tax evasion that prompted the changes in the Tax Reform Act of 1986. However, the standards would have had to reflect the Treasury's tax exposure from particular wholesale dealers and would further have required flexibility in how financial responsibility was demonstrated including, but not limited to, demonstration of assets, bonds, and letters of credit.

The Treasury Department does not believe that requiring proof of financial responsibility is adequate to prevent a recurrence of significant amounts of organized tax evasion. That is especially true if financial responsibility can be shown without reference to an independent third party. Showing financial responsibility only helps in collecting unpaid taxes once they are assessed. It does not prevent use of the daisy-chain type schemes which have been so troublesome. Unless audit coverage is expanded very significantly, even with bonding it will be difficult to identify and collect evaded taxes. Moreover, by increasing the number of entities which may hold and purchase gasoline without paying the excise tax, the change would exacerbate the difficulties of providing adequate audit coverage.

II. ENFORCEMENT OF THE GASOLINE EXCISE TAX

A. Identifying Taxpayers for IRS Examination

Each year IRS prepares a list of excise taxpayers from its file of all business taxpayers. Appropriate portions of this list are distributed to each IRS District. Excise tax specialists in each District then review their portion of the list to identify potential noncompliance. Information from these reports currently provides significant leads for the IRS Tax Examination Program.

The exchange of information with the States provides another source of compliance leads. IRS often obtains copies of State examination reports, lists of registrants or licenses, and other State data that can be used to identify noncompliance. Referrals from other IRS activities such as collection, criminal investigation, or income tax examination are also sources of leads for excise tax examiners.

"Information gathering projects" provide a further method of identifying potential evasion of the gasoline tax. An information gathering project is a project authorized to collect tax-related information on taxpayers not currently under IRS examination. Its purpose is to identify taxpayers with the greatest potential for examination. Such projects may be authorized by IRS district directors, assistant regional commissioners, and assistant commissioners. This approach may be used when information indicating potential noncompliance is obtained from informants, governmental agencies, or other sources. One such project used information from the Department of Energy to identify the importers of gasoline from 1981 through 1984.

Much of the recent IRS activity in the gasoline excise tax area has centered on criminal investigation of tax evasion. Investigations have been focused in the Brooklyn District, where IRS personnel have participated in a task force of approximately 40 people, representing 12 State and Federal investigative or prosecutorial organizations. This two-year effort has identified major evasion schemes throughout the entire New York City and Long Island metropolitan areas. The investigation has also uncovered evidence of widespread organized crime involvement. In addition to these areas, IRS has other criminal cases pending against individuals, not identified with organized crime, in six of its seven national regions.

B. Results of IRS Examinations

IRS examinations of gasoline excise tax returns have identified various forms of noncompliance. Noncompliance may result from use of incorrect tax rates or failure to file. In addition, taxpayers may make errors in characterizing certain sales as tax exempt. However, the noncompliance which is most difficult to control has resulted from the criminal tax evasion mentioned above.

IRS examined 7.1 percent of the 33,792 excise tax returns filed for fiscal year 1986 which showed gasoline excise tax liability. Civil examinations of gasoline excise tax returns yielded a total of $36 million in proposed tax adjustments and penalties, or an average of $14,911 per return for the 2,411 returns examined. In addition, interest from the due date of the return would generally be charged on tax adjustments.

Despite the success of these efforts, the current (i.e. pre-1988) collection method has hindered enforcement against willful, organized evasion. Agents must identify taxpayers from among numerous entities that have held title to the gasoline. A common practice in evasion schemes, however, is to sell and resell the gasoline many times (even if the gasoline itself has not moved physically) in an attempt to make it difficult to determine that evasion has occurred. In addition, because IRS has not been able to require the producers and wholesalers who collect the gasoline excise tax to post bonds guaranteeing payments of the taxes collected and because attempts to track ownership and transfers are of necessity undertaken long after the product has been consumed, even if delinquent taxpayers are located unpaid taxes may not be collectible.

3.e RECENT DISCLOSURES INVOLVING CRIMINALe TAX EVASION OF THE GASOLINE EXCISE TAXe

In 1959, the Congress deferred payment of the gasoline excise tax until a sale is made to the retailer or, in some cases, to the ultimate consumer as an accommodation to independent marketers and jobbers. Such a deferral departs from the usual practice of collecting excise taxes at the point of initial sale by a producer, as is done, for example, in the case of the other manufacturers excise taxes (e.g., on tires, coal, and recreational equipment), the tobacco and alcoholic beverage excise taxes, and the crude oil windfall profit tax. The change, as provided by the Tax Reform Act of 1986, to impose the tax beginning in 1988 upon removal from the refinery or from a distribution terminal, generally conforms the gasoline excise tax to other excises, with the exception of the option that permits tax free storage in certain bulk terminals.

In recent years, the weakness in the current (pre-1988) collection system has been exploited to divert for private gain the excise taxes, both Federal and State, that are due upon the sale of gasoline. During fiscal years 1983, 1984, 1985, there were criminal convictions in cases involving nearly $2 million in gasoline excise tax deficiencies. In fiscal year 1986 alone, gasoline tax deficiencies in cases of criminal convictions increased to over $11 million. From the second half of fiscal 1986 through fiscal 1987, the IRS Criminal Investigation Division initiated more than 100 investigations involving gasoline excise tax. Many of these investigations were conducted jointly with the FBI and State and local law enforcement agencies. The criminal convictions obtained in these investigations revealed more than $35 million in gasoline excise tax deficiencies. In addition to the cases under investigation, IRS uncovered a number of potential high-dollar cases on which it has not yet been able to begin work because its existing resources are already being fully utilized.

I. EVASION SCHEMES

A gasoline excise tax evasion scheme typically involves "paper" sales of gasoline by a refiner or wholesaler through a chain of tax-free distributors, each of which qualifies as a distributor because it has obtained an IRS registration number. Some of these tax-exempt distributors may be nothing more than post office boxes, with no assets and with officers who are foreign domiciliaries. Others may conduct some bona fide sales while using or permitting the use of their exemption certificates for other sales involving evasion of excise taxes. A taxable sale is ultimately made to a nonexempt entity, such as a gasoline distributor that has not registered as a producer or a retailer. The nonexempt distributor's payment to the last entity in the chain ostensibly includes the Federal excise tax. The tax collected, if any, is retained by the participants in the sales chain and is not paid to the Federal government as is required by law. In the meantime, the gasoline itself has been shipped directly to the nonexempt distributor for further distribution or for sale to consumers. As the result of the tax evasion, the retailer may be able to purchase the gasoline at a reduced price and, thereby, to undercut gasoline prices charged by retailers who purchase gasoline tax-paid. Alternatively, the retailer may not lower his sales price to reflect his reduced cost and may pocket the additional profit. In other evasion schemes, the distributor may not share any of the benefit of the unpaid excise tax with the retailer.

An audit of these paper transactions would reveal that the nonexempt distributor or retailer bought tax-paid gasoline. The final "producer" in the paper chain that sold the gasoline, and thus the party that is liable for the tax, might ultimately be discovered by tracing the transfers of title to the gasoline, either back from the point of retail sale or forward from the refinery or point of importation. These "daisy chain" evasion schemes are designed, however, to make tracing difficult, time-consuming, and costly. Moreover, the IRS auditor would often discover that, once located, the "producer" that sold the gasoline to the distributor would have no assets or would not have officers from whom the tax could actually be collected.

There are recent indications that the daisy-chain evasion techniques are now being used earlier in the distribution chain at layers at larger terminals. Information available to IRS and FBI agents indicates that in some areas of the country organized crime leaders have significant influence in, or direct control of, such terminals.

II. IMPACT OF TAX EVASION

The "daisy-chain" type of tax evasion scheme described above results in loss of tax revenues to the Federal and State governments and a concomitant loss of respect for tax administration. Moreover, these criminal activities have a perverse influence on the marketplace. Dishonest distributors who evade the gasoline excise tax may undersell their competitors, thereby driving law-abiding distributors out of the marketplace. Thus, dishonest distributors place great pressure on competing dealers to engage in similar purchases of untaxed gasoline from criminal elements in order to survive. The continued existence of these schemes has a corrupting effect on the entire gasoline distribution system.

On July 15, 1986, the Ways and Means Subcommittee on Oversight held a hearing to investigate the extent of gasoline excise tax evasion.[2] Testimony was presented by representatives of the Treasury Department, the Internal Revenue Service, the Federal Highway Administration, the Department of Justice, and the Federal Bureau of Investigation. Representatives of the Tax Commissions of California, New York, and Florida and the Executive Secretary of the National Association of Tax Administrators also testified. The thrust of the testimony was that the States and the Federal government were losing millions of dollars annually through the evasion of gasoline excise taxes.

The Subcommittee also heard from a "mystery witness" who is in the Department of Justice witness protection program and who had operated a gasoline distribution business in four States in conjunction with an organized crime family. He testified that his profits on evaded Federal, State, and local taxes were $8 million a week. He also testified that he would not have been able to conduct such a scheme had the law required payment of tax upon removal from a refinery.

There was unanimous agreement by the officials testifying that the only effective means of substantially preventing criminal elements from evading the tax was to change the point of collection of the tax, as several State governments have done and as the Federal government was considering doing (and subsequently did in the Tax Reform Act of 1986).

III. DIESEL FUEL TAX EVASION

For some years, there has been concern among State and Federal taxing authorities about possible noncompliance with the diesel excise taxes which are imposed at the retail level. Various problems, some of which are similar to those cited above for the gasoline excise tax, make it difficult to determine whether there is a serious compliance problem for the diesel excise taxes. Nevertheless, the possibilities for organized tax evasion do exist. These problems could be compounded by the difficulty of distinguishing between diesel fuel and similar products that have other uses. For example, number 2 fuel oil sold as heating oil is tax exempt; however, it can also be used as fuel for motor vehicles. Moreover, a significant proportion of diesel fuel is used for off-highway purposes and, hence, is nontaxable. The variety of tax-exempt uses for diesel-type fuels and the quantitative significance of such uses provide administrative difficulties for IRS, complexity and confusion for taxpayers, substantial opportunities for noncompliance including evasion, revenue loss for the Treasury, and competitive dilemmas for honest taxpayers faced with unfair competition from untaxed, lower-priced fuel.

The Administration has concluded that there is a need to change the point at which the Federal excise tax on diesel fuel is levied. The potential for tax evasion and other forms of noncompliance can be minimized only if the point at which the tax is imposed is moved closer to the beginning of the distribution stream.

4. STATE EFFORTS TO DEAL WITH GASOLINE EXCISE TAX EVASION

Data reported at the Ways and Means Committee hearing by California and New York authorities make it clear (a) that there have been major evasion schemes involving gasoline excise taxes and (b) that the current (pre-1988) Federal tax collection system may encourage people who intend to evade gasoline excise taxes to enter the business. California, New York, and other States have recently amended their laws in order to shift the collection of gasoline excise taxes to points earlier in the distribution chain and, thus, to prevent the evasion schemes currently employed to evade both State and Federal taxes.

As reported in the statement of Roderick G. W. Chu, Commissioner of the New York State Department of Taxation and Finance, before the House Ways and Means Committee's Subcommittee on Oversight, a study by the State of New York estimated an annual loss of between $173 and $254 million in State and local taxes from gasoline tax evasion.[3] Using the lower figure, it appears that the State of New York lost the tax revenue on about 20 percent of the gasoline consumed in the State. This figure is consistent with the drop in quantity of gasoline for the State of New York as reported by the Federal Highway Administration and is also consistent with the increase in tax receipts reported since the State of New York changed its tax collection system in 1985.

Robert Nunes from the California State Board of Equalization stated that $30 million to $50 million of tax had been evaded, or the excise tax on about 5 percent of the gasoline sold in California.[4]

Testimony by the representative of the State of Florida indicated that evasion by organized crime accounted for a relatively small loss of revenue for the State. The figures presented for Florida suggest a tax loss on less than one percent of the volume of gasoline sold in Florida.

The fuel tax collection changes recently adopted by six States in order to minimize organized tax evasion are summarized in Table 1. The revenue increase figures represent the increase for the first full year following the change. No adjustments have been made for changes in prices or quantities of fuel taxed. Except for Florida (where there had been little evidence of organized gasoline tax evasion), the States' expectation of substantial revenue gains from changes in the point of collection were generally realized.[5]

Table 1

Changes in Point of Collection and Revenue Increases of Motor Fuel Taxes, by State

State	Fuel/Tax	Change in Point of Tax Collection frome :	to :	Date of Change	Revenue Gain over Prior Year[1] ($ millions) :	(%)	1986 Audit Assessment ($ millions)	Estimate of Tax Evasion Prior to Change ($ millions)
California	gasoline/sales	retail	first sale in state	July 1986	NA	NA	19.4	30 - 50
New York	{gasoline/sales} {gasoline/excise}	distributor	import into state	June 1985	72.0 88.0	21.5e 24.5e	NA NA	173-254[2]
Florida	gasoline/excise	retail	first sale in state	January 1985	9.8	5.4	8.8	NA
Maine	diesel/excise	retail	wholesale	October 1983	4.0	38.0	[4]	NA
Maryland	diesel/excise	end user	wholesale	July 1985	6.2[3]	20.0	NA	NA
Michigan	gasoline/sales	retail	import into state	January 1984	NA	20.0	NA	NA

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NA: Not Available

[1] Prior year was determined as the 12 months proceeding the first full year in which the tax change came in to effect.

[2] Source: National Economic Research Associated Inc., Report to the New York Petroleum Council on Gasoline Taxe Evasion in New York State, February 25, 1985.

[3] Source: Highway Statistics 1985, Federal Highway Administration.

[4] Less than $50 thousand.

Source: Data compiled by IRS from reports of state revenue authorities.

To combat fraudulent tax-exempt sales and elaborate "daisy chain" schemes designed to avoid payment of tax. five of the States listed in Table 1 have significantly restricted tax-exempt sales of motor fuel. California allows tax-free sales between distributors only in limited situations. To qualify for tax-exempt purchases. the distributor must meet certain financial requirements. Only 27 distributors have thus far qualified for tax-exempt purchase; all operate refineries. New York allows tax-exempt purchases only by governmental entities and hospitals and for purchases of gasoline for immediate export out of the State. Florida allows tax-exempt sales only between refineries. Maine allows tax-exempt sales only to tanks that are specifically marked as tax exempt for special fuels. Maryland requires the posting of a bond by the tax-exempt purchaser.

Some of the States have imposed tougher licensing requirements and have reinforced them with larger penalties for noncompliance. In Florida, the new licensing of refiners. importers. wholesalers, jobbers. retail vendors. terminal facilities. and carriers. together with enhanced reporting provisions. are believed to have made evasion of motor fuel taxes more difficult. Each licensee must report on product bought. sold. stored. or transported in that State. Provisions of the New York law require re-registration of a distributor in the event of a significant transfer of ownership. Seizure of fuel and equipment may result from failure to re-register as well as from operating without a license.

5. ESTIMATE OF THE FEDERAL REVENUE LOSS FROM NONCOMPLIANCE

This chapter includes estimates of the revenue currently being lost due to failure to comply with the Federal excise tax on gasoline. The chapter also includes estimates of the effect of changing the point at which the excise tax is imposed, as provided in the Tax Reform Act of 1986. Finally, estimates are given for a partial reversal of the Tax Reform Act changes as provided in H.R. 3545, as approved by the U.S. House of Representatives on October 26, 1987.

I. CURRENT LEVELS OF NONCOMPLIANCE

Noncompliance with the Federal excise tax on gasoline follows three basic patterns. One is the criminal evasion scheme of the type described in Chapter 3. Normal audit procedures are unlikely to detect this type of evasion. A second type of evasion occurs when a taxpayer operating alone fails to report some or all of his taxable transactions either erroneously or in the hope that he will not be audited. Normal audit procedures, however, are likely to detect this type of evasion, but only for those returns which are actually audited. The third type of noncompliance occurs when taxpayers report correctly but fail to pay their liabilities and, instead, use those funds to meet other obligations in the hope of avoiding financial failure. Normal accounts receivable monitoring and enforcement--and even normal processing of excise tax returns--will usually detect such noncompliance, but with less than complete assurance of financial recovery. Moreover, IRS does not have an effective compliance program to detect, as swiftly as necessary, entities which have never filed the required excise tax return.

The estimate of noncompliance given below is the result of piecing together evidence from Federal and State experience and the use of plausible assumptions. It is assumed, for example, that when a gasoline purchaser is not in compliance with State tax laws, the purchaser is generally not in compliance with the Federal tax law. Thus, reports of State tax noncompliance provide clues about the extent of Federal noncompliance. Conversely, gasoline may be taxed at the State, but not the Federal level, usually where States such as California and New York collect the tax earlier in the distribution chain than the Federal government does currently.

The total nationwide Federal excise tax revenue loss from noncompliance with Federal gasoline excise tax, as it is administered under pre-1988 collection procedures, is estimated to be about $250 million per year. About 40 percent of the total noncompliance, or about $100 million is estimated to be attributable to organized tax evasion efforts.

II. FEDERAL REVENUE GAIN FROM CHANGED COLLECTION PROCEDURES

The Treasury Department estimates that the change in the point of collection of the Federal gasoline excise tax on January 1, 1988 to the refiner, importer, or terminal operator, as mandated by section 1703 of the Tax Reform Act of 1986, will increase excise tax receipts by about

Table 2

Estimated Increase in the Federal Excise Tax on Gasoline from the January 1988 Change in the Point of Collection[a]

Fiscal Year	Gross Excise Tax Revenue Increase ($ in millions)
1988	300[b]
1989	200
1990	200
1991	200
1992	200
Total, 1988-1992	$1,100

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[a] As mandated by Section 1703 of the Tax Reform Act of 1986.
[b] The tax increase for fiscal year 1988 is larger than for other years because the change in the point of collection occurs in 1988. Thus, tax receipts received during 1988 will cover more than one full year's gasoline production.

$200 million per year compared to the current base. This estimate assumes that some evasion will occur under any system but that the change in law will eliminate about 80 percent of the Federal gasoline excise tax evasion. As shown in Table 2, the January 1988 change in the point of tax collection is estimated to increase Federal gasoline excise tax collections by $300 million in fiscal year 1988 and about $200 million a year thereafter. Thus, by the end of 1992, $1.1 billion of additional excise tax will be collected.[6]

III. FEDERAL REVENUE LOSS FROM H.R. 3545

As discussed in Chapter 2, H.R. 3545 as approved by the House on October 26, 1987 would have partially reversed the changes in gasoline excise taxes made by the Tax Reform Act of 1986. Under H.R. 3545, gasoline wholesale dealers who provided proof of financial responsibility would have been able to purchase gasoline from a refinery or bonded terminal without payment of the federal gasoline excise tax. The Treasury Department believes that such a change would produce a significant and continuing revenue loss which would be attributable to increased noncompliance, primarily tax evasion schemes. If the H.R. 3545 changes had become effective on January 1, 1988, the Treasury Department estimates that revenue would have declined by at least $39 million in fiscal year 1988. Revenue would have declined by at least $60 million each subsequent year through fiscal year 1992. Thus, between fiscal years 1988 and 1992, the total revenue loss would have been at least $279 million. In fact, it is likely that as potential tax evaders became more familiar with the provision, revenue losses would have become significantly greater and would have continued to expand each year.

6. CONCLUSION

Testimony taken by the House Ways and Means Committee's Subcommittee on Oversight, the experience of State tax administrators, increases in State gasoline tax collections following changes in the point at which such taxes are collected, and Federal enforcement experience all strongly support the conclusion that the annual excise tax loss being sustained by the Federal government from noncompliance with the gasoline excise tax has been at least $250 million per year in the recent past. Recent disclosures have also led to an appreciation of the ease with which gasoline excise taxes can be evaded when such taxes are collected near the end of the distribution chain. Without a change in the point of collection, as provided in section 1703 of the 1986 Act, this loss would continue and would probably grow very significantly even with increased IRS enforcement efforts.

The Treasury Department has considered other options to improve the operation of the existing tax collection system. These include imposing a requirement that distributors post a bond to guarantee tax payments, having the Internal Revenue Service exercise greater scrutiny of applicants for tax exemption, and using more strenuous administrative enforcement measures. We have concluded, however, that while these options may provide some assistance in obtaining additional compliance, they would not be effective enough. We believe that they would significantly increase administrative costs for both IRS and taxpayers, while failing to deal effectively with the cause of the problem--the ability to arrange for the serial transfer of title among many entities and thereby make auditing prohibitively expensive. Bonding by itself, for example, as a condition of registering as a producer is of little benefit if time-consuming auditing of multiple transactions is required in order to locate the entity where the tax evasion has taken place or if bonding is abandoned after an exemption certificate has been obtained. However, bonding in conjunction with other enforcement measures may be useful in assuring payment when evaded taxes are discovered.

Although IRS is attacking this compliance problem administratively on many fronts, such measures cannot be completely effective because they cannot assure continuous supervision of the exempt producers. Nonqualified entities can obtain certificates through the use of "fronts" involving independent dealers who may be coerced or bribed into obtaining exemptions. Criminal groups can also (as has been reported) purchase exemption certificates from legitimate distributors. Accordingly, we do not believe that such administrative options alone can or will stem the revenue loss from the evasion schemes summarized in Chapter 3. Imposition of changes which mitigate tax evasion and other noncompliance will reduce the resources that IRS needs to devote to gasoline tax enforcement. Diminishing the number of tax-free sales of gasoline will also reduce the administrative compliance burdens of refiners and terminal operators. Moreover, such changes will free IRS resources to continue their efforts to uncover past noncompliance and to recover uncollected excise taxes.

The Treasury Department is convinced that the only practical solution to the gasoline excise tax evasion problem lies in changing the imposition of the tax from the point of sale to a nonexempt distributor or retailer to the point at which the gasoline is first removed from the refinery. As a general rule, tax compliance can be best assured if the audit trail is short and attention can be focused on a relatively small number of taxpayers. Collection at the refinery or terminal will reduce the number of taxpayers to be audited (and burdened with return requirements) from approximately 8,200 under the current law to between 200 and 300 (starting in 1988) under the Tax Reform Act of 1986. In addition, because the time of tax payment will not depend upon whether the gasoline is distributed directly by refiners or through independent marketers, integrated companies will not have the tax deferral advantage over independent marketers that existed prior to 1959 and which prompted the 1959 amendment to the Internal Revenue Code.

The Treasury Department opposed the provision of H.R. 3545 which would have permitted tax-free sales to wholesale dealers who demonstrate financial responsibility. The Treasury Department believes that such a change would have been counterproductive and would have opened the way to significant revenue losses from tax evasion and other noncompliance.

We are confident that the Tax Reform Act will help to stem the tide of tax evasion schemes, assure the availability of funds for the Nation's highway construction program, and maintain public respect for our tax system.

FOOTNOTES

[1] Generally, the revenue from 0.1 cents per gallon of this tax is transferred to the Leakinge Underground Storage Tank Trust Fund: the remaining 9.0 cents per gallon is transferred to the Highway Trust Fund from which a small portion representing taxed gasoline used as motor boat fuel is subsequently transferred to the Aquatic Resources Trust Fund. However, revenue attributable to the Federal excise taxes on fuel for noncommercial aviation is transferred to the Airport and Airway Trust Fund. The Federal excise tax on gasoline increased from 9.0 cents per gallon to 9.1 cents per gallon on January 1, 1987.

[2] United States Congress, House Committee on Ways and Means, *Compliance with Federal Gasoline Excise Tax Provisions: Hearing Before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives, 99th Congress, Second Session, July 15, 1986.* U.S. Government Printing Office, 1987.

[3] *Op cit.*, p. 130.

[4] *Op cit.*, p. 121.

[5] Subsequently, New York made additional changes in tax collection procedures. However, these changes involve interstate shipment of gasoline and are not relevant for Federal excise tax consideration.

[6] As indicated in footnote b to Table 3, the larger tax increase for fiscal year 1988 than for other years results from the fact that the change in the point of tax collection occurs during that year. Thus, tax receipts during 1988 will cover more than one full year's gasoline production. Such a one-time increase in tax revenue occurs whenever tax collections are accelerated.

This study was prepared by Allen H. Lerman and Sonia Conly of the Office of Tax Analysis and Moshe Schuldinger of the Office of Tax Legislative Counsel under the direction of James R. Nunns. Secretarial assistance was provided by Eunice Taylor.