

**Opportunities Exist for Further Reducing  
Erroneous Fuel Tax Credits**

**March 2000**

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**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**



INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 31, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

*Margaret E. Bezz*

FROM: for Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Opportunities Exist for Further Reducing  
Erroneous Fuel Tax Credits

This report presents the results of our review of the Internal Revenue Service's (IRS) processing of individual income tax returns claiming fuel tax credits. Our review focused on evaluating the actions taken by the IRS in response to a prior audit report which showed that the IRS' controls over processing, screening, and examining returns controls were not effective for identifying and correcting a significant number of returns claiming erroneous credits.

In summary, we found that the actions taken in response to the prior audit report have reduced the number of erroneous fuel tax credits that avoid detection by the IRS. However, opportunities exist for the IRS to further reduce erroneous fuel tax credits by re-emphasizing certain procedures for screening and examining returns and by educating tax practitioners on the regulations prohibiting credits for undyed diesel fuel used in farming. Our recommendations will assist the IRS in protecting a significant amount of tax revenue on an annual basis.

IRS management agreed to the findings in this report but did not agree with one of our four recommendations that involved sending educational notices to taxpayers who file returns improperly claiming tax credits for diesel fuel used in farming. Instead, management is changing the Examination criteria to require a greater number of returns claiming fuel tax credits to be screened. We concur with this alternative corrective action. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

Attachment

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### Executive Summary

During 1998, the Internal Revenue Service (IRS) received 448,960 individual income tax returns that claimed nearly \$106 million in tax credits for the Federal excise taxes paid on certain fuels. The overall objective of this audit was to determine whether the actions taken by the IRS in response to a prior audit report titled, *Review of Processing Fuel Tax Claims* (Reference Number 070804, dated December 30, 1996) were functioning effectively to reduce the number of erroneous credits.

### Results

The actions taken in response to the prior audit report have had mixed success for reducing the number of erroneous fuel tax credits that avoid detection by the IRS. For example, this follow-up audit showed that changes to the processing procedures have helped to ensure that almost all returns claiming fuel tax credits are identified for manual screening when appropriate. However, the actions taken have been ineffective for ensuring that prior year returns are checked when fuel tax credits are disallowed on the current year returns. In addition, the revisions to the tax form and publication were only partially effective for reducing the number of erroneous claims for tax credits for undyed diesel fuel.

### **The Examination Function Did Not Check 79 Percent of the Prior Year Returns for the Same Issue When Adjusting Unallowable Fuel Tax Credits Claimed on the Current Year Returns**

The prior audit found that, in 73 percent of the returns for which the fuel tax credit claimed was adjusted, the taxpayer's prior year return was not checked for the same issue. The IRS subsequently issued instructions requiring the service center Examination function to check the prior year returns. However, we were advised that management took no follow-up actions to ensure the instructions were being followed.

The follow-up audit found that, nationwide, the Examination function had not checked the prior year return in 851 (79 percent) of 1,079 applicable cases where adjustments were made to the fuel tax credits on Tax Year (TY) 1997 returns. The potentially unallowable fuel tax credits claimed on these returns totaled nearly \$794,000.

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### **More than 15,000 Taxpayers May Have Improperly Received Tax Credits for Undyed Diesel Fuel Used on Farms**

Only the “registered ultimate vendor” (i.e., the person who sells the fuel to the person who actually uses it) can claim a credit or refund for undyed diesel fuel used on a farm for farming purposes. The prior audit identified more than 23,000 taxpayers who incorrectly claimed \$4.5 million in tax credits on their 1995 individual income tax returns for undyed diesel fuel used on farms. At least 19,000 of these taxpayers incorrectly received over \$2 million in credits for undyed diesel fuel because the amount claimed was less than the dollar amount that was subject to IRS review. Paid return preparers had prepared 83 percent of the returns that incorrectly claimed credits for undyed diesel fuel. Beginning with TY 1996, the IRS changed the tax form, the taxpayer instructions, and the tax publication to include specific statements that tax credits are not allowed for undyed diesel fuel used on a farm for farming purposes.

Nevertheless, this follow-up audit showed that there were still 15,926 individual taxpayers, nationwide, who incorrectly claimed tax credits for undyed diesel fuel totaling \$2.45 million on their 1997 returns. Of these returns, 80 percent were professionally prepared.

The IRS questioned the fuel tax credits claimed on only 921 of these 15,926 returns. The remaining 15,005 taxpayers received nearly \$1.78 million in fuel tax credits to which they were likely not entitled. These included 14,039 taxpayers who claimed credit amounts that were below the dollar level requiring Examination function screening and 966 taxpayers who claimed credits that were above the dollar level for screening. The credits claimed by the latter 966 taxpayers were not disallowed even though the Examination function’s procedures contained explicit instructions to disallow credits for undyed diesel fuel used in farming.

### **Summary of Recommendations**

The IRS has the opportunity to further reduce the number of erroneous fuel tax credits claimed by taxpayers and reduce the number of erroneous credits that avoid detection. This follow-up audit report recommends providing educational notices to taxpayers and professional return preparers and re-emphasizing certain procedures for screening returns claiming fuel tax credits.

Management's Response: Customer Service management is incorporating procedures in the Internal Revenue Manual (IRM) to provide both technical and procedural guidance for employees who work fuel tax credit cases. The 1998 and 1999 versions of the tax forms used for claiming fuel tax credits were revised to provide an explicit caution to preparers not to claim the credit for diesel fuel used on a farm for farming purposes. Educational efforts will be

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directed to taxpayers who continue to claim unallowable fuel tax credits despite changes made in both forms and publications designed to improve taxpayer compliance.

Customer Service management did not agree with our recommendation to send educational notices to taxpayers who file returns claiming unallowable fuel tax credits. Instead, they are changing the Examination screening criteria to identify a greater number of returns for manual screening.

Office of Audit Comment: We concur with management's alternative corrective action to change the criteria for screening returns claiming fuel tax credits.

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### Objective and Scope

*The audit was conducted to determine whether the IRS had taken actions to effectively correct three previously reported conditions.*

The overall objective of this audit was to determine whether the actions taken by the Internal Revenue Service (IRS) in response to a prior audit report titled, *Review of Processing Fuel Tax Claims* (Reference Number 070804, dated December 30, 1996) were functioning effectively to reduce the number of erroneous credits. Specifically, we followed up to determine whether the corrective actions were effective to ensure that the:

- Controls over the processing of individual income tax returns claiming fuel tax credits caused the returns to be identified for screening by the Examination function.
- Examination function routinely checked the taxpayer's prior year return for the same issue when adjusting unallowable fuel tax credits identified on the current year return.
- Number of taxpayers that improperly claimed tax credits for undyed diesel fuel used for farming purposes was significantly reduced.

This follow-up review was conducted in accordance with *Government Auditing Standards*. To accomplish our audit objective, we reviewed the IRS' procedures for processing and examining individual income tax returns claiming fuel tax credits, analyzed various IRS computer files containing records of individual taxpayer accounts, and reviewed tax returns processed at the Austin, Cincinnati, and Fresno Service Centers. Our fieldwork was performed between February and October 1999.

Appendix I contains the detailed objective, scope, and methodology of our review. A listing of major contributors to this report is shown in Appendix II.



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As part of this audit, we also worked in partnership with the Office of Excise Taxes and the Ohio District Office Research Analysis Division to evaluate a potential approach for identifying erroneous and/or fraudulent fuel tax claims filed by business taxpayers. The approach involves applying digital analysis software (a technology designed to find abnormal duplication of digits, digit combinations, specific numbers, and round numbers in corporate data) to the IRS' national database of fuel tax claims. The claims filed during 1998 by about 35 percent of the taxpayers did not conform to a mathematical theory (Benford's Law) on the expected distribution of digits in tabulated data that has been successfully used in the public and private sectors to identify fraudulent transactions. Excise tax agents will be examining a statistical sample of the claims identified to test the effectiveness of this approach. The results of this evaluation will be issued in a separate audit report.

### Background

*The identification and screening of returns that claim fuel tax credits is part of the IRS' Revenue Protection Strategy.*

The General Accounting Office (GAO) has cited filing fraud as a high-risk area for the IRS since 1995. Senator Fred Thompson also cited tax filing fraud as a high risk area of particular concern in an August 17, 1999, letter to the Secretary of the Treasury.

The IRS implemented a Revenue Protection Strategy in Fiscal Year (FY) 1995 to address the growing number of fraudulent returns. The strategy encompasses the understanding and control of fraud through research and prevention and through detection and enforcement.

The detection component of the Revenue Protection Strategy uses automated techniques to identify and screen tax returns for indicators of potential noncompliance. The identification and screening of individual income tax returns claiming fuel tax credits is one risk area that is part of these detection efforts.

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*In 1998, the IRS received almost 450,000 returns that claimed a fuel tax credit.*

Federal excise taxes are assessed on the sale, use, or inventory of certain fuels such as gasoline, gasohol, and diesel fuel. Individual taxpayers may claim credits, as offsets to income taxes, for the excise taxes they paid on tax exempt fuels. Examples of tax exempt fuels include gasoline used on a farm for farming purposes and undyed<sup>1</sup> diesel fuel used for off-highway business purposes.

To claim the credit, taxpayers file a Credit for Federal Tax Paid on Fuels (Form 4136) as an attachment to their Individual Income Tax Return (Form 1040). In 1998, the IRS processed 448,960 Forms 4136 that claimed fuel tax credits totaling nearly \$106 million.

During the processing of Forms 1040 at the IRS service centers, computer programs identify those returns claiming fuel tax credits that are above an established dollar threshold. The Examination function at each service center, which is part of the IRS' Customer Service organization, is responsible for manually screening these returns to determine whether the credits claimed should be disallowed. During calendar year 1998, the Examination function screened the fuel tax credits claimed on 41,526 returns and determined that 5,621 (13.5 percent) were unallowable or questionable.

*The prior audit identified three areas where the IRS could improve the detection and/or prevention of erroneous fuel tax credits.*

The prior audit identified three areas where the IRS could improve the detection and/or prevention of erroneous fuel tax credits.

- Eleven percent of a sample of returns claiming fuel tax credits which exceeded the mandatory review criteria were not identified during processing for manual screening by the Examination function.

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<sup>1</sup> The Omnibus Budget Reconciliation Act of 1993 strengthened the enforcement of diesel fuel tax collections by moving the tax collection point from the wholesale to the terminal level and requiring that any diesel fuel removed from the terminal for tax-free use must be dyed.

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- The Examination function had not checked the prior year returns for the same issue in 73 percent of the cases when it disallowed the fuel tax credits claimed on the current year returns.
- Approximately 19,000 taxpayers improperly received tax credits totaling more than \$2 million for undyed diesel fuel used for farming purposes because the individual amounts claimed were below the dollar threshold for screening by the Examination function.

### Results

The IRS took three primary actions to correct the prior audit findings. First, changes were made to the procedures for processing returns that claimed fuel tax credits. Second, instructions were issued requiring the Examination function to check the prior year return when a fuel tax credit claimed on the current year return was disallowed. Finally, revisions to the tax form and tax publication were made to better inform taxpayers that credits for undyed diesel fuel used for farming purposes are not allowed.

This follow-up audit showed that the changes to the processing instructions have been generally effective. For example, 98 percent of the sampled returns claiming fuel tax credits above the mandatory review criteria had been computer identified during processing for manual screening by the Examination function.

*The corrective actions taken by the IRS in response to the prior audit have not been completely effective.*

However, the instructions to Examination function personnel have been generally ineffective for ensuring that the prior year returns were checked. In addition, the revisions to the tax form and publication were only partially effective for reducing the number of erroneous claims for tax credits for undyed diesel fuel.

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This follow-up audit identified two areas where the IRS could take additional actions to improve the detection and/or prevention of erroneous fuel tax credits.

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### **The Examination Function Did Not Check 79 Percent of the Prior Year Returns for the Same Issue When Adjusting Unallowable Fuel Tax Credits Claimed on the Current Year Returns**

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Examination function personnel manually screen individual income tax returns claiming all types of fuel tax credits that exceed, in total, a specified dollar amount. They assign a code to those returns containing fuel tax credits that are determined to be potentially unallowable or questionable. The code causes a proposed notice of adjustment to be sent to the taxpayer. The taxpayer either agrees to the proposed adjustment or explains why the fuel tax credit should be allowed. The end result of this process is an allowance, a partial disallowance, or a full disallowance of the fuel tax credit.

*The IRS adjusted nearly  
\$6.6 million in unallowable  
fuel tax credits in FY 1998.*

During FY 1998, the Examination function closed 5,585 fuel tax credit cases. Of these, 4,245 (76 percent) resulted in an adjustment to the credit amount claimed. The adjustments totaled nearly \$6.6 million, or an average of \$1,550 per changed return. The Examination function's return on investment was \$1,071 per hour.

### **The prior audit found that the Examination function was not always checking the prior year return for the same issue when they adjusted fuel tax credits claimed on the current year return**

The prior audit analyzed a sample of 60 Tax Year (TY) 1995 returns for which the Examination function had adjusted the amount of fuel tax credits claimed. Of the 60 taxpayers, 41 (68 percent) had also claimed fuel tax credits on their TY 1994 return which met the Examination

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function's screening criteria. However, 30 (73 percent) of these 41 returns had not been reviewed by the Examination function.

*The Examination function had instructions to check the prior year returns when closing current year fuel tax cases with an adjustment.*

In response to this finding, the IRS was to issue instructions requiring the Examination function to check the prior year return if an adjustment was made to the current year return. Headquarters staff field visitations and Revenue Protection Teleconferences would be used to verify that these instructions were followed.

### **The follow-up audit found that the Examination function is still not considering the prior year return when making fuel tax credit adjustments on the current year return**

Nationwide, we identified 1,499 taxpayers who had:

1. Claimed fuel tax credits on both their 1996 and 1997 returns.
2. The fuel tax credit claimed on their 1997 return partially or fully disallowed by the Examination function.
3. No adjustments to the fuel tax credits claimed on their 1996 return.

*In 79 percent of the applicable cases, the Examination function did not check the prior year return when adjusting fuel tax credits claimed on the current year return.*

We found that 1,079 (72 percent) of the 1,499 taxpayers claimed one or more of the same type(s) of fuel tax credits on their 1996 returns that were adjusted on their 1997 returns. However, there was no evidence that the Examination function had checked 851 (79 percent) of these 1,079 returns to determine whether fuel tax credits claimed on these prior year returns should also be disallowed. The potentially unallowable fuel tax credits claimed on these 851 returns totaled nearly \$794,000.

Instructions for screening TY 1997 returns required the Examination function to check the prior year returns and examine the returns if the amounts were significant. However, we were advised that there were no follow-up

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actions taken to ensure these instructions were being followed.

### Recommendation

*Requirements to check prior year returns need additional emphasis.*

1. The Assistant Commissioner (Customer Service) needs to emphasize the importance of checking prior year returns for fuel tax credits when closing current year fuel tax cases with an adjustment, and to establish management controls to ensure that the requirement is followed.

Management's Response: An Internal Revenue Manual (IRM) update was issued on February 14, 2000. It provides guidance to employees who screen original and amended returns with fuel tax credits to check prior years and, when warranted, to select the prior year returns for examination. This update will be incorporated into the May 8, 2000, revision of IRM 21.8.1, Service Center Examination Operations.

During regularly scheduled site visitations, Customer Service management will verify that these IRM procedures are followed. Updating the IRM will require the Service Center Examination Branch (SCEB) to review cases completed under these procedures to ensure that quality standards are maintained.

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### More than 15,000 Taxpayers May Have Improperly Received Tax Credits for Undyed Diesel Fuel Used on Farms

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*Internal Revenue Code section 6427(l)(5)(A)(i) prohibits the user from claiming tax credits for undyed diesel fuel used in farming.*

Taxpayers may be able to claim a credit for the excise taxes included in the price of gasoline used on a farm for farming purposes. However, only the “registered ultimate vendor” (i.e., the person who sells the fuel to the person who actually uses it) can claim a credit for undyed diesel fuel used on a farm for farming purposes.

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### **The prior audit reported that 19,000 farmers had improperly received tax credits for undyed diesel fuel totaling more than \$2 million**

The prior audit identified more than 23,000 taxpayers who had incorrectly claimed tax credits totaling more than \$4.5 million on their 1995 individual income tax returns for undyed diesel fuel used on farms. Tax credits totaling \$2.5 million that were claimed by approximately 4,000 of these taxpayers were subject to manual screening by the Examination function. However, the remaining 19,000 taxpayers had received tax credits totaling over \$2.0 million because the amounts claimed were less than the dollar amount that was subject to manual screening by Examination. Paid return preparers had prepared 83 percent of the returns that incorrectly claimed credits for undyed diesel fuel.

*The IRS changed the tax form and publication in response to the prior audit findings.*

The prior audit report recommended that the IRS take steps to educate taxpayers and return preparers that farmers may not take tax credits for undyed diesel fuel purchased. Beginning with the TY 1996 returns, the IRS changed Form 4136 and its accompanying instructions to include direct statements that tax credits are not allowed for undyed diesel fuel used on a farm for farming purposes. In addition, Fuel Tax Credits and Refunds (Publication 378) was revised to include more explicit instructions regarding farmers claiming credits for undyed diesel fuel.

### **The follow-up audit found that over 15,000 farmers may have improperly received \$1.8 million in tax credits for undyed diesel fuel in Tax Year 1997**

The changes to the tax form and publication have reduced the number and amount of erroneous claims for tax credits for undyed diesel fuel used in farming. The following table, which compares the findings of the prior audit and the follow-up audit, shows that the number of returns that improperly claimed tax credits for undyed diesel fuel used in

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farming declined by more than 7,000 (30 percent), after the IRS added new language to the Form 4136 and related taxpayer instructions. Similarly, the total amount of improperly claimed credits for undyed diesel fuel declined by over \$2 million (45 percent).

### ***Tax Credits Claimed for Undyed Diesel Fuel Used in Farming***

*Changes to the tax form and publication have resulted in improved taxpayer compliance.*

	<b>Tax Year 1995</b>	<b>Tax Year 1997</b>
Number of taxpayers claiming credits for undyed diesel fuel used in farming	23,000	15,926
Total amount of credits claimed for undyed diesel fuel used in farming	\$4.5 million	\$2.45 million

Although taxpayer compliance has improved, 15,926 taxpayers still improperly claimed tax credits for undyed diesel fuel totaling \$2.45 million on their 1997 returns. Almost 80 percent (12,726 of 15,926) of these taxpayers had used paid preparers to prepare their returns.

The IRS identified and questioned the tax credits claimed on only 921 of these 15,926 returns. The remaining 15,005 taxpayers received tax credits for undyed diesel fuel totaling nearly \$1.78 million to which they were likely not entitled.

Specifically, the follow-up audit showed that:

- Nearly 12 percent (1,887 of 15,926) of the taxpayers claimed tax credits for undyed diesel fuel that exceeded the dollar criteria for manual screening by the Examination function. The credits claimed on these returns totaled \$1.05 million.



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*Most erroneous claims for undyed diesel fuel credits avoid detection because they are below the dollar threshold for screening by the Examination function.*

- More than 88 percent (14,039 of 15,926) of the taxpayers claimed tax credits for undyed diesel fuel that were less than the minimum dollar amount subject to manual screening by Examination. Thus, these taxpayers received credits totaling \$1.4 million for which they were likely not entitled.

The Examination function's procedures for screening returns claiming fuel tax credits contain explicit instructions to disallow credits for undyed diesel fuel used in farming. However, analysis of the 1,887 returns which met the criteria for this screening showed that:

*The Examination function questioned only about one half of the returns that had claimed tax credits for undyed diesel fuel used in farming and were identified for screening.*

- Less than 49 percent (921 of 1,887) of the returns were computer-identified for further taxpayer contact. The IRS subsequently made adjustments to the fuel tax credits claimed on 771 (84 percent) of the 921 returns.
- The IRS' screeners accepted the tax credits for undyed diesel fuel that were claimed on the remaining 51 percent (966 of 1,887) of the returns without questioning the taxpayers. As a result, the IRS missed the opportunity to prevent the allowance of \$379,388 in potentially unallowable credits for undyed diesel fuel that were claimed on these 966 returns.

### Recommendations

*Opportunities exist for the IRS to take additional actions to further reduce erroneous claims for tax credits for undyed diesel fuel.*

2. The Assistant Commissioner (Customer Service) needs to provide professional preparer organizations with appropriate educational materials on the tax regulations relating to tax credits for undyed diesel fuel used by farmers.
3. The Assistant Commissioner (Customer Service) should send information (i.e., educational) notices to taxpayers who file returns claiming tax credits for undyed diesel fuel that are under the minimum dollar amount for manual

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screening by the Examination function. The notices should explain that the tax regulations specifically prohibit fuel tax credits for undyed diesel fuel used on a farm for farming purposes.

4. The Assistant Commissioner (Customer Service) needs to issue instructions to its technical Examination function personnel who are responsible for screening returns claiming fuel tax credits re-emphasizing that no credit is allowable for undyed diesel fuel used on farms for farming purposes.

*The IRS is planning a number of actions to address the problem with farmers claiming tax credits for undyed diesel fuel.*

Management's Response: The IRS revised the 1998 and 1999 versions of Form 4136 to provide an explicit caution to preparers on the face of the form not to claim the credit for diesel fuel used on a farm for farming purposes. This caution is a significant improvement over prior year versions because of the prominence of the caution where preparer input is required. Taxpayer Education will pursue developing targeted communications to those taxpayers located in large farming areas. Customer Service will provide information about the fuel tax credit in the Digital Daily, which can be accessed by taxpayers and farming organizations. Customer Service will analyze Masterfile extracts to determine if compliance trends in subsequent years are improved by the targeted educational outreach.

In lieu of sending educational notices to taxpayers, the IRS will change its criteria for manually screening returns to capture the majority of the fuel tax credits that are inappropriately claimed. Customer Service management believes this alternative corrective action will provide a direct and immediate benefit.

An IRM update was issued on February 14, 2000, to provide technical guidance to SCEB personnel, emphasizing current tax law and procedures. This update will be incorporated into the May 8, 2000, revision of IRM 21.8.1, Service Center Examination Operations.

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Office of Audit Comment: We concur with management's alternative corrective action to change the criteria for screening returns claiming fuel tax credits.

### Conclusion

The IRS took timely corrective actions for each of the previous audit findings. These actions have reduced the number of returns that inadvertently bypass manual screening. However, the actions were not effective for ensuring that the taxpayer's prior year return is checked for the same issue when potentially unallowable tax credits are identified on the current year return. In addition, the actions taken to reduce the number of erroneous tax credits for undyed diesel fuel have been only partially effective.

Opportunities exist for the IRS to protect revenue by further reducing erroneous claims for tax credits for undyed diesel fuel. These include educating taxpayers and professional preparers and re-emphasizing certain procedures for screening and examining returns.

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### Appendix I

#### Detailed Objective, Scope, and Methodology

The overall objective of this audit was to follow up on the prior audit report<sup>1</sup> to determine whether corrective actions have been taken and are functioning effectively to correct the previously reported conditions. To accomplish this objective, we:

- I. Determined whether individual income tax returns claiming fuel tax credits above a certain dollar threshold were identified for manual screening by the Examination function.
  - A. Researched the Internal Revenue Manual and the Law Enforcement Manual to determine the current criteria for assigning an Action Code 300 (a computer generated code assigned during the processing of individual income tax returns whenever the total fuel tax credits claimed by a taxpayer are equal to or greater than the established dollar threshold for manual screening by the Examination function).
  - B. Determined whether processing instructions in the Error Resolution Manual have been revised to require tax examiners to, when applicable, manually input an Action Code 300 on returns claiming a fuel tax credit that is above the dollar threshold for the Examination function's screening.
  - C. Obtained Tape Edit Processor data from the Austin, Cincinnati, and Fresno Service Centers on a daily basis for the weeks ending November 13 through December 31, 1998. Performed computer analyses of this data and identified 400 returns claiming fuel tax credits that were equal to, or greater than, the established dollar threshold.
  - D. Obtained Electronic Online Network System (EONS) report Error Resolution System (ERS)-17-40 data from the Austin, Cincinnati, and Fresno Service Centers on a daily basis for the weeks ending November 13 through December 31, 1998. Performed computer analyses of this data and identified 382 returns that had received an Action Code 300.
  - E. Compared the returns identified in Step I.C with the returns identified in Step I.D to determine how many of the returns that met the dollar criteria for the

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<sup>1</sup> *Review of Processing Fuel Tax Claims* (Report Number 070804, dated December 30, 1996)

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Examination function's screening had received an Action Code 300.

- F. Analyzed the non-matched records from Step I.E to determine why the returns did not get an Action Code 300.
- II. Determined whether service center Examination function personnel had checked the taxpayers' prior year returns for fuel tax credits when they made adjustments to the fuel tax credits claimed on the taxpayers' current year returns.
- A. Performed a computer analysis of the Return Transaction File for 1998. This file contained all individual income tax returns, regardless of the tax year, that were processed during calendar year 1998. Identified 5,602 returns which had been assigned an Unallowable Code 85. (Examination function personnel manually screen individual income tax returns claiming fuel tax credits and assign an Unallowable Code 85 to those returns claiming credits that are determined to be unallowable or questionable.)
  - B. Obtained transcripts of the taxpayer's account for each of the 5,602 returns identified in Step II.A. Determined that 3,365 of the 5,602 returns had fuel tax credit adjustments made by the Examination function. Determined further that the fuel tax credit adjustments for 2,152 of the 3,365 returns involved Tax Year (TY) 1997. (Adjustments to fuel tax credits were identified by the presence of a Transaction Code 767 posted to the taxpayer's account.)
  - C. Researched all 2,152 accounts identified in Step II.B and identified 1,499 taxpayers who had claimed a fuel tax credit on their 1996 return that was not adjusted by the Examination function (i.e., no Transaction Code 767).
  - D. Researched the Integrated Data Retrieval System (IDRS) for each of the 1,499 taxpayers identified in Step II.C and determined that 1,079 taxpayers had claimed the same types of fuel tax credits on both the 1996 and 1997 returns.
  - E. Obtained an IDRS audit trail and analyzed the historical activity on each of the 1,079 taxpayer accounts identified in Step II.D to determine whether there was any evidence that the Examination function had researched or requested the 1996 returns.
  - F. Reviewed the service center Examination function's operating procedures to determine if instructions were received requiring that prior year returns be checked

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for fuel tax credits when closing current year fuel tax cases with an adjustment. Also determined if follow-ups to ensure these instructions are followed had been accomplished through field visitations by the National Office staff and Revenue Protection Teleconferences.

- III. Determined whether taxpayers are claiming fuel tax credits for undyed diesel used for farming purposes.
  - A. Reviewed Credit for Federal Tax Paid on Fuels (Form 4136) and its accompanying taxpayer instructions to determine if they had been revised to include additional direct statements that farmers are not allowed to claim tax credits for undyed diesel fuel used on a farm for farming purposes.
  - B. Reviewed Fuel Tax Credits and Refunds (Publication 378) to determine if it had been revised to include additional explicit instructions regarding farmers claiming tax credits for undyed diesel fuel.
  - C. Obtained and analyzed a Masterfile extract to identify those taxpayers who filed TY 1997 individual income tax returns which included a Profit or Loss from Farming (Schedule F) and claimed a tax credit for undyed diesel fuel.
  - D. Selected a random sample of 50 of the 24,181 accounts identified in Step III.C and researched the applicable tax returns to determine whether the Masterfile extract criteria was successful.
  - E. Excluded 8,255 of the 24,181 taxpayers who met the criteria in Step III. C but also filed a Profit or Loss from Business (Schedule C) and/or filed a Supplemental Income and Loss (Schedule E) reporting partnership or S-Corporation income. We assumed that the remaining 15,926 taxpayers had used the undyed diesel fuel exclusively for farming purposes.
  - F. Analyzed the 15,926 taxpayer accounts identified in Step III.E to determine the:
    - 1. Amount of tax credits claimed in TY 1997 for undyed diesel fuel used on farms.
    - 2. Number and amount of the tax credits for undyed diesel fuel that were above/below the dollar threshold requiring screening by the Examination function.

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3. Number and amount of the tax credits for undyed diesel fuel that were disallowed by the Examination function.
  
4. Number of returns that were professionally prepared.

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**Appendix II**

**Major Contributors to This Report**

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**Opportunities Exist for Further Reducing  
Erroneous Fuel Tax Credits**

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**Appendix III**

**Report Distribution List**

Deputy Commissioner Operations C:DO

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National Director for Legislative Affairs CL:LA

Office of the Chief Counsel CC

Office of Management Controls M:CFO:A:M

Audit Liaisons:

Office of the Assistant Commissioner (Customer Service) OP:C

## Opportunities Exist for Further Reducing Erroneous Fuel Tax Credits

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### Appendix IV

#### Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

##### Finding and recommendation:

The Examination function is not usually checking the prior year return for the same issue when making adjustments to the fuel tax credit claimed on the current year return. Nationwide, we identified 1,079 taxpayers who claimed the same type(s) of fuel tax credits on their 1997 and 1996 returns, had the fuel tax credits claimed on the 1997 return either partially or fully disallowed by the Examination function, and had no adjustments made to the fuel tax credits claimed on the 1996 returns. For 851 (79 percent) of the 1,079 cases, we found no evidence that the Examination function had checked the taxpayers' 1996 returns to determine whether the fuel tax credits claimed on these returns should also be disallowed. The potentially unallowable fuel tax credits claimed on these 851 returns totaled nearly \$794,000 (see pages 5 and 6).

This report recommends that the IRS issue instructions to Examination function personnel responsible for screening fuel tax credits re-emphasizing the importance of checking the prior year returns when closing current year fuel tax cases with an adjustment (see page 7).

##### Type of Outcome Measure:

Increased Revenue: \$794,000 - Potential

##### Value of the Benefit:

If this recommendation had been implemented in 1998, the Examination function potentially would have checked the 1996 returns filed by 851 taxpayers whose fuel tax credits claimed on their 1997 tax returns were partially or fully disallowed. These 851 taxpayers had claimed the same types of fuel tax credits, totaling \$794,000, on their Tax Year (TY) 1996 returns. The fuel tax credits claimed on the 1996 returns would have had a high probability for adjustments because they involved one or more of the same types of fuel tax credits that were adjusted on the TY 1997 returns.

##### Methodology Used to Measure the Reported Benefit:

## **Opportunities Exist for Further Reducing Erroneous Fuel Tax Credits**

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We analyzed the Return Transaction File to identify 1,499 taxpayers who claimed fuel tax credits on both their 1997 and 1996 returns, had the fuel tax credits claimed on the 1997 return adjusted by the Examination function, and had no adjustments made to the fuel tax credits claimed on the 1996 return. For each of these taxpayers, we researched the Integrated Data Retrieval System (IDRS) to identify the specific types of fuel tax credits claimed on the 1997 and 1996 returns. We identified 1,079 taxpayers who had claimed the same types of fuel tax credits on their 1996 returns that the Examination function had adjusted on their 1997 returns.

We obtained an IDRS audit trail and analyzed the historical activity on each of these 1,079 taxpayer accounts. For 851 of the 1,079 taxpayers, there was no evidence that the Examination function had researched or requested the 1996 returns.

### Finding and Recommendation:

Internal Revenue Code section 6427(l)(5)(A)(i) prohibits the user from claiming tax credits for undyed diesel fuel used in farming. Taxpayers are still improperly claiming tax credits for undyed diesel fuel used on farms. For TY 1997, 15,926 taxpayers improperly claimed credits for undyed diesel fuel totaling \$2.45 million. Nearly 80 percent of their returns were professionally prepared. The IRS questioned the credits claimed on only 921 of the 15,926 returns. Thus, the remaining 15,505 taxpayers received tax credits for undyed diesel fuel totaling \$1.78 million to which they were likely not entitled. These included 14,039 taxpayers who claimed credits for undyed diesel fuel that were below the dollar threshold for the Examination function's screening and 966 taxpayers who claimed credits for undyed diesel fuel that were allowed even though they had met the Examination function screening criteria (see pages 7-10).

The report recommended that the IRS alert professional preparer organizations to the specific tax regulations which prohibit claims for tax credits for undyed diesel fuel used in farming. The report also recommended that the IRS send information (i.e., educational) notices to those taxpayers who file returns claiming tax credits for undyed diesel fuel that are under the minimum dollar amount that requires the Examination function's screening. In addition, the report recommended that the IRS issue instructions to Examination function personnel responsible for screening returns claiming fuel tax credits re-emphasizing that no credit is allowable for undyed diesel fuel used on farms for farming purposes (see pages 10 and 11).

## **Opportunities Exist for Further Reducing Erroneous Fuel Tax Credits**

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### Type of Outcome Measure:

Increased Revenue: \$600,000 - Actual

Increased Revenue: \$1,780,000 - Potential

### Value of the Benefit:

From TY 1995 to TY 1997, the total amount of erroneous tax credits for undyed fuel used on farms that avoided detection and correction by the IRS because they were below the dollar criteria for screening by the Examination function declined by \$600,000. This improvement is attributable to the actions taken by the IRS in response to the prior audit report.

The implementation of the recommendations contained in the current audit report could prevent the IRS from allowing \$1.78 million in erroneous tax credits for undyed diesel fuel used on farms.

### Methodology Used to Measure the Reported Benefit:

We calculated the actual increased revenue/revenue protection measure of \$600,000 by comparing the prior audit results with the current audit results and quantifying the reduction in the amount of erroneous credits that avoided IRS detection. The prior audit reported that, in TY 1995, 19,000 taxpayers had claimed credits totaling \$2 million that were below the dollar threshold for screening by the Examination function. The follow-up audit showed that, in TY 1997, approximately 14,000 taxpayers claimed tax credits totaling \$1.4 million that were below the dollar threshold for screening by the Examination function. In our judgment, this decrease of \$600,000 in fuel tax credits is attributable to the corrective actions taken as a result of the prior report. In response to the audit recommendations in that report, the IRS, beginning with TY 1996, changed the tax form and its accompanying instructions to include direct statements that tax credits are not allowed for undyed diesel fuel used on a farm for farming purposes. In addition, the applicable tax publication was also revised to include more explicit instructions regarding the prohibition on farmers claiming credits for undyed diesel fuel.

We based the potential increased revenue/revenue protection measure of \$1.78 million on the current audit results which showed, for TY 1997, the amount of tax credits for diesel fuel used on farms that avoided detection and correction by the IRS. This amount included \$1.4 million in credits that were less than the minimum dollar amount that is subject to the Examination function's screening and \$379,000 in credits that were allowed even though they met Examination function screening criteria.

## **Opportunities Exist for Further Reducing Erroneous Fuel Tax Credits**

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The current audit results were based on an analysis of a Masterfile extract that identified 24,181 taxpayers that filed a 1997 individual income tax return which claimed a tax credit for undyed diesel fuel and included a Profit or Loss from Farming (Schedule F). From this population, we identified, and excluded, 8,255 taxpayers whose 1997 return also included a Profit or Loss from Business (Schedule C) and/or reported partnership or S Corporation income or loss on Supplemental Income and Loss (Schedule E). The remaining 15,926 taxpayers were assumed to have used undyed diesel fuel exclusively for farming purposes.

**Opportunities Exist for Further Reducing  
Erroneous Fuel Tax Credits**

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**Appendix V**

**Management's Response to the Draft Report**

## Opportunities Exist for Further Reducing Erroneous Fuel Tax Credits

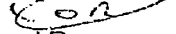


COMMISSIONER

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

March 29, 2000

### MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Charles O. Rossotti   
Commissioner of Internal Revenue

SUBJECT: Draft Audit Report – Opportunities Exist for Further Reducing  
Erroneous Fuel Tax Credits

Thank you for the opportunity to respond to your draft report entitled "Opportunities Exist for Further Reducing Erroneous Fuel Tax Credits." Your audit found that the actions taken by the Internal Revenue Service (IRS) in response to the prior Internal Audit report have reduced the number of returns claiming erroneous fuel tax credits that avoid detection. We agree that opportunities still exist for the IRS to apply the tax law with integrity and fairness to all by further reducing erroneous fuel tax credits claimed by taxpayers.

To this end, we are incorporating procedures in our Internal Revenue Manual (IRM) to provide both technical and procedural guidance for employees who work these cases. Educational efforts will be directed to both taxpayers and their preparers who continue to claim unallowable fuel tax credits despite changes made in both forms and publications designed to improve taxpayer compliance. To ensure that management controls are maintained, the Assistant Commissioner (Customer Service), along with Customer Service Field Operations, will communicate with the service centers to ensure that IRM procedures are followed and that quality standards are maintained.

We do not agree that sending educational notices to taxpayers who file returns claiming diesel fuel tax credits under the minimum dollar amount for Examination screening will deter noncompliant behavior by taxpayers or their preparers. Instead, we are changing screening criteria to identify a greater number of returns claiming unallowable diesel fuel tax credits and thus further enhance compliance.

A separate attachment discusses our specific changes to Examination screening criteria. We request that the attachment be protected from public disclosure because of its law enforcement classification.

## Opportunities Exist for Further Reducing Erroneous Fuel Tax Credits

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### IDENTITY OF RECOMMENDATION/FINDING

The Assistant Commissioner (Customer Service) needs to emphasize the importance of checking prior year returns for fuel tax credits when closing current year fuel tax credits with an adjustment and to establish management controls to ensure that the requirement is followed.

### ASSESSMENT OF CAUSE(S)

While instructions were made available to employees to check prior year returns, they were never formalized into the IRM.

### CORRECTIVE ACTIONS

We agree with your assessment that the potential exists to enhance compliance if we implement this recommendation. Therefore, we are taking the following corrective actions:

IRM/Procedural Update #00055 was issued on February 14, 2000. It provides guidance to employees who screen original and amended returns with fuel tax credits to check prior years and, when warranted, to select the prior year returns for examination. We will incorporate this update into the May 8, 2000, revision of IRM 21.8.1, Service Center Examination Operations.

To ensure that management controls are in place, during regularly scheduled site visitations, we will verify that these IRM procedures are followed and that quality standards are maintained.

### IMPLEMENTATION DATE:

PROPOSED: May 8, 2000

### RESPONSIBLE OFFICIAL

National Director, Compliance and Accounts Division

### CORRECTIVE ACTION(S) MONITORING PLAN

The Service Center Examination Branch (SCEB) will ensure that IRM/Procedural Update # 00055 is incorporated into the May 8, 2000, revision of IRM 21.8.1.

Updating the IRM will require the Quality Review functions in the SCEB to review completed cases under these procedures, and to ensure that quality standards are maintained.



## Opportunities Exist for Further Reducing Erroneous Fuel Tax Credits

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### IDENTITY OF RECOMMENDATION/FINDING

The Assistant Commissioner (Customer Service) needs to provide professional preparer organizations with appropriate educational materials on the tax regulations relating to tax credits for undyed diesel fuel used by farmers.

### ASSESSMENT OF CAUSE(S)

It is difficult to gauge the reasons for noncompliance, especially by professional preparers, despite changes to forms and publications explaining the tax law. It may be because prior tax laws permitted farmers to claim credits for diesel fuels.

### CORRECTIVE ACTIONS

The IRS revised the 1998 and 1999 versions of Form 4136, Credit for Federal Tax Paid on Fuels, to provide an explicit caution to preparers on the face of the form not to claim the credit for diesel fuel used on a farm for farming purposes. This caution is a significant improvement over prior year versions because of the prominence of the caution where preparer input is required.

Taxpayer Education will pursue developing targeted communications to those taxpayers located in large farming areas. We will provide information about the fuel tax credit in the Digital Daily, which can be accessed by taxpayers and farming organizations.

### IMPLEMENTATION DATE:

PROPOSED: June 1, 2000

### RESPONSIBLE OFFICIAL

National Director, Compliance and Accounts Division

### CORRECTIVE ACTION(S) MONITORING PLAN

Customer Service will analyze Masterfile extracts to determine if compliance trends in subsequent years are improved by the targeted educational outreach.

### IDENTITY OF RECOMMENDATION/FINDING

The Assistant Commissioner (Customer Service) should send information (i.e., educational) notices to taxpayers who file returns claiming tax credits for undyed diesel fuel that are under the minimum dollar amount for manual screening by the Examination function. The notices should explain that the tax regulations specifically prohibit fuel tax credits for undyed diesel fuel used on a farm for farming purposes.

### ASSESSMENT OF CAUSE(S)

As stated in an earlier assessment, it is difficult to gauge the reasons for noncompliance, especially by professional preparers despite changes to forms and publications explaining the new tax laws. It may be because prior tax laws allowed

## Opportunities Exist for Further Reducing Erroneous Fuel Tax Credits

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farmers to claim credits for diesel fuels. In addition, preparers may be aware of the IRS' screening criteria and make claims to avoid detection.

### **CORRECTIVE ACTIONS**

We feel that sending educational notices does not always deter taxpayers from subsequently claiming the credits. Instead, we will continue to treat farmers claiming the fuel tax credit as an unallowable item but will change the screening criteria. This will capture the majority of those who are inappropriately claiming the fuel tax credit, and provide a direct and immediate benefit.

### **IMPLEMENTATION DATE:**

**PROPOSED:** January 1, 2001

### **RESPONSIBLE OFFICIAL(S)**

National Director, Compliance and Accounts Division

### **CORRECTIVE ACTION(S) MONITORING PLAN**

The SCEB will monitor the implementation of the Request for Information Services (RIS) submitted on February 28, 2000, to Information Systems that will provide for a systemic change during the processing of individual income tax returns to change the screening criteria for farmers that claim diesel fuel tax credits. The proposed implementation date of this RIS is January 1, 2001.

### **IDENTITY OF RECOMMENDATION/FINDING**

The Assistant Commissioner (Customer Service) needs to issue instructions to its technical Examination function personnel who are responsible for screening returns claiming fuel tax credits reemphasizing that no credit is allowable for undyed diesel fuel used on farms for farming purposes.

### **ASSESSMENT OF CAUSE(S)**

While instructions were made available to SCEB personnel who work fuel tax credits, they were never formalized into an IRM.

### **CORRECTIVE ACTIONS**

IRM/Procedural Update #00055 dated February 14, 2000, was issued to provide technical guidance to SCEB personnel, emphasizing current tax law and procedures. We will incorporate this update in the May 8, 2000, revision of IRM 21.8.1, Service Center Examination Operations.

## Opportunities Exist for Further Reducing Erroneous Fuel Tax Credits

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IMPLEMENTATION DATE:  
PROPOSED: May 8, 2000

RESPONSIBLE OFFICIAL  
National Director, Compliance and Accounts Division

CORRECTIVE ACTION(S) MONITORING PLAN  
The SCEB will ensure that Customer Service IRM/Procedural Update #00055 is incorporated into the May 8, 2000, revision of IRM 21.8.1.

If you have any questions, please call Rob Wilkerson, Assistant Commissioner (Customer Service), at (202) 622-5044.

Attachment