

NATIONAL COOPERATIVE HIGHWAY RESEARCH PROGRAM
SYNTHESIS OF HIGHWAY PRACTICE

164

MEASURES TO CURTAIL STATE FUEL
TAX EVASION

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NATIONAL COOPERATIVE HIGHWAY RESEARCH PROGRAM
SYNTHESIS OF HIGHWAY PRACTICE **164**

MEASURES TO CURTAIL STATE FUEL TAX EVASION

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The members of the technical committee selected to monitor this project and to review this report were chosen for recognized scholarly competence and with due consideration for the balance of disciplines appropriate to the project. The opinions and conclusions expressed or implied are those of the research agency that performed the research, and, while they have been accepted as appropriate by the technical committee, they are not necessarily those of the Transportation Research Board, the National Research Council, the American Association of State Highway and Transportation Officials, or the Federal Highway Administration of the U.S. Department of Transportation.

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PREFACE

A vast storehouse of information exists on nearly every subject of concern to highway administrators and engineers. Much of this information has resulted from both research and the successful application of solutions to the problems faced by practitioners in their daily work. Because previously there has been no systematic means for compiling such useful information and making it available to the entire highway community, the American Association of State Highway and Transportation Officials has, through the mechanism of the National Cooperative Highway Research Program, authorized the Transportation Research Board to undertake a continuing project to search out and synthesize useful knowledge from all available sources and to prepare documented reports on current practices in the subject areas of concern.

This synthesis series reports on various practices, making specific recommendations where appropriate but without the detailed directions usually found in handbooks or design manuals. Nonetheless, these documents can serve similar purposes, for each is a compendium of the best knowledge available on those measures found to be the most successful in resolving specific problems. The extent to which these reports are useful will be tempered by the user's knowledge and experience in the particular problem area.

FOREWORD

*By Staff
Transportation
Research Board*

This synthesis will be of interest to finance officers, administrators, legislators, and others interested in the actions that states can take to stem evasion of highway fuel taxes. Information is presented on the types of schemes that are being used to evade paying fuel taxes and on practices that have been successful in eliminating those schemes and increasing fuel tax revenues.

Administrators, engineers, and researchers are continually faced with highway problems on which much information exists, either in the form of reports or in terms of undocumented experience and practice. Unfortunately, this information often is scattered and unevaluated, and, as a consequence, in seeking solutions, full information on what has been learned about a problem frequently is not assembled. Costly research findings may go unused, valuable experience may be overlooked, and full consideration may not be given to available practices for solving or alleviating the problem. In an effort to correct this situation, a continuing NCHRP project, carried out by the Transportation Research Board as the research agency, has the objective of reporting on common highway problems and synthesizing available information. The synthesis reports from this endeavor constitute an NCHRP publication series in which various forms of relevant information are assembled into single, concise documents pertaining to specific highway problems or sets of closely related problems.

With shortages of funds to meet current and future highway needs, it is important for states to stem evasion of fuel taxes. This report of the Transportation Research Board describes some of the schemes that have been devised to evade paying fuel taxes and a number of successful practices that states have used to foil those schemes.

To develop this synthesis in a comprehensive manner and to ensure inclusion of significant knowledge, the Board analyzed available information assembled from numerous sources, including a large number of state highway and transportation departments. A topic panel of experts in the subject area was established to guide the researcher in organizing and evaluating the collected data, and to review the final synthesis report.

This synthesis is an immediately useful document that records practices that were acceptable within the limitations of the knowledge available at the time of its preparation. As the processes of advancement continue, new knowledge can be expected to be added to that now at hand.

CONTENTS

- 1 SUMMARY
- 3 CHAPTER ONE INTRODUCTION
 - Fuel Types and Types of Taxes, 3
- 5 CHAPTER TWO DESCRIPTION OF EVASION SCHEMES
- 7 CHAPTER THREE SUCCESSFUL PRACTICES TO CURTAIL EVASION
 - Point of Taxation, 7
 - Screening, Licensing, Permitting, and Bonding, 8
 - Information and Reporting, 8
 - Uniform Form for Motor Carrier Fuel Tax Reporting, 9
 - Fuel Purchase Invoice Requirements, 9
 - Audit Efforts, 9
 - Cooperation among Agencies, 10
 - Base State Compacts and Audits, 10
 - Criminal Investigations, 11
 - Diesel Fuel Coloring, 11
- 12 CHAPTER FOUR CONCLUSIONS AND RECOMMENDATIONS
 - Point of Taxation, 12
 - Screening, Bonding, Permitting, and Licensing, 12
 - Information and Reporting, 12
 - Auditing, 12
 - Criminal Investigations and Sanctions, 12
 - State and Federal Cooperation, 13
 - Fuel Coloration, 13
- 14 REFERENCES

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Information on current practice was provided by many highway and transportation agencies. Their cooperation and assistance were most helpful.

METHODS TO CURTAIL STATE FUEL TAX EVASION

SUMMARY

This synthesis is a summary of fuel tax evasion problems, the methods perpetrators have used to evade fuel taxes in the past, and the successful countermeasures that states have adopted to address these problems. It focuses on state activities to collect taxes on gasoline, diesel fuel, fuel use, and blended fuels (i.e., gasohol), rather than on federal attempts to improve fuel tax compliance, although it discusses cooperative state and federal actions.

Gasoline is the predominant motor fuel used in light highway vehicles and is responsible for most of the states' fuel tax income. Diesel fuel is used chiefly by large commercial trucks and buses. Both fuels are also used for off-road transportation purposes and have other tax-exempt uses such as in government vehicles. Diesel fuel is essentially the same product sold as tax-free heating oil, further complicating the assessment and collection of diesel fuel taxes.

Fuel use taxes are levied on large commercial vehicles for the portion of their travel taking place in individual states independent of where the fuel was originally pumped into the vehicle. These taxes impose further reporting requirements on the fuel users and additional administrative and compliance auditing requirements on the state fuel tax collection agencies. Blended fuels such as gasohol receive special tax treatment in some states. Gasohol is a blend of 10 percent high-priced ethyl alcohol and 90 percent lower-priced gasoline, the total product receiving a favored tax treatment. Because of the disparities between the cost of the alcohol and gasoline, states are required to test the final product to enforce the alcohol content requirement.

Fuel tax evasion schemes take many forms, but fall into four major categories. The first major area of fuel tax evasion is the failure to file information, reports, or returns (i.e., to operate completely outside the tax framework). These schemes include failure to apply for licenses or permits.

The second type of fuel tax evasion includes filing false information that either underestimates tax liability or misrepresents payment of fuel taxes. False information can include data on the taxable fuel quantity sold or on paper transfers of fuel. Fuel can be reported as used in a low-tax-rate state when it is actually shipped to a high-tax-rate state for resale. The fuel use tax can be partially evaded by underreporting mileage in high-fuel-use-tax-rate states. Gasohol quantity and quality are both subject to misrepresentation. "Daisy chain" evasion schemes involve the use of dummy companies that claim to have paid fuel oil taxes during a series of complex paper transactions but that, in reality, disappear after a few months, leaving no records and no assets.

The third type of fuel tax evasion involves filing false exemptions from taxes that are legally granted to special classes of users or to tax-favored fuels such as gasohol. Examples of this type of evasion include diverting nontaxable fuel oil to highway use, falsely claiming off-road use of fuel used on the highway, reducing or omitting the alcohol content in gasohol, and falsifying shipping documents to show delivery to nontax entities when the fuel is shipped to taxable users.

The last type of fuel tax evasion is the failure to pay taxes that have been assessed and agreed to. This type of evasion occurs when a fuel taxpaying firm experiences

business difficulties and ends up without enough assets to meet its fuel tax or other obligations. Dummy corporations also lack assets to meet fuel tax obligations, but their violations are willful and fall under the second category.

One successful state practice used to curtail the types of evasion listed above is to move the point of taxation. The higher up the distribution chain taxes are collected, the less evasion occurs. In practice, this means that gasoline fuel taxes are collected at the distributor or first importation level, rather than at the point of sale level. This results in fewer taxpayers, fewer difficulties in administering and auditing the taxes, and lower tax revenue losses.

Other successful state practices include improved screening, licensing, permitting, and bonding of taxpaying entities, whether they be importers, distributors, fuel transporters, or major users. Information collecting and reporting are also necessary to good tax compliance. Computerized uniform reporting allows states to reconcile various sources of information quickly and to cooperate with each other and with the federal government.

Fuel purchase invoice requirements are aimed at improving state access to information relating to determining fuel tax liability. Such information permits improved tax return auditing and field auditing. Although a recent auditing of state gasoline and diesel tax accounts yielded excellent returns in terms of increased federal and state tax collections, additional auditing resources are required if audit cycles are to be frequent enough to maximize tax revenues.

Interagency cooperation has proved to be an extremely effective tool in the overall efforts to curb evasion. Cooperation through information exchanges, voluntary cooperative agreements, and joint cooperative enforcement efforts have all proved successful.

Base state compacts and audits are another area in which interstate cooperation has improved compliance. The base state, where an interstate carrier registers its vehicles, assumes primary responsibility for fuel tax enforcement and audits and the distribution of tax receipts to other states, freeing the resources of those states to concentrate on other tax revenue sources.

Criminal penalties are helpful in deterring and punishing fuel tax evaders. Currently, 45 states have criminal sanctions for evading motor fuel taxes but only 19 include fuel tax evasion as a possible felony violation. Twenty-one states have the ability to hold corporate officers personally liable for tax evasion. This area of deterrence needs to be reexamined for possible improvement by states that do not have strong criminal penalties to combat fuel tax evasion schemes.

Fuel coloration of diesel oil products intended for nonhighway use is practiced in several Canadian provinces. The same concept would be practical on a national level in the United States. The addition of a single color nationwide would permit state enforcement personnel to determine immediately if nontaxed fuel was being used to propel highway vehicles. Such a determination would also serve to identify carriers requiring further fuel tax evasion investigation.

CHAPTER ONE

INTRODUCTION

This synthesis provides a summary of the problems that have occurred for states because of the evasion of state fuel taxes, describes the means through which evasion can occur for each type of tax, assesses which approaches have proved to be successful in curtailing evasion, and recommends actions that states should consider taking when they are concerned about fuel tax evasion. Tax administrators have taken many recent initiatives to solve the problems of evasion, and these initiatives are a major focus of this synthesis.

Estimates of fuel tax evasion indicate that more than \$500 million per year in state and federal taxes may have been lost in a single state. There are other comparable estimates for other states. This indicates that fuel tax evasion is a very important state revenue and law enforcement issue. Curtailing evasion could increase revenues for highway programs and could bring economic benefits to society. In addition, curtailing evasion will make tax collections more equitable and will enforce the perception that lawlessness of any type will not be tolerated.

Evasion of state fuel taxes is intrinsically difficult to estimate, but many very knowledgeable tax officials have concluded that evasion is a major problem. The difficulty of estimating evasion does not detract from the importance of curtailing it to achieve equity among taxpayers and assure that much-needed highway revenue is available for states and localities.

The synthesis covers evasion of all types of highway fuel taxes that are collected by the states. These include:

- gasoline taxes (per gallon and sales)
- diesel fuel taxes
- fuel use taxes
- blended fuels (i.e., gasohol) taxes

Although the relationship of evasion of state fuel taxes to the evasion of federal fuel taxes and other highway-related state and federal taxes is touched upon in this synthesis, its focus is on the motor fuel taxes that are collected by states. Recent efforts to foster cooperation among the states and Internal Revenue Service (IRS) offices on fuel tax evasion have proved to be extremely successful, with many of the benefits accruing in additional collections of federal fuel taxes. Further success in curtailing state fuel tax evasion could, through a continuation of the recent cooperative efforts, also result in beneficial impacts on federal enforcement efforts.

Nonpayment of state fuel taxes occurs as a result of deliberate criminal activity, or in some cases because of oversight by the taxpayer. However, inadvertent oversight is considered to be rare, if not improbable, and the focus of this synthesis is on curtailing deliberate evasion of the taxes that are due.

Minimizing evasion depends on a number of factors that are within the control of a state and a number of factors that are outside a state's control. Factors that are important to evasion and that should be considered to be within the state's control include the following:

- point of tax collection/number of taxpayers
- permitting requirements
- qualifications for handling nontaxed fuels
- forms and data to be reported
- reporting/record-keeping requirements
- reporting/record-keeping for nontaxed fuels
- procedures for inspection of facilities
- staff size and skills for reporting/auditing
- staff size and skills for facilities inspection
- auditing techniques and frequency
- field enforcement activities
- coordination with other agencies
- existence and scope of exemptions
- treatment of blended fuels (gasohol)
- actions to differentiate products (fuel coloring)

Each of these factors is discussed in the synthesis, and successful approaches that have been taken to deal with each factor are highlighted. Some of these factors are, of course, highly interdependent and all influence evasion together as well as individually.

Other factors outside the control of state administrative and enforcement personnel are also important, including taxpayer attitudes toward compliance, availability of fuel at borders, ability to pass desirable corrective legislation, and tax rates within bordering states.

FUEL TYPES AND TYPES OF TAXES

The different types of fuels and fuel taxes need to be distinguished because there are variations in opportunities for evasion based on the type of fuel and type of tax. Fuel taxes are never easy or trivial to administer, in terms of curtailing evasion, but difficulties multiply for some types of fuels and taxes compared with others. Gasoline itself represents the most straightforward situation. Additional opportunities for evasion are present with diesel fuel, with blends such as gasohol given special tax treatment, and with more complex tax schemes such as fuel use taxes, which are collected based on place of use rather than place of sale.

Gasoline is the predominant motor fuel used in light highway vehicles and is responsible for the majority of fuel taxes raised

by the states. Gasoline taxes are generally paid fairly high up along the distribution chain, by refiners, distributors, wholesalers, and jobbers, because there are few alternative uses for which the product is intended other than taxable highway use. Alternative nonhighway uses of gasoline include farm, industrial, and construction vehicles; marine motors; general aviation; other recreational vehicles (snowmobiles, trailbikes, etc.); and household uses (lawnmowers, chainsaws, etc.). Tax-exempt uses may include state and local government and public-transit vehicles. However, most gasoline is consumed for taxable highway use, and the nonhighway uses in some vehicles probably involve the use of some gasoline on which taxes have been paid.

Because of its predominant use in highway transportation, and the consequent ease of taxing gasoline at the higher points in the distribution chain, the enforcement of gasoline tax collections is frequently less complicated than tax collection enforcement for other fuels. This is basically because of the small number of entities responsible for paying gasoline taxes when the point of taxation is set high up the distribution chain. High up the distribution chain means as close as possible to the original producer. By no means, however, is enforcement of gasoline fuel taxes either easy or straightforward. Evasion schemes of many types have been used, and the countermeasures take time, effort, and care.

Diesel fuel is a less highly refined product and is essentially the same product that can be used for heating oil. Most highway use of diesel fuel is by large commercial trucks and buses. Diesel fuel taxes are collected in some states at the point at which the fuel is pumped into the highway vehicle. However, the diesel fuel use taxes by each state on interstate operators of heavy vehicles are based on estimated use within each state, not on the point of sale.

Fuel use taxes for large commercial vehicles are based on the proportion of mileage traveled in each state, multiplied by the operators' total diesel fuel use, independent of where the fuel

was purchased or where it was placed into a vehicle's fuel tank. Typically, fuel will be purchased and the tax paid in one state but it will be used in another. Fuel use reports reconcile the amounts of taxes due the various states. Fuel use taxes thus require a reporting mechanism based on miles of highways used rather than on the point of sale for the fuel. This adds a complication that does not occur with regard to light-duty vehicles. The collection of state fuel use taxes based on miles of travel rather than on purchase location is paralleled by the apportioning of heavy-vehicle registration fees among many states based on miles of travel within the state compared with miles of travel in all jurisdictions. The need to monitor place of use, in addition to the large number of taxpayers responsible for fuel use diesel taxes, makes their administration more difficult. Also, there usually will be more total taxpayers who report or file and are responsible for remitting diesel fuel taxes than gasoline taxes.

Sales taxes are also collected on fuel in some states. The sales taxes can be applied to non-fuel sales as well, so reporting mechanisms and intended uses of the proceeds may be unlike those for other taxes on fuel. Sales taxes for gasoline are sometimes collected at the higher distribution levels as with gasoline per gallon taxes, but sales taxes are more likely to be local-option taxes and to vary by substate jurisdiction, thus making collection or estimating at a lower level necessary.

Special tax treatment is accorded to gasohol in some states. Gasohol has been defined as a blend of 10 percent ethyl alcohol and 90 percent gasoline. By blending higher-priced ethyl alcohol with lower-priced gasoline, favored tax treatment is received on all of the final product. The effect is a subsidy for ethyl alcohol producers, provided out of fuel tax revenues that would otherwise have accrued to the states. The difficulty added, besides the direct loss of much-needed highway revenues, is that additional checks are necessary to assure that a product sold as gasohol on a tax-favored basis does indeed contain a minimum of 10 percent of the more expensive alcohol component.

CHAPTER TWO

DESCRIPTION OF EVASION SCHEMES

Although creativity has few limits for those who will search for ways to evade taxes, types of evasion schemes can be classified, and the attributes on which those schemes rely to make evasion possible can be identified.

As with evasion of other taxes, schemes can be broadly classified as falling into these categories:

- failure to file information, reports, or returns (e.g., attempting to operate completely outside of the system of compliance and reporting);
- filing false information that either misrepresents taxes as having been paid or that underestimates tax liability;
- falsely claiming an exemption from taxes that is legally granted to special classes of users or to tax-favored fuels such as gasohol; and
- failure to pay taxes that have been assessed and on which no disagreement exists.

Examples of the first type of state fuel tax evasion include instances of handlers, distributors, or fuel users who are never licensed or who fail to file information or tax returns. These can be either wholesale or retail businesses operating in a seemingly normal way to customers but not filing information or returns. Some information other than what is submitted voluntarily by the businesses themselves is necessary to find such operations. The normal means of discovering such operations would be through field observations of businesses for which no records can be found, reports of transactions such as sales or purchases that are filed by others, and through informants.

The second type of evasion is filing false information. False information can be filed about prices of sales, gallonage, end use of the fuel, or whether taxes have been paid on the product. One example of this second type of evasion is the "daisy chain" operation, in which a dummy company with no assets claims to have paid taxes within a complex set of paper transactions in which taxable fuel product is transferred among distributors. Examples of daisy chain operations were uncovered in New York State several years ago. The daisy chains of businesses, which existed only on paper, sold gasoline in a successive chain of transactions, and at some point, a paper or fictitious company claimed to have paid state and federal taxes on the fuel. The company that supposedly paid the taxes, a so-called "burn" company in the parlance of the New York evaders, would disappear after several months without leaving a trace of any records (1). Variations on the scheme would involve either deliveries to a new terminal or paper transfers without the gasoline even leaving a specific terminal.

New York State enacted a so-called "First Import Law" (Chapter 44 of the Laws of 1985) under which motor fuels and

sales taxes are imposed at the point of importation into the state rather than at the sale location (2). First import law assures that fuel inventory information has to be kept at all times while the fuel is in the state. This eliminated the opportunity to use daisy chains and shifted the focus of enforcement to monitoring first importations. It also provided the additional information needed to track fuel and transactions.

Examples of the second type also include inaccurate reporting of information in order to misrepresent tax liability. This could occur through understating the taxable gallonage or other falsification of records. A scheme uncovered in Delaware and Pennsylvania involved the falsification of duplicate master shift reports from a station, and alteration of meter readings. Fuel sold at a truck stop was instead listed as nontaxable sales. About 85 to 90 percent of sales were recorded as "nontaxable miscellaneous rack sales" (3). Thanks to the diligence of Delaware officials, this scheme was uncovered and prosecuted. It also caused Delaware officials to advocate legislation to make officers of corporations personally liable for any taxes due (3).

Another example is the evader who pays taxes in a state with low fuel taxes but ships the product for sale or use into a state with higher fuel taxes. A variation of this is the underreporting of miles of travel in a high-fuel-use-tax state and the attribution of more travel to states with more favorable rates of fuel use taxes (or of the total taxes, which are based on miles of travel within the jurisdiction).

The third type of evasion is the false exemption claim or the pretense of exempt use. Examples of this third type would include diverting nontaxable fuel oil to use as diesel fuel for highway purposes, or falsely claiming off-road use of all fuel even though some is used in highway travel. Claims for off-road use can be made with regard to functions such as agriculture, mining, construction, and similar industries in which fuel is used extensively in vehicles and other nonhighway transportation.

This third type of evasion can also be a problem for those who do make legitimate use of large quantities of heating oil in addition to operating vehicles on the highways using diesel fuels, and for large mining or agricultural concerns that have major (and legitimate) needs to use fuels in off-road vehicles. In such cases, failure to keep correct, accurate records about the relative proportions of the end uses of the fuel could be considered an evasion.

Another example of this type of evasion is related to the special tax treatment accorded to gasohol in many states. Gasohol is granted exemption from some or all portions of fuel taxes, resulting in a subsidy by state highway agencies, and also resulting in additional unique opportunities for evasion. Because the gasohol tax exemption is often generous and the ethyl alcohol compo-

ment of the blend is much more expensive than the gasoline component, there is a great incentive to potential evaders to minimize the ethyl alcohol content (e.g., below 10 percent), or even to sell as gasohol a product that contains no ethyl alcohol at all. This places additional requirements on the states for field monitoring and testing of the product being sold as gasohol.

Finally, sellers have been caught falsifying shipment of fuels to nontaxable entities such as farming, boating, home heating oil, or other nontaxed uses when in reality the product is being shipped to taxable users. In this case the users may not be fully

aware that taxes haven't been paid, except through suspicion that the price of the product was unreasonably low.

The fourth type of evasion is failure to pay taxes that both the state and the taxpayer know to be due. Examples of the fourth type will often overlap with the second type, because the dummy corporations established for daisy chain transfers will have no assets. It is also possible for a firm in business difficulties to end up without enough assets to meet its fuel tax or other obligations. Most states require bonding of distributors, so that defaults of this sort may be partially or entirely offset by the bonds.

CHAPTER THREE

SUCCESSFUL PRACTICES TO CURTAIL EVASION

Despite the large number of potential evasion schemes, states have had increasing success in identifying actions and measures that are effective in curtailing evasion. The actions include: (a) generating and controlling information about the movement and sale of fuel and its tax status; (b) controlling and checking those responsible for taxes; (c) choosing an appropriate point of taxation to minimize the number of entities with tax responsibilities; (d) having field checks at terminals and border crossings by tankers; (e) achieving an appropriate level of auditing resources and using those audit resources effectively; and (f) and cooperating with other agencies within the state, other states, or the IRS.

By comparison with the federal government, states have required more comprehensive reporting, devoted more resources to auditing fuel taxes, and generally taxed products at a point closer to the original producer. States have learned from each other and the federal government has clearly learned from the states (4).

The approaches to curtailing state fuel tax evasion are discussed below by topic area. Each covers one or more innovative or effective actions that states or Canadian provinces have used, or plan to use, as part of their efforts to curtail evasion.

The first step in curtailing evasion has been recognition that there was a problem of considerable magnitude and that actions that could be taken to resolve that the problem would be cost-effective. Fuel taxes are now much higher than they used to be, and although they haven't increased in real terms compared with several decades ago, the increases in state fuel taxes during the 1980s have made tax evasion a relatively bigger concern.

A survey conducted for the Committee on Motor Fuel Tax Evasion of the National Association of Tax Administrators found (5):

Most states had reported that they had problems with evasion of gasoline tax, diesel fuel tax, or both. Ninety-five percent indicated a desire for increased interstate cooperation. Ninety-two percent indicated that they were willing to share information. Ninety-two percent wanted to do more to uncover false invoicing. Seventy percent were interested in using magnetic tape reporting in fuel tax administration. Nine states reported instituting new collection procedures in the last year.

Diesel fuel tax evasion was the first problem to be widely recognized as significant. The opportunity for evasion of diesel fuel taxes is somewhat more prevalent than for gasoline taxes because heating oil is indistinguishable from diesel fuel and can be used in highway vehicles. In addition, motor fuel use taxes, which apply to diesel fuel used by interstate vehicles, present additional problems in terms of complexity of reporting and the number of entities responsible for paying taxes.

Another difficulty is that many perceive that resources used to help curtail fuel tax evasion could bring an even bigger return in terms of increased revenues if they were devoted to more general and lucrative taxes, such as state income or sales taxes. Thus, even though highway and taxation agencies have demonstrated significant dollar returns from the additional effort and expense of auditing fuel tax accounts, the auditing of other types of taxes and taxpayers has been shown to be even more lucrative in terms of added tax collections. Tax agencies also are reluctant to increase enforcement activities as they approach the point at which the dollar returns become close to the resource costs of enforcement. This results from the perception that enforcement activities are relatively intrusive to those who are paying all their taxes, because of the time and expense of record-keeping and submitting to auditing.

POINT OF TAXATION

Raising the point of taxation to a higher level in the distribution chain of fuel has been a successful measure to curtail evasion, and has often been the number one initiative to combat evasion. After changing its point of taxation to the distributor level in 1983, Maine experienced a 40 percent increase in diesel fuel tax collections, despite an estimated increase of only 6 percent in travel (6). The state of Connecticut estimated an increase of 23 percent in reported gallonage after changing the point of collection to licensed distributors rather than retailers and users (6).

New York's experience with changing the point of taxation to the point of first import into the state had an important impact. The law was enacted to reduce an estimated \$90 million to \$200 million in fuel tax evasion per year resulting from the daisy chains and other evasion schemes (7). The point of first import law and its enforcement were also intended to help crack down on bootleggers who would bring in a product from a neighboring state with an \$0.08 per gallon tax rate and sell it in New York, where gallonage and sales taxes amounted to \$0.17 to \$0.26 per gallon. After the June 1985 imposition of the new point of taxation in New York State, estimated tax payments increased 21.5 percent in 1985 and 24.5 percent the next year (4).

Maryland estimated a 20 percent revenue increase after changing its diesel/excise tax point of collection from the end user to the wholesale level in July 1985. Michigan estimated a 20 percent revenue increase from the gasoline/sales tax after it changed its point of collection from the retail to the first import level in January 1984. California estimated a \$30 million to \$50 million gasoline/sales tax evasion before changing its point of taxation from retail to first sale in July 1986, but made no subsequent

estimate of tax revenue gains (4). California tax officials believe that getting to the highest level is the way to avoid evasion. Only 13 companies now pay 90 percent of the gasoline tax due in the state of California (E.V. Anderson, personal communication, March 1, 1989).

SCREENING, LICENSING, PERMITTING, AND BONDING

As of 1985, a survey by Guzik of New York State indicated that only 17 of the states (33 percent) investigated new applicants for a distributor's license and many of the 17 conducted only a

TABLE 1
SCREENING AND REPORTING REQUIREMENTS (8)

Requirement	No. of States	Percent
Investigation	17	33
Financial statement	8	16
with CPA certification	4	8
License storage facilities	15	29
Monthly reports		
Terminals and storage facilities	24	47
Transportation and pipeline cos.	36	70

cursory examination (Table 1, 8). Only eight required financial statements and only four of that eight required certification from a certified public accountant (8). Only 15 states (29 percent) licensed storage facilities, 24 (47 percent) required terminals and storage facilities to file monthly reports, and 36 (70 percent) required reports from transportation and pipeline companies. All of these screening and reporting requirements could prove crucial to establishing the credibility of companies and provide a trail of information and accountability.

Checking on the fitness and background of applicants for licenses in the fuels business has proved to be effective. Texas changed its system of dealing with applicants to include a field investigation of those who applied for a permit to be a diesel fuel supplier or gasoline distributor. The field officer can determine whether there is a real company being operated by real people (D. Lawrence, personal communication, February 21, 1989).

As with other aspects, a smaller number of potential taxpayers is consistent with ease of enforcement with regard to screening, licensing, and bonding. Florida identified difficulties after a 1983 law increased the registrations of distributors from 335 to 475. Bonding requirements were raised from \$35,000 to \$100,000, but most of the new distributors registered over a short period were companies with whom the state had no previous experience, and some set up in Florida to "rob the bank" (9). This meant that some of the new companies were those that had identified the opportunities for fraud and entered business in Florida with a specific intent to evade fuel taxes. The lack of ability to screen these potential taxpayers when large numbers of new firms become eligible under deregulation can thus prove to be disastrous.

For Florida, bonds of \$100,000 proved to be little deterrent to those who believed they could evade such amounts within a very short period, and keep their paper corporations from view. Florida now conducts investigations of all applicants as a result of the 1983 experience.

The National Association of Tax Administrators' (NATA's) (now the Federation of Tax Administrators') Motor Fuel Tax Section Tax Evasion Committee recommends very comprehensive screening and checking of applicants for all licenses dealing with fuel taxes (10):

The license application should be modified to include certified financial statements on past operations. A personal contact with the applicant and a physical inspection of the anticipated operation should be part of the licensing procedure. Changes in ownership of a controlling interest should require reapplication. Annual relicensing should provide an opportunity to review the operator and the operation.

INFORMATION AND REPORTING

The trail of information and reporting is an important aspect of efforts to curtail evasion. Information on product movements and transactions provides the basic records necessary to determine amounts of tax that are due. It is important for the state agencies to have legal access to, and to review, all relevant information. Computerized information is felt by many to be crucial to the ability of the state to reconcile various sources of information, and to use inconsistencies to identify potential illegal actions. Record-keeping that enables tracking fuel from import through each transaction to final use is felt to be an effective means to detect evasion (9).

Although there have been considerable efforts to achieve uniformity, reporting requirements and periods vary somewhat among the states. Most efforts to achieve uniformity involve various aspects of fuel use taxes, which are paid by interstate motor carriers to many states on a regular basis.

A uniform reporting medium has been identified by the NATA's Motor Fuel Tax Section Committee on Evasion as an important concern (10):

Consideration and development of a uniform reporting medium to simplify reporting should be undertaken on a national basis. Automated reporting as an outgrowth of uniformity is a logical extension of uniformity and should be a long-range objective of uniformity. Passage of title by paper has resulted in an added burden on the Office Reconciliation Program. Uniformity followed by an automated reporting system will permit the Office Reconciliation Program to respond to differences in a more timely manner.

A program to develop and implement a Uniform Motor Fuel/Special Fuel Report Format was undertaken by the NATA. The Uniform Report provides some flexibility for specific requirements in each state but provides a common information base for fuel use tax reporting. As discussed later, uniformity is exceptionally important in promoting the type of information exchange that allows the states and the federal government to cooperate and benefit from the total resources that can go into curtailing evasion. Another intent of uniformity is to reduce the reporting costs to motor carriers and other industries and to assure more accurate reporting.

UNIFORM FORM FOR MOTOR CARRIER FUEL TAX REPORTING

A uniform form for motor carrier fuel tax reporting was adopted by the North American Gasoline Tax Conference (NAGTC, now the Motor Fuel Tax Section of the Federation of Tax Administrators) in 1981, and clarifications of instructions were promulgated in 1985. The National Governors Association (NGA) collected information in 1987 on state practices in important areas relating to uniformity as recommended by the NATA and NGA. The number of states conforming to each of the important aspects of the uniform form is summarized below (11):

- Annual Filing—Thirteen states allowed annual filing for taxpayers with a small annual liability.
- Filing Frequency—Forty-one states required filing only quarterly.
- Due Dates—Thirty-two states required filing by the last day of the month following the calendar quarter.
- Composite Tax Rate to Include Sales Tax—Three of five states that have this issue have composite reporting.
- Vehicles Covered—The suggested requirement was changed, and conformity was not relevant.
- Using Miles per Gallon to Determine Fuel Used—Thirty-eight states used a carrier's fleet miles per gallon as a step in estimating fuel use.
- MPG Decimal Places—All but four states used two decimal places.
- Limits on Credit Carryovers—Fifteen states did not conform by allowing credit carryovers for eight or more quarters.
- Requirements for Proof of Payment to Another State—Thirty-five states were in conformance by not requiring those applying for a refund to show proof of payment to another state.

FUEL PURCHASE INVOICE REQUIREMENTS

Fuel purchase invoices are an important source of information on activity in the motor fuel use tax area. The North American Gasoline Tax Conference adopted fuel purchase invoice requirements in 1962 that included (12):

- (1) date of sale; (2) name and station address of vendor, machine printed or credit card with credit card imprint; (3) name and address of purchaser or licensee; (4) number of gallons; (5) name of product; (6) state tax rate charged; (7) signature of purchaser; (8) company unit number or motor vehicle license number and state of the power unit; and (9) the original invoice prepared over double face carbon shall be required except in case of a credit card purchase.

Recommendations were made by a 1987 NATA committee headed by Dale A. Shuirman, Director of the Delaware Division of Motor Fuel Tax, to modify the requirements and to apply them to the withdrawing of tax-paid fuels from licensee-owned bulk storage. Credit could be obtained in association with withdrawals from licensee-owned bulk storage if these records were maintained (12):

- (1) date of withdrawal; (2) number of gallons; (3) fuel type; (4) company unit number or vehicle license plate number and state;

and (5) purchase and inventory records to substantiate that tax was paid on all bulk purchases.

The NATA members have also undertaken to develop a Uniform Definition on the Point of Sale for Export and Import of Fuel. The definition language developed in 1987 by NATA reads (13):

When gasoline (and fuels taxed in the same manner as gasoline) under the origin state's statutes are sold for export and delivered out of state by or for the seller, that is an export by the seller in the origin state and an import by the seller in the destination state. When gasoline (and fuels taxed in the same manner as gasoline) under the origin state's statutes are purchased for export and transported out-of-state by or for the purchaser, that is an export by the purchaser in the origin state and an import by the purchaser in the destination state.

It is also desirable to have access to information that may be related to the determination of tax liability. The state of Delaware has found it beneficial to have a law that provides the state access to the records of home heating oil sales. This provides some additional information helpful to tracing whether a product is used as diesel fuel or as heating oil. It would be helpful to have reports include information on nontaxable sales of all types of fuel, in addition to keeping records of such sales for review by audit personnel. The NATA Motor Fuel Tax Section Committee on Tax Evasion has recommended (10):

Development of third party informational returns from carriers and storage facilities should be incorporated into an examination program. . . . Quality of third party reporting should be the same as tax return filings.

AUDIT EFFORTS

Audit efforts have been shown to be crucial in reducing evasion and in recouping unremitted taxes. Auditing of returns and field auditing have both been cited as important elements. Tax returns and other information are examined for evidence of any likely irregularities and cross-checked with other information. Field visits to terminal locations can help confirm the accuracy of reported information.

A survey in 1985 of practices in the states indicated only 260 full-time and 172 part-time auditors protected \$11 billion in state gasoline tax revenue, and that audits of state fuel taxes were yielding \$67 million in additional taxes per year, or 0.6 of 1 percent of total gasoline tax yields (8). Ideally, an audit cycle would be frequent enough so that all those involved with motor fuel taxes would be audited regularly, and all years and transactions would be covered. The level of audit resources has not generally been sufficient. Some states, such as Delaware, have been able to audit all taxpayers, and have seen a massive increase in the amount of tax collected (6). A three-year cycle has been adopted in some states, yielding an audit of all taxpayers at least that frequently.

If all taxpayer accounts cannot be audited regularly, then the auditors must select accounts to audit based on the likelihood of potential evasion and the amount of taxes at stake. The selection may be based on the magnitude of the taxpayer's operations, prior tax evasion, information from informants, conflicting information from other records, or random selection factors. Enforce-

ment and audit personnel have found that it is beneficial to talk with truckers, check fueling locations, and become generally knowledgeable about what is going on in the field to help select potential audit accounts.

The yield of additional dollars collected per hour of audit resources is a commonly used measure of how worthwhile the use of audit resources is on a particular tax source. By this measure, audit resources devoted to fuel taxes have shown very positive returns, but it is widely believed that state audit resources devoted to income and sales taxes have even better returns per hour of audit effort. However, maintaining a strong audit presence in the fuel tax area has a large deterrent effect on tax evasion.

The auditing of state gasoline and diesel tax accounts, as part of the recent Federal-State Cooperative Motor Fuel Tax Noncompliance Projects, yielded excellent returns in terms of additional federal and state tax collections. State audit results from the gasoline tax phase averaged \$1400 per hour return in terms of increased dollars of assessed taxes. The range was from \$18 per hour in Illinois to \$6435 per hour in New York (14). The diesel phase of the cooperative project resulted in \$229 per hour in state revenues, with a range from \$112 per hour in Pennsylvania to \$705 per hour in California (15). Both phases of the cooperative project resulted in greater assessments of federal taxes due than of state taxes due.

Audit efforts should be expanded to recoup more unpaid taxes. One approach, never applied comprehensively, calculated the portion of the evaded taxes that could be collected through additional audit efforts as a function of the results of audits (16). Under the assumption that audit targets were well chosen, the estimate was that audits for many state highway taxes could be expanded substantially before audit costs exceeded the added revenues resulting from the audits.

There are further important advances that can be made in terms of matching and automatically reconciling field information and reported information (F. Munoz, personal communication, February 21, 1989). New York State compares field and reported information, and is seeking to establish an automated system that will allow field and reported information to be reconciled in real time. The field presence is an important element of New York's regulatory approach, as it is aimed at assuring the accuracy of the information reported.

COOPERATION AMONG AGENCIES

Cooperation among agencies has already proved to be an extremely effective tool in the overall efforts to curtail evasion. Instances of cooperation among agencies within a given state, among states, among states and the federal government, among states and Canadian provinces, and among state agencies and concerned nonevading companies and industry groups have all proved to be important.

Cooperation is helpful between agencies in the same state, because in many states, different entities collect motor fuel taxes and registration fees or other taxes, and because regulatory bodies for motor carriers may have additional information that is helpful for enforcement of motor fuel taxes. Cooperation among the states and between the states and the federal government has proved very valuable and has been increasing rapidly. Cooperation has occurred through many mechanisms, including ex-

changes of information at meetings of the NATA, through voluntary cooperative agreements such as the International Fuel Tax Agreement and the Regional Fuel Tax Agreement, which apply to fuel use taxes, and through joint cooperative enforcement efforts such as the Six Point Plan and the Internal Revenue Service/National Association of Tax Administrators Cooperative Federal/State Motor Fuel Tax Exchange Project (also called the NATA-IRS Cooperative Motor Fuel Tax Noncompliance Project).

The amount of cooperation that is occurring is already very impressive. The NATA surveyed the states on issues of state and federal cooperation and found that two-thirds of the responding states were engaged in cooperative activities with the IRS, mostly through meetings and the exchange of audit results and taxpayer lists (17). Perhaps the most productive cooperative activities are the continuing efforts of the Motor Fuel Tax Section of the NATA, which has been working diligently on all aspects of the problems of evasion, and which provides for continuing exchanges of information.

Attention should also be devoted to cooperating with private companies, including all types of companies up and down the distribution chain, from pipeline companies to legitimate distributors and station owners who are concerned about the potential impacts of evasion on their businesses. Specific information received from industry personnel should be considered privileged information and remain confidential up to the point that litigation becomes necessary. The information should then be subpoenaed from industry sources to support allegations of tax underpayment.

BASE STATE COMPACTS AND AUDITS

An important element of cooperation is the development and acceptance of the base state concept, wherein primary responsibility for enforcement rests with the base state of registration of a motor carrier who has fuel use taxes due in other states. Two cooperative agreements, the International Fuel Tax Agreement (IFTA) and the Regional Fuel Tax Agreement, have been developed for motor fuel taxes.

The important features of fuel tax agreements are the consolidation of reporting requirements that the motor carriers face and the reliance on the base state of operation to process the information and to take responsibility for audits and enforcement. Reliance on a base state can provide benefits to the other states by freeing up their resources to concentrate on accounts that might otherwise be overlooked. Additional benefits can accrue from cooperation between those administering the fuel taxes and motor vehicle agencies, including those administering the International Registration Plan, under which state registration fees are distributed among the states based on the percentage of miles traveled in each state.

The fuel tax agreements must establish standards for the performance of functions by all the participating jurisdictions. This has resulted in some difficulties in attracting membership. The requirement that the base state audit every account every three years under the IFTA calls for more auditing resources than some states now have available. The existence of fairly strict standard audit requirements is necessary, however, to avoid carriers choosing a base state with nominal enforcement levels.

Evasion is of concern to a vast majority of private companies that pay their fair taxes, because evasion results in a competitive disadvantage to legitimate operators. Private-industry personnel have been willing to share information about suspected illegal practices so that public-agency actions can be taken to eliminate the unfair competition of tax evaders (F. Munoz, personal communication, February 21, 1989). Industry representatives should provide information directly, however, because anonymously delivered information about competitors may be given the least credibility by the enforcement agencies (9).

CRIMINAL INVESTIGATIONS

For those who attempt to operate outside the reporting system, a criminal investigations approach is necessary, involving gathering of information through surveillance of activities in the field in addition to the checking of records.

Criminal penalties are felt to be helpful in deterrence and punishment of fuel tax evaders. However, penalties for fuel tax evasion are not consistent among the states. Forty-five states have criminal sanctions for evading motor fuel taxes, according to a survey conducted by Guzik in 1985. Six states had only civil sanctions, and among the 45 with criminal penalties, only 19, or 42 percent, had felony or felony and misdemeanor definitions for evasion, whereas 58 percent had only misdemeanor penalties (8). The survey also indicated that only 21 of the 51 states (including the District of Columbia), or 41 percent, had the ability to hold officers of a corporate distributor personally liable (8).

States might also look to the types of penalties being imposed. Confiscation of a truck and its load could prove an effective deterrent. Substantial jail terms and asset attachment may help to deter potential evaders from a perception that tax evasion will be dealt with lightly.

DIESEL FUEL COLORING

Ontario and other Canadian provinces add color to Number 2 distillate fuel that is intended for nontaxable uses. Ontario has had fuel coloring since 1982. Tax is paid on clear fuel. The tax is collected from 18 distributors, which are generally major oil

companies, 12 importers, and 6400 interjurisdictional motor carriers, which pay on the same basis as do motor carriers paying fuel use taxes in the United States. Tax is paid on the sale of all clear fuel. The motor carriers apply for refunds or pay extra taxes based on their miles per gallon and proportion of miles within Ontario.

The province reimburses the costs of coloring of fuel and requires extensive reporting on all transactions of taxable and nontaxable fuel. Requirements for supporting documentation are also extensive. Ontario experienced an estimated 16 percent increase in diesel fuel taxes collected after going to coloration (18). Before coloration, it had a system of extensive reporting and auditing similar to procedures used by some U.S. states.

Ontario officials report that enforcement efforts under fuel coloration have shifted from clerks checking reports to inspectors in the field. Enforcement involves 25 personnel who inspect 70 terminals, 500 bulk plants, and 400 service stations. Terminal inspections assure that fuel is properly dyed, and that the roadside inspectors check vehicles for untaxed fuel and for other requirements (19).

A recent enforcement effort has been developed cooperatively with the Canadian federal government, involving the collection of diesel fuel taxes or the dyeing of fuel at border crossings from the United States into Canada. Before this effort, no records were required for imported fuel concerning its Ontario tax status, and the importation of fuel was increasing. As a result of the joint effort, the number of gallons of imported fuel dropped, and collections increased by \$2.4 million. The problem of evasion resulting from untaxed clear fuel, ostensibly destined for use as heating oil, coming from the United States into Canada declined substantially when it had to be dyed or tax paid at the border (20).

Although Canadian fuel taxes are higher, and thus the payoff from evasion of taxes is greater, the lessons for the United States are obvious. Coloration operates far up the chain of distribution of diesel fuel and related products, and the existence of colored fuel in a highway vehicle's fuel tank is easy to determine and provides a simple means of checking compliance. Only 500 instances of the use of colorized fuel in highway vehicles in Ontario were observed in the first five years after 1982, all involving small accounts. Coloration has clearly shown substantial benefits for all of the Canadian provinces, and it could be expected to have substantial benefits if widely applied in the United States.

CHAPTER FOUR

CONCLUSIONS AND RECOMMENDATIONS

Significant evasion of state fuel taxes can be curtailed with the right resources, organization, effort, intelligence and diligence. The officials in charge of collecting taxes and the associated law enforcement officials are more than a match for potential evaders on the basis of diligence and intelligence. However, the right legislation has to be in place, the resources to support the officials have to be sufficient, and the overall regulatory structure and sharing of information among agencies has to make it as difficult as possible to evade fuel taxes. The following practices have been reported to be successful by a number of agencies and should be considered by others.

POINT OF TAXATION

Several states have increased fuel tax collections by moving the point of taxation up the distribution chain, toward the producer of the product or the first importer into a state rather than to the ultimate consumer. Limiting the number of entities that handle any product before full taxes are paid will minimize the efforts necessary to monitor payment of taxes due. Choosing a point of taxation high up the distribution chain is a major means of limiting the likely number of taxpayers. Legislative action is generally required to move the point of taxation. Arguments to move it include the likelihood of large increases in revenues and the fairness of more equitable collection of taxes. On the other hand, the number of users exempt from payment of the tax may increase, resulting in a greater administrative burden and new opportunities for evasion. A formal study of the benefits and drawbacks of moving the point of taxation may help to achieve legislative action.

SCREENING, BONDING, PERMITTING, AND LICENSING

The NATA recommends that only businesses that have been thoroughly investigated and have demonstrated fiscal responsibility should be allowed to deal with fuel before taxes are paid and documented. Full investigations should be conducted of all those that handle and pay taxes on fuel products. Screening could include certified financial information about previous operations, personal contacts, and field inspections. Appropriate bonding and licensing arrangements would assure that the state's interests are protected at all times.

INFORMATION AND REPORTING

Information and reporting that is complete, timely, and accurate should be required of those handling fuel before taxation

and those remitting taxes. Deregulation of entry into fuel distributorships, or of reporting information necessary to collect and monitor taxes, may lead to abuses unless careful screening procedures are instituted, as Florida discovered.

A desirable information and reporting system will provide timely information and full supporting documentation of all transactions involving both taxable fuel and nontaxable fuel that could be used in highway vehicles. The information and reporting system should be able to interact cooperatively with other tax and law enforcement agencies and their information and reporting systems, in order that any inconsistencies, anomalies, or suspicious practices be made as readily apparent as possible to all responsible for tax collection and law enforcement.

Use of a consistent form for reporting among jurisdictions that elicits all information necessary to determine compliance would allow states to exchange information easily. Computerized information should be the goal of tax and highway agencies in order to speed the processes through which information can be cross-checked, verified, and processed.

AUDITING

Auditing resources should be sufficient to assure that all taxpayers and potential taxpayers are audited regularly. Some states audit every three years, and most audit more frequently if a problem appears or if information warrants it. A base state audit and state-federal cooperation would contribute to the effectiveness with which audit resources could be deployed. The average level of state resources devoted to fuel tax audits should be increased. Paybacks in one study averaged \$1400 per hour for gasoline and \$229 per hour for diesel. The recipients of the tax revenues, such as the state DOTs, should be allowed to contract for, and pay for, higher levels of audit and other enforcement efforts to assure adequate revenues.

Auditing in the field should be a regular activity to assure that records are accurate and that field information is consistent with reports of activities. Spot checks of terminals and stations should be frequent, unannounced, and random, so that the risk of observation of any illegal activity is raised.

CRIMINAL INVESTIGATIONS AND SANCTIONS

Most states have both criminal and civil penalties available for the prosecution of fuel tax evasion. In most states, the criminal evasion is only a misdemeanor. States should consider whether willful evasion of fuel taxes of more than a minor dollar amount

should be a felony and whether minimum prison terms should be mandatory.

Because some forms of evasion are hard to detect except through criminal-investigation procedures, including surveillance and undercover work, state tax enforcement officials and law enforcement agencies should work cooperatively on overall state programs to curtail evasion. Activities should include field monitoring and contacts with truckers and other businesspeople who may be knowledgeable of the operations of fuel businesses.

The ability to hold corporate officers personally liable for payment of fuel taxes may help prevent some evasion schemes.

STATE AND FEDERAL COOPERATION

Cooperative efforts to curtail fuel tax evasion should continue and should include:

- multistate compacts
- sharing of information
- cooperative auditing among states
- joint state-IRS auditing
- lists of target companies

FUEL COLORATION

In Ontario and other Canadian provinces, diesel fuel intended for use in highway transportation is clear, and all similar product supposedly for nonhighway use is dyed. The experience of Ontario shows that tax collections increased without a significant increase in costs. If used in the United States, the coloration scheme would only be practical on the national level, however, when the addition of a single color would have the advantage of determining if nontaxed fuel was being used to propel vehicles on highways.

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