

**STATEMENT OF
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UNITED STATES DEPARTMENT OF TRANSPORTATION
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
HEARING ON
SCHEMES, SCAMS, AND CONS: FUEL TAX FRAUD
JULY 17, 2002**

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

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

Background

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Fuel Tax Evasion Today

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Conclusion

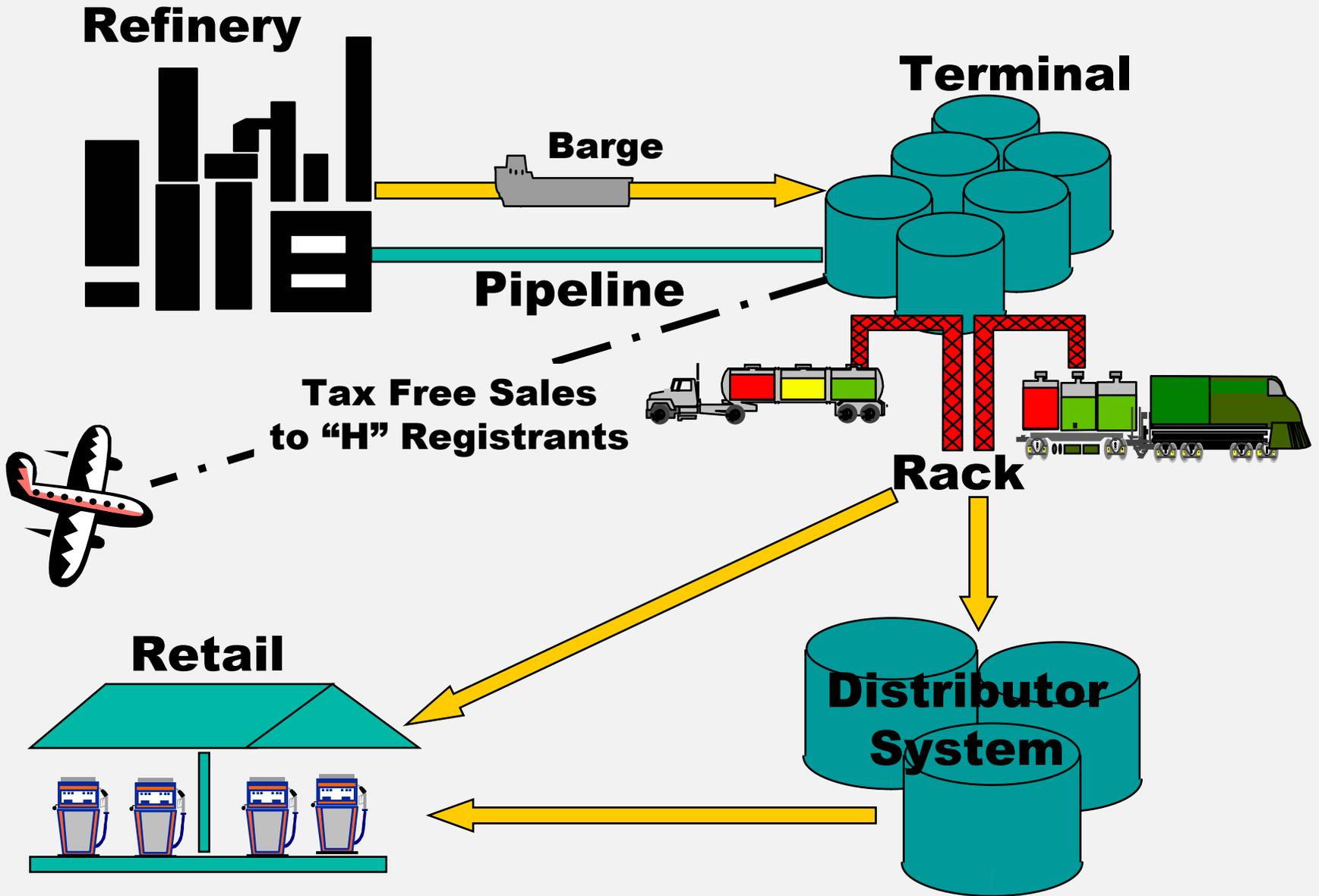
In shaping the Administration's reauthorization bill, Secretary Mineta has committed to maximizing the safety and security of surface transportation for all Americans, even as the Department seeks to enhance mobility, reduce congestion, and facilitate growth in the economy. If we are to realize these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

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

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

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

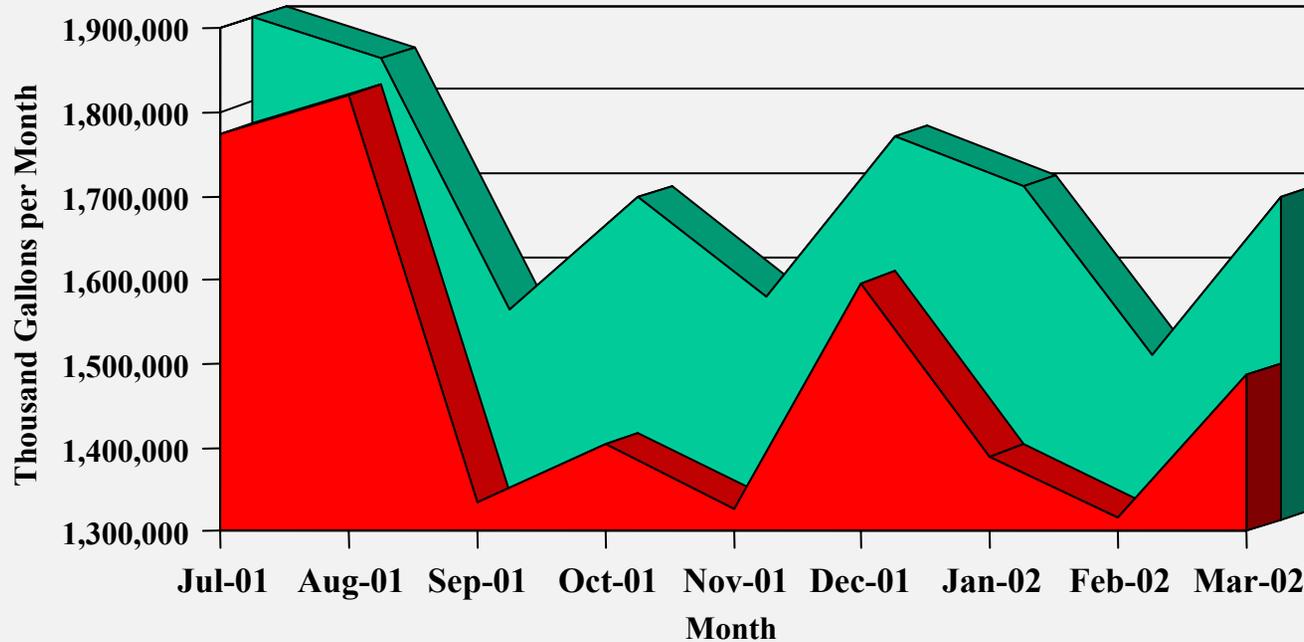
Fuel Distribution System



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

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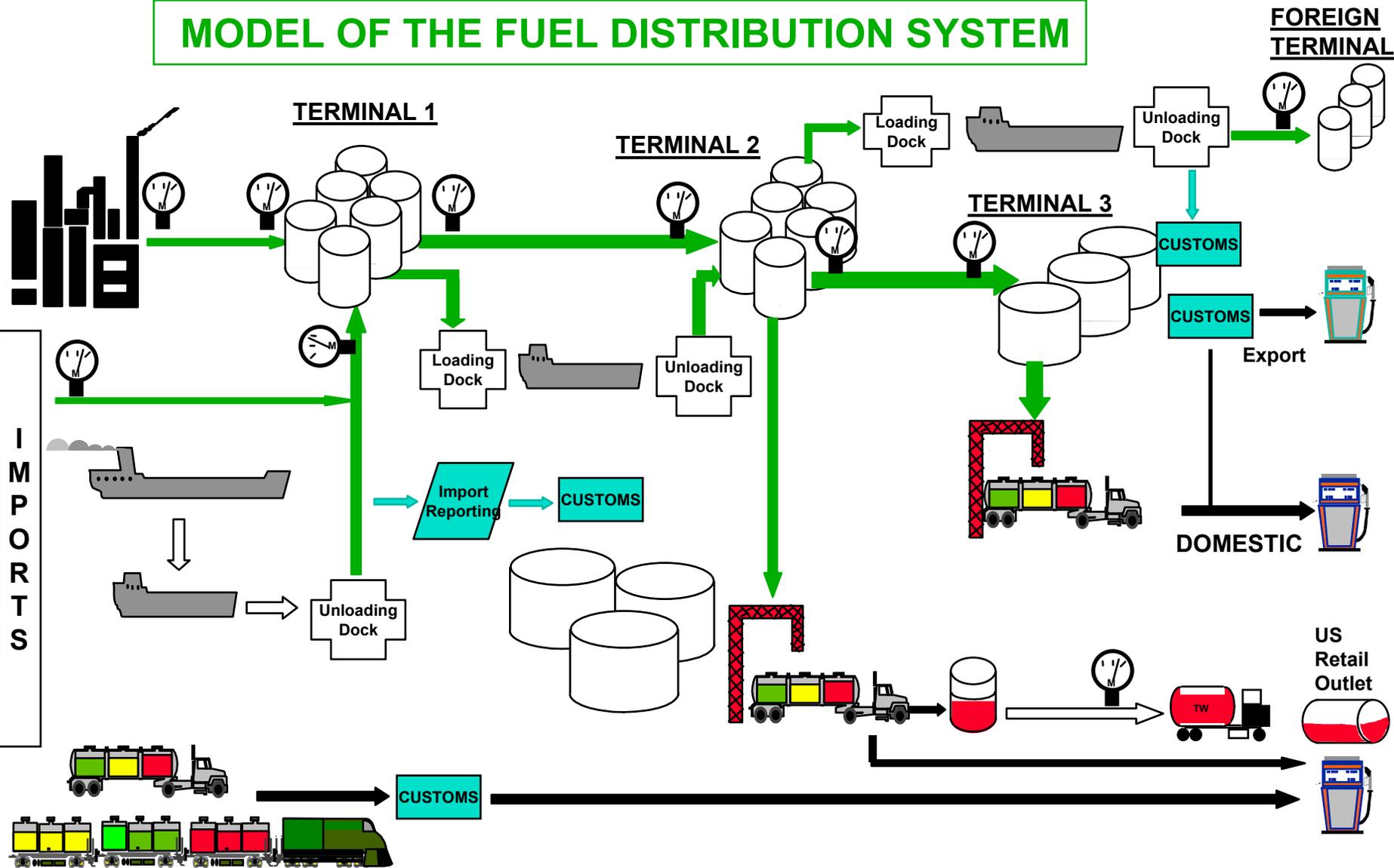
Airline Consumption (B.T.S.)



■ Airline Consumption (Bureau of Transportation Statistics)

■ U.S. Refinery Production - Commercial Kerosene-Type Jet Fuel
(U.S. Energy Information Administration - Table 29)

MODEL OF THE FUEL DISTRIBUTION SYSTEM



LEGEND

| | | | | |
|-----------------|--------------|--------------|---------------|--------------------|
| PipeLine | Loading Rack | Loading Dock | Dock | Consumer tank |
| Transport Route | Bulk Plant | Tankwagon | Retail Outlet | Reports on Imp/Exp |
| Meter | | | | |