



*The Fuel Excise Tax Compliance Program
Has Made Significant Progress, but Program
Improvements Are Needed to Increase
Highway Trust Fund Revenue*

March 30, 2009

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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.

Redaction Legend:

1 = Tax Return/Return Information

3(d) = Identifying Information - Other Identifying Information of an Individual or Individuals



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 30, 2009

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips

Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – The Fuel Excise Tax Compliance Program Has Made Significant Progress, but Program Improvements Are Needed to Increase Highway Trust Fund Revenue (Audit # 200820006)

This report presents the results of our review to determine whether the Excise Files Information Retrieval System (ExFIRS) has been effectively implemented to enhance tax enforcement activities and increase Highway Trust Fund revenue. This review was part of our Fiscal Year 2008 audit plan coverage under the major management challenge of Modernization of the Internal Revenue Service (IRS).

Impact on the Taxpayer

The IRS established the Excise Compliance Operations organization in November 2005 and has made significant progress in improving motor fuel excise tax compliance. The IRS has implemented electronic filing requirements for excise tax reporting documents, and through its examination process, assessed almost \$135 million in additional taxes through April 2008. However, improvements are needed in the areas of compliance and penalty program effectiveness, properly transferring payments to the Highway Trust Fund, measuring program results, and submitting required reports. Improvements in these areas will improve the effectiveness of the ExFIRS Compliance Program and reduce motor fuel excise tax evasion.

Synopsis

The Highway Trust Fund was established as a mechanism to provide dependable financing for Federal Government highway construction and is a critical source of funding for Department of Transportation (DOT) programs. Motor fuel excise tax receipts total \$30 billion to \$40 billion



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annually and account for more than 90 percent of Highway Trust Fund receipts. Motor fuel excise tax evasion is estimated to be from \$1 billion annually to as much as 25 percent of total revenues.¹ Since Fiscal Year 1999, Congress has appropriated almost \$160 million to the IRS from the Highway Trust Fund for ExFIRS development and compliance efforts.

The IRS has taken actions to improve the ExFIRS Compliance Program and address concerns identified in our prior audit report.² These actions include holding ongoing meetings with the Federal Highway Administration (FHWA) to identify and resolve ongoing issues or concerns, implementing an outreach and education initiative to ensure awareness of the new electronic filing requirements, and issuing annual status reports to the DOT describing the project and enforcement activities and results. The IRS established two new organizations and identified seven motor fuel strategies to better understand areas of fuel tax compliance and noncompliance, and the ExFIRS Compliance Team began performing penalty reviews, educating taxpayers regarding filing requirements, identifying non-filers, and assessing penalties for noncompliance.

While significant actions have been taken, additional improvements are needed to ensure a more effective ExFIRS Compliance Program. Foremost, the IRS needs to work with the FHWA to develop a more accurate and current estimate of the potential motor fuel excise tax compliance gap. The IRS has questioned the reliability of existing estimates, but has not yet established a reliable excise tax evasion estimate or the current compliance rate. A current and reliable estimate of the size and makeup of the potential motor fuel excise tax gap will provide the IRS and the FHWA with information needed to ensure program resources are effectively focused on identified tax gap areas. Focusing program resources on identified tax gap areas will also allow the IRS to measure the effectiveness of the ExFIRS Compliance Program in reducing the tax gap.

In addition, information reporting gaps in the movement of motor fuel continue because the IRS currently does not receive product receipt and disbursement information from refineries similar to information received from fuel terminals. Since Fiscal Year 2006, the IRS identified more than 12,000 tax periods for review that are associated with potentially noncompliant terminals. The IRS can assess penalties of \$10,000 for each tax period that terminal operators fail to file in a timely manner and/or furnish accurate information and do not present reasonable cause for such failures.³ The IRS uses the penalty primarily as a tool to compel noncompliant taxpayers into compliance rather than as remedial consequences or monetary sanctions against taxpayers

¹ The estimate was obtained from the FHWA Office of Transportation Policy Studies web site, which qualifies the estimate by citing, "Numerous research projects have tried to determine losses resulting from motor fuel tax evasion. Estimates have been made by non-FHWA sources during Congressional testimony, through econometric and statistical analyses, as well as through revenue modeling, with results varying from about \$1 billion annually to as much as 25 percent of total revenues. Reliable estimates of evasion are not available."

² *The Excise Files Information Retrieval System Has Not Been Effectively Implemented* (Reference Number 2006-20-001, dated October 2005).

³ 26 U.S.C. Sec. 6725.



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for their noncompliance. Still, a significant portion of the \$120 million in potential penalties could be assessed.

The program to review the potential penalty assessments continues to mature, and the number of terminals in compliance with electronic filing has increased. Initially, the IRS was not consistently assessing the penalty, and we identified a significant number of cases identified for potential assessment of a penalty that were worked to closure with no penalty being assessed. As the program matures, the IRS has become more consistent in applying penalties when appropriate and working the cases. However, we found that the penalties that have been collected were not properly handled. The IRS collected approximately \$1.7 million in penalty assessments as of September 10, 2008, but the funds were deposited in the general fund and not transferred to the Highway Trust Fund as required.

Improvements to the program measures used to evaluate the ExFIRS Compliance Program are also needed. The IRS captures and reports information such as the status, age, and results of compliance cases. However, these measures do not provide information regarding program effectiveness in addressing areas with the highest risk for noncompliance. Once a valid estimate of the motor fuel excise tax compliance gap is developed, measures and outcomes such as return on investment, change in excise tax gap, and change in compliance rate would provide better program effectiveness information.

We also found that reported ExFIRS compliance-related information is not fully representative of program results or submitted to the DOT in a timely manner. The IRS issued annual status reports to the DOT and included the information agreed to in the Memorandum of Understanding⁴ between the IRS and the DOT. However, IRS management did not use data from the official IRS tax accounts available via the Integrated Data Retrieval System, but rather data from another system used to report enforcement revenue for the report. In addition, updated information (i.e., consideration of penalty abatements) for multiple fiscal years was not presented. As a result, as of September 10, 2008, the difference between the amount of penalty assessments reported in the Fiscal Years 2006 and 2007 annual status reports and the net assessments reported in the Integrated Data Retrieval System total \$4,965,000 and \$800,000, respectively. In addition, the status reports are due to the DOT by September 30 each year; however, the IRS did not issue the Fiscal Years 2006 and 2007 annual status reports until April 6, 2007, and March 28, 2008, respectively.

⁴ See Appendix VIII for a glossary of terms.



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Recommendations

We recommended that the Commissioner, Small Business/Self-Employed Division, ensure that 1) information reporting at the refineries is implemented; 2) the amount of the motor fuel excise tax gap and the compliance rate are validated; 3) the Examination Returns Control System tracking fuel strategy cases is updated to allow tracking of cases identifiable by multiple strategies; 4) measures for the components of the motor fuel evasion program are developed to assess the successes and identify opportunities to redirect resources, if necessary; 5) the penalty for failure to file timely and accurate information documents is applied consistently to all taxpayers; 6) funds collected from the assessment of ExFIRS compliance-related penalties are transferred to the Highway Trust Fund; 7) performance measures and outcomes are developed and used to assess program effectiveness in improving fuel tax compliance; 8) the penalty information contained in the annual status report to the DOT is based on information obtained from the Integrated Data Retrieval System; 9) the annual status reports are enhanced to show penalty assessments, abatements, funds collected, and transfers for multiple years; and 10) the annual status reports to the DOT are issued by September 30 as required by law.

Response

IRS management agreed with or agreed in principle with eight recommendations, disagreed with two recommendations, and questioned the outcome measures contained in the audit report. The corrective actions taken or planned to be taken include developing a strategy document outlining potential actions for implementing information reporting at refineries; working with the FHWA and other Federal and State partners to determine the feasibility of developing the methodologies needed to estimate the motor fuel excise tax gap; taking actions to strengthen the penalty program; coordinating with the Chief Financial Officer to ensure that collected amounts of assessed ExFIRS penalties are properly certified and transferred to the Highway Trust Fund; and developing a report format that will incorporate penalty assessments and abatements and accelerating data analysis in order to deliver future reports by November 30.

However, management disagreed with the recommendation to ensure that performance measures and outcomes such as return on investment, compliance rate, and change in excise tax gap are developed and used to assess program effectiveness in improving fuel tax compliance. Management commented that, while such measures can be used as long-term strategic goals, they should not be used as performance measures. Management also disagreed with the recommendation that penalty information contained in the annual status report to the DOT be based on information obtained from the Integrated Data Retrieval System. Management commented that the Information Data Retrieval System reports single account results, while the Enforcement Revenue Information System reports cumulative results and is, therefore, a more suitable reporting tool for complete fiscal year results. Management's complete response to the draft report is included as Appendix IX.



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Office of Audit Comment

IRS management stated that they strongly agree that a credible estimate of the motor fuel tax gap would be beneficial to tax administration and policy makers. However, the corrective actions planned result in determining only the feasibility of estimating the tax gap, rather than the identification of a valid estimate of the motor fuel tax gap and compliance rate. Until a valid estimate of the tax gap and compliance rate is identified, the IRS and the FHWA continue to risk inefficiently expending resources on initiatives that might not contribute to the reduction of the excise tax gap, not increase the compliance rate, and not significantly increase Highway Trust Fund receipts.

Because the IRS is using Highway Trust Fund monies to develop the ExFIRS and to fund related compliance efforts, we believe measures and outcomes such as return on investment, compliance rate, and change in excise tax gap are necessary to assess the IRS' effectiveness in using Highway Trust Fund money to improve motor fuel tax compliance. Also, while we did not independently validate the cumulative results reported in the Enforcement Revenue Information System, our comparison of the annual status report information and taxpayer account information obtained from the Integrated Data Retrieval System identified inconsistencies. Therefore, we believe the Integrated Data Retrieval System is a better source for reporting program results.

IRS management commented that they have reservations about the validity of the outcome measure "Increased Revenue – Actual; \$1.7 million" due to the very small case sample upon which it relies. However, the outcome we are reporting is an actual amount, not a projection based on a sample. We reviewed 16 taxpayer accounts that were assessed a penalty and determined that the IRS collected approximately \$1.7 million in penalty assessments as of September 10, 2008, but the payments were not transferred to the Highway Trust Fund as required.

IRS management also questioned the justification for the outcome measure "Reliability of Information – Actual; 5,765,000." Management stated the annual report accurately reflected fiscal year end aggregate data required by the FHWA. However, the IRS is required to establish management controls to ensure that timely, reliable, and complete information is obtained, maintained, reported, and used for decision making. By not providing the detailed information in its annual status report, the IRS did not report complete and reliable program results to the FHWA. Also, Figure 5 in the report shows that the 2007 Fiscal Year-end aggregate data are not accurate, and we stand by the amount of the outcome measures reported.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Acting Assistant Inspector General for Audit (Security and Information Technology Services), at (202) 622-8510.



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Abbreviations

DOT	Department of Transportation
ExFIRS	Excise Files Information Retrieval System
ExSTARS	Excise Summary Terminal Activity Reporting System
FHWA	Federal Highway Administration
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed



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Background

The Internal Revenue Service (IRS) administers more than 40 separate excise taxes that finance 6 separate trust funds¹ for special programs within the Federal Government. One of these trust funds is the Highway Trust Fund, which was established as a mechanism to provide dependable financing for Federal Government highway construction and is a critical source of funding for Department of Transportation (DOT) programs. The Highway Trust Fund receives its revenue from highway use taxes, including excise taxes on motor fuels and truck-related taxes on truck tires, sales of trucks and trailers, and heavy vehicle use. Motor fuel excise tax receipts total \$30 billion to \$40 billion annually and account for more than 90 percent of Highway Trust Fund receipts.

Throughout the 1980s and early 1990s, motor fuel excise tax evasion schemes were perpetrated by organized crime syndicates. To reduce the opportunities for taxpayers to evade motor fuel excise taxes, several legislative and regulatory changes have been enacted.² One of the legislative changes that was enacted moved the point of taxation for motor fuels so that gasoline, diesel fuel, and kerosene are now taxed upon removal from a terminal. A regulatory change made the position holder (i.e., the person holding the position in the fuel on the records of the terminal operator) the person liable for this tax. Position holders report their excise tax liabilities on Quarterly Federal Excise Tax Returns (Form 720).

Motor fuel excise tax receipts total \$30 billion to \$40 billion annually; however, motor fuel excise tax evasion estimates vary from \$1 billion annually to as much as 25 percent of total revenues.

Within the IRS, the Specialty Programs organization under the Small Business/Self-Employed (SB/SE) Division is charged with motor fuel excise tax compliance. Partnering with the IRS, the DOT Federal Highway Administration (FHWA) is responsible for stewardship of the Highway Trust Fund and administration of the FHWA's motor fuel tax evasion program.

Motor fuel excise tax evasion is estimated to be from \$1 billion annually to as much as 25 percent of total revenues.³ In June 1998, Congress passed the Transportation Equity Act for

¹ See Appendix VIII for a glossary of terms.

² See Appendix V for several of the major legislative changes impacting fuel tax compliance.

³ The estimate was obtained from the FHWA Office of Transportation Policy Studies web site which qualifies the estimate by citing, "Numerous research projects have tried to determine losses resulting from motor fuel tax evasion. Estimates have been made by non-FHWA sources during Congressional testimony, through econometric and statistical analyses, as well as through revenue modeling, with results varying from about \$1 billion annually to as much as 25 percent of total revenues. Reliable estimates of evasion are not available."



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the 21st Century⁴ authorizing the IRS to use Highway Trust Fund monies to expand enforcement efforts, supplement examinations and criminal investigations, and develop an excise fuel reporting system. The IRS collects the motor fuel excise taxes for the DOT and has developed the Excise Files Information Retrieval System (ExFIRS) to facilitate the reporting and payment of motor fuel excise taxes. Figure 1 provides a breakdown of the almost \$160 million appropriated from the Highway Trust Fund for ExFIRS development and compliance efforts.

**Figure 1: ExFIRS Project Office Appropriations
(Fiscal Years 1999 – 2008)**

Fiscal Year(s)	Information Technology Development	Compliance and Support Activities	Totals
1999 – 2004*	\$39,897,755	\$10,990,938	\$50,888,693
2005**	\$3,600,000	\$1,400,000	\$5,000,000
2006**	\$34,800,000	\$8,000,000	\$42,800,000
2007**	\$42,300,000	\$9,000,000	\$51,300,000
2008**	\$0	\$10,000,000	\$10,000,000
Total	\$120,597,755***	\$39,390,938	\$159,988,693

Source: Treasury Inspector General for Tax Administration report, *The Excise Files Information Retrieval System Has Not Been Effectively Implemented* (Reference Number 2006-20-001, dated October 2005), and the January 2006 Memorandum of Understanding between the DOT and the IRS.

* Actual expenditures.

** Spend plan estimates.

*** \$32,400,000 of the \$120,597,755 was allocated to the Excise Tax E-File and Compliance system development. The remainder of the information technology funds was used for ExFIRS development and operations and maintenance.

The ExFIRS is a system comprised of six subsystems that support the collection of motor fuel industry information and is used to conduct automated analysis of this information to identify areas with the highest risk for nonpayment of motor fuel excise tax liabilities. A description of the subsystems is provided in Appendix VI.

The most critical ExFIRS subsystem is the Excise Summary Terminal Activity Reporting System (ExSTARS), which was designed through a collaborative effort among the IRS, the FHWA, State governments, and fuel industry stakeholders to detect and prevent the existence of illegal tax evasion schemes by tracking the movement of motor fuel to and from approved terminals. The IRS began development of the ExSTARS in Fiscal Year 1998 and reported to Congress that

⁴ Pub. L. No. 105-178, 112 Stat. 107 (1998).



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the subsystem was implemented in April 2001. In addition, the compliance process of data matching to detect underreported tax was planned to start in the calendar quarter beginning in January 2004. However, in April 2005, the IRS reported to Congress that the use of the ExSTARS to detect underreported tax had been limited because only 70 percent of the 6 million to 9 million monthly fuel transactions were received electronically, and it would be cost prohibitive to transcribe the detailed information from the remaining 30 percent of monthly fuel transactions that are filed on paper in order to match data using the ExSTARS.

In November 2005, the IRS initiated broad-based and individual outreach and education activities to taxpayer entities that were filing paper returns to ensure that all filers understood the electronic filing requirements⁵ for excise tax reporting documents and could begin electronically filing their fuel transactions using a new electronic data transmission format. The IRS also developed a schedule for converting all filers to the new electronic data transmission format. Anticipating increased electronic filings due to its outreach and education efforts, the IRS began to use the ExFIRS to perform data matching in April 2006.

This review was performed at the SB/SE Division's Excise Tax Program offices in Washington, D.C., during the period October 2007 through November 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁵ Pub. L. No. 108-357, 118 Stat. 1418 (2004).



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Results of Review

Actions Have Been Taken to Improve the Excise Files Information Retrieval System Compliance Program

In a prior audit report,⁶ we made seven recommendations to improve the ExFIRS systems development project and compliance program. Appendix VII provides details on the recommendations related to the compliance program and the corrective actions taken by the IRS. The status of the systems development recommendations and corrective actions will be reviewed in a separate audit. Office of Management and Budget Circular A-50, *Audit Follow-Up*, emphasizes the importance of followup to monitor the implementation of resolved audit recommendations and ensure that promised corrective action is actually taken.

Generally, the IRS has taken the following significant actions to improve the compliance program and address concerns identified in our prior report:

- Holds bi-monthly conference calls and quarterly meetings with the FHWA to identify, discuss, and resolve ongoing issues, problems, and concerns. The IRS also submits annual status reports to the Secretary of the DOT describing the project and enforcement activities and results. In addition, the IRS provides information on electronic filing and the number of ExFIRS-generated field referrals.
- Established the Excise Compliance Operations organization in November 2005. In addition, the National Fuel Territory organization was established to monitor and improve compliance for the excise tax on fuels with plans to use forensic accounting techniques to ensure fuel tax compliance. The IRS also identified seven motor fuel strategies to better understand areas of fuel tax compliance and noncompliance. Using these strategies, fuel policy analysts began conducting data matching analysis and referring leads for examinations in April 2006. As of April 2008, \$134,789,712 in taxes had been assessed.
- Implemented broad-based and individual outreach and education initiatives for businesses filing paper returns that were required to file electronically (i.e., terminals with 25 or more reportable transactions per month) beginning on January 1, 2006. The initiatives were implemented to ensure awareness of the new electronic filing requirements for excise tax reporting documents and a smooth transition to the new

⁶ *The Excise Files Information Retrieval System Has Not Been Effectively Implemented* (Reference Number 2006-20-001, dated October 2005).



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electronic filing format. In addition, letters were issued to the fuel industry regarding failure to file and failure to register penalties and the schedule for conversion to the new electronic filing format. Onsite visitations were also made to software vendors and third-party transmitters regarding compliance. The ExFIRS Compliance Team also began performing penalty reviews, educating taxpayers regarding excise tax filing requirements, and using information from the ExSTARS to identify excise tax non-filers and assessing penalties for noncompliance. In addition, the IRS continued to run both electronic data transmission formats through June 30, 2008, 2½ years after the mandated electronic filing deadline to provide taxpayers with sufficient time to transition to the new electronic data transmission format.

The above actions generally address our previous recommendations and have improved the effectiveness and efficiency of the ExFIRS Compliance Program. The corrective actions also address the Office of Management and Budget Circular A-123, *Management's Responsibility for Internal Control*, which requires agencies to take timely and effective action to correct management control deficiencies and to complete implementation of agreed corrective actions within 1 year to the extent practicable.

While the IRS has taken several steps to improve the ExFIRS Compliance Program, there are several areas including the penalty program, penalty payments transferred to the Highway Trust Fund, and measuring and reporting program results that need to be improved to ensure a more effective compliance program.

Improvements Are Needed to Ensure a More Effective Compliance Program

The IRS needs to work with the FHWA to develop a more accurate and current estimate of the potential motor fuel excise tax compliance gap. The estimates of the amount of motor fuel tax evasion are varied and none appear to be statistically reliable. The estimates we identified place the range of tax evasion to be from \$1 billion annually to as much as 25 percent of total revenues. The IRS has questioned the reliability of existing estimates, but has not yet established a reliable excise tax evasion estimate or the current compliance rate. A current and reliable estimate of the size and makeup of the potential motor fuel excise tax gap will provide the IRS and the FHWA with information needed to ensure program resources are effectively focused on identified tax gap areas. Focusing program resources on identified tax gap areas will also allow the IRS to measure the effectiveness of the ExFIRS compliance program in reducing the tax gap.

In addition, the IRS currently does not receive product receipt and disbursement information from refineries similar to the information received from fuel terminals, resulting in a fuel information reporting gap. Therefore, the Excise Tax Program cannot use the ExSTARS to obtain a complete understanding of the products flowing into and out of the refineries and, as a result, the effectiveness of the compliance program is limited.



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The IRS has conducted talks with the oil industry on an initiative to institute refinery reporting similar to the current terminal reporting via the ExSTARS. Despite these discussions, refinery reporting has not been implemented. IRS management has received a limited amount of information from a refinery to test how the information might be used. The IRS also established a motor fuel tax strategy focused on conducting refinery compliance reviews. However, these reviews are conducted at the refinery location and are labor intensive.

To aid in better understanding areas of fuel compliance and noncompliance, the IRS developed and implemented seven motor fuel strategies. The strategies were developed by conducting brainstorming sessions with subject matter experts from Federal and State agencies and the fuel industry to identify how fuel excise tax could be evaded and considering allegations of noncompliance activity. These strategies were not created to address specific known excise tax gap areas and are not evaluated to assess the effectiveness of the strategies in addressing the excise tax gap.

In addition, in implementing the strategies, the IRS does not currently ensure that reliable fuel strategy-related information is obtained, maintained, reported, and ultimately used for decision making. For example, cases identified for examination might originate from one or more of the fuel strategies. Unique four-digit tracking codes are identified for each of the seven fuel strategies. However, the Examination Returns Control System used to track the results only records one tracking code per case. As a result, the dollars assessed are not currently tracked by multiple strategies. In Fiscal Year 2007, the IRS reported only two of seven strategies had tax assessments, and as of April 2008, only three of seven strategies had tax assessments. IRS management agreed that until it breaks down the number and type of strategies for each case along with the associated dollars assessed per strategy, it cannot be assured of reporting reliable information. A program analyst has begun tracking the results of cases identifiable by multiple fuel strategies. IRS management also commented that the fact that the strategies have not resulted in a significant number of compliance cases suggests the allegations the strategies are based on are largely not true.

The Joint Operations Center for National Fuel Tax Compliance is under development and is dedicated to the mission of expanding motor fuel tax compliance activities, fostering interagency and multi-national cooperation, and providing strategic analyses of domestic and foreign motor fuel distribution trends and patterns. The Joint Operations Center will leverage resources across Federal and State agencies, allowing Federal and State field agents to conduct joint investigations of specific targets that are identified and developed through the analysis of IRS, State, and third-party data sources. The Joint Operations Center, in association with the Energy Information Administration and the United States Army Corps of Engineers, is moving to acquire additional data sources and identify and track fuel production and movement beyond that previously allowed by the ExSTARS. The Energy Information Administration will allow the ExSTARS fuel distribution data to be tied to fuel industry-provided data concerning petroleum production and movement, while the United States Army Corps of Engineers will provide lock



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and trip report data filed by barge operators on the inland waterway system. The compiled data will then be used to track and trend fuel movement within the nation's fuel distribution system to identify areas resistant to compliance; develop baselines for measuring fuel supply, distribution, and consumption; enable the Joint Operations Center to identify suspicious activities and tax evasion schemes; and perform economic analyses. At the heart of the Joint Operations Center, a national data center is being created and modeled after the Financial Crimes Enforcement Network. Both the Joint Operations Center and the National Data Center are funded solely with Highway Trust Fund monies.

The Joint IRS and FHWA Strategy to Address Fuel Tax Noncompliance incorporates many of the activities currently ongoing. The strategy also includes another element to develop program measures for the components of the motor fuel tax evasion program to assess the successes, and identify opportunities to redirect resources, if necessary. However, measures have not been fully developed for the program components for use in evaluating effectiveness or reapplying resources.

Office of Management and Budget Circular A-123 requires that management controls be established to ensure that programs and resources are protected from waste, fraud, and mismanagement and that timely, reliable, and complete information is obtained, maintained, reported, and used for decision making. Congress enacted the Government Performance and Results Act of 1993⁷ to improve the efficiency and effectiveness of Federal programs by establishing a system to set goals for program performance and to measure results. The Act stipulates that each program activity will establish performance goals, measure performance, compare actual performance to the goals, and report on program performance.

IRS management advised us that the lack of refinery reporting was a significant problem in its attempt to track fuel, detect evasion, or measure compliance and that it cannot discuss legislative proposals with Congress unless initially approached by Congress. IRS management also advised us that it has not estimated the amount of the motor fuel excise tax gap or determined the compliance rate due to a lack of resources. Without complete information to effectively track the movement of fuel, there is an increased risk of excise tax evasion. In addition, without determining the amount and source of the excise tax gap and the compliance rate, the IRS and the FHWA risk inefficiently expending resources on initiatives that might not contribute to the reduction of the excise tax gap, increase the compliance rate, and significantly increase Highway Trust Fund receipts.

⁷ Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).



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Recommendations

The Commissioner, SB/SE Division, should ensure that:

Recommendation 1: The Excise Tax Program continues to work with oil industry representatives to implement information reporting at the refineries. If these efforts are unsuccessful, the Excise Tax Program should pursue regulatory options by working with the Department of the Treasury and/or the Office of Legislative Affairs to propose regulations/legislation requiring oil companies to file information documents reporting the products received at and transported from refineries.

Management's Response: Management agreed to work with oil industry representatives to implement information reporting at the refineries. Although sustained implementation efforts will remain contingent upon IRS strategic priorities and funding, the IRS is currently partnering with industry and identifying refinery reporting requirements. Management will develop a strategy document by October 15, 2009, outlining potential actions for implementing information reporting at refineries.

Recommendation 2: The Excise Tax Program works with the FHWA to validate the amount of the motor fuel excise tax gap and the compliance rate.

Management's Response: Management agreed in principle with this recommendation because a credible estimate of the motor fuel excise tax does not exist. The tax gap consists of three mutually exclusive types of noncompliance: filing, reporting, and payment noncompliance. Each component of the tax gap requires a different estimation strategy. Management has taken steps to ensure reporting of fuel transactions and develop methodologies to estimate the tax gap. However, the IRS will need to assess whether additional data are needed. Management will work with Federal and State partners, including the FHWA, to determine the feasibility of developing the methodologies needed to estimate motor fuel excise tax gap.

Office of Audit Comment: IRS management stated that they strongly agree that a credible estimate of the motor fuel tax gap would be beneficial to tax administration and policy makers. However, the corrective actions to be taken in response to this recommendation result in determining only the feasibility of estimating the tax gap, rather than the identification of a validated estimate of the motor fuel tax gap and compliance rate. Until a valid estimate of the tax gap and compliance rate is identified, the IRS and the FHWA continue to risk inefficiently expending resources on initiatives that might not contribute to the reduction of the excise tax gap, not increase the compliance rate, and not significantly increase Highway Trust Fund receipts.

Recommendation 3: The Examination Returns Control System tracking the fuel strategy cases is updated to allow tracking of cases identifiable by multiple strategies.



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Management's Response: Management agreed in principle with this recommendation. However, at this time, only one tracking code may be entered into the Examination Returns Control System on each controlled tax period. It would not be cost effective to make a significant computer programming change to the Examination Returns Control System to allow entry of multiple tracking codes for the limited number of multiple coded excise tax returns annually. (Fewer than 800 Forms 720 with multiple tracking codes were received during Fiscal Year 2008.)

During 2008, the Excise Tax Program developed a Fuel Strategy Feedback Sheet to capture the completed case results of field operations. The Feedback Sheet lists all fuel strategies and is used to record the associated tax adjustment amounts for each. It is also used to gather case information to evaluate the effectiveness of each fuel strategy in order to improve issue identification. Results from the Feedback Sheets are aggregated in a monthly progress report about fuel strategies for Small Business/Self-Employed Division management. Management will continue to use the Fuel Strategy Feedback Sheets to compile and evaluate data on returns evidencing multiple fuel strategies.

Office of Audit Comment: While the IRS does not plan to update the Examination Returns Control System to allow entry of multiple tracking codes due to the cost effectiveness of the computer programming changes, we agree the manual process implemented will provide similar information.

Recommendation 4: The Excise Tax Program works with the FHWA and completes the element in the Joint IRS and FHWA Strategy to Address Fuel Tax Noncompliance to develop program measures for the components of the motor fuel evasion program to assess the successes and identify opportunities to redirect resources, if necessary.

Management's Response: Management agreed with this recommendation. The Excise Tax Joint Operations Center has already taken actions to complete this recommendation. It has established strategic data analysis and compliance initiatives to identify and address motor fuel tax evasion activities. The IRS and the FHWA meet bi-monthly to discuss Joint Operations Center analysis and initiatives. The IRS includes the results of fuel tax evasion efforts and associated resource management in its annual report to the FHWA.

The Failure to File Penalty Program Can Be Improved

The IRS began identifying taxpayer entities in Fiscal Year 2006 for potential assertion of the \$10,000 penalty under Internal Revenue Code Section 6725⁸ for failure to file in a timely manner and/or furnish accurate information to the ExSTARS and not presenting reasonable cause for such failures. Prior to January 1, 2005, the penalty was only \$50 per failure and the IRS

⁸ 26 U.S.C. Sec. 6725.



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acknowledges noncompliance had been extremely high because taxpayers had little incentive for voluntary compliance. In fact, taxpayers sometimes elected to pay the penalty rather than incur the costs associated with becoming compliant with the electronic filing requirements. The ExSTARS Penalty Compliance Program established a 100 percent filing compliance goal and initiated a process for ensuring that every terminal is assigned to a fuel tax analyst for compliance reviews. As a result, since Fiscal Year 2006, more than 12,000 tax periods associated with potentially noncompliant terminals were identified for compliance reviews. Based on the number of tax periods, maximum penalty assessments could total more than \$120 million (12,000 tax periods x \$10,000), if reasonable cause was not applicable. While many of the terminal operators would have a reasonable cause for not timely or accurately filing information, there could still be a significant portion of the \$120 million in potential penalty assessments that could be assessed.

The ExSTARS Penalty Compliance Program that reviews the potential penalty assessments continues to mature and the number of terminals in compliance with electronic filing has increased, but improvements are needed to ensure a more effective penalty program. The increased penalty amount captured taxpayers' attention. However, in our opinion, initially the IRS was not consistently assessing the penalty under Internal Revenue Code Section 6725. The IRS uses the penalty primarily as a tool to compel noncompliant taxpayers into compliance rather than as remedial consequences or monetary sanctions against taxpayers for their noncompliance. Once the taxpayers are in full compliance, the penalty is most often abated in part or with a full Federal Government concession. For example, our review of 10 cases determined that the IRS assessed approximately 18 percent of the maximum penalty amounts, if reasonable cause did not apply. For purposes of establishing reasonable cause, ordinary business care and prudence includes making provisions for business obligations to be met when reasonable foreseeable events occur. In addition, it requires that the taxpayer continue to attempt to meet the requirements even though late. Figure 2 summarizes the maximum penalty, without application of reasonable cause or penalty appeals, and actual penalties identified for the 10 cases reviewed.



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Figure 2: Maximum Penalty Versus Actual Penalty Assessments for the Cases Reviewed

Taxpayer	Maximum Penalty Amount	Actual Penalty Amount	Percentage of Maximum Penalty Amount Actually Assessed
1			
Total	\$14,490,000	\$2,630,000	18.2%

Source: IRS penalty case files documentation.

Our review of the cases also reflected that some of the penalty assessments were initially made without properly applying the law, which unduly burdened taxpayers and resulted in unnecessary use of resources. For example, Internal Revenue Code Section 6725 states that the penalty for failure to file timely and accurate ExSTARS reports will not be imposed where the taxpayer can show reasonable cause; however, Excise Tax organization management initially took the position that the penalties were not subject to consideration for relief based on reasonable cause. Therefore, a significant number of tax periods were identified for penalty assessments upon determining the taxpayer was noncompliant without affording taxpayers the opportunity for relief consideration based on reasonable cause. As a result,

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As taxpayers submitted requests for relief to the IRS Taxpayer Advocate Service and/or requested Appeals hearings, several cases were returned from the Taxpayer Advocate Service to Excise Tax organization management for consideration of reasonable cause. Upon conducting additional research, Excise Tax organization management concluded reasonable cause would be considered for these ExSTARS penalty cases. Additionally, because IRS managers perform reviews of assessments made by their employees, examiner decisions may be reversed by management. In such cases, results were not always clearly communicated, resulting in an undue burden to the taxpayer. For example, 1



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With a growing number of taxpayers requesting relief from the penalties based on reasonable cause and the rising number of appeals requests, management made a decision to reduce the burden on the Office of Appeals and streamline these processes. The Office of Appeals and the Excise Tax Specialty Program office worked together to develop procedures for addressing appeals requests relative to ExSTARS penalty cases. To test the new processes, management temporarily suspended ExSTARS penalty assessments and reviewed three of the larger corporations using the Appeals Fast Track Mediation process. The results from the three cases provided the framework for developing the Excise Tax Penalty Procedures and the SB/SE Division Appeals Settlement Position, which would be used in processing ExSTARS penalty cases.

The Appeals Settlement Position addresses only the issue of reasonable cause and provides that, where there is ambiguity concerning evidence of reasonable cause, the penalty might be settled after the completion of negotiations⁹ with a percentage Federal Government concession. In addition to the general reasonable cause standards set forth in the Internal Revenue Manual, the Appeals Settlement Position establishes additional critical factors for consideration, such as the taxpayer's compliance history. It also requires that taxpayers demonstrate that they are currently in full compliance with Internal Revenue Code Section 6725. Once the taxpayer is in full compliance, only noncompliant prior tax periods would be subject to the settlement. Management also provided that penalties would not be assessed from the point in time when noncompliant taxpayers became actively engaged in working with the IRS to resolve a noncompliance history, became fully compliant, and agreed to sign a statement requiring their full compliance for 60 months. The taxpayers were also required to consent that if they were noncompliant for 90 days or longer during this 60-month period, they would voluntarily abrogate their registration.

Based on our review of the three Appeals Fast Track Mediation settlement cases, we determined that, while assessing the penalties resulted in the taxpayer becoming and remaining compliant for the period of time reviewed, the IRS might be too liberal in granting relief from the penalties due to reasonable cause. For example:

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⁹ When the IRS negotiates settlements, penalties can be waived, suppressed, or abated.



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Based on our review of the remaining seven cases identified in our sample, we determined the 1 [redacted] fully conceded by the Federal Government in four cases, and 1 [redacted]

- 1 [redacted]

- In the 4 cases resolved with full Federal Government concessions, IRS management conceded 1 [redacted] The IRS agreed to the



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concessions after considering information specific to each case, including discrepancy of filing dates, software implementation issues, personnel medical issues, and mergers.

- 1

As the ExSTARS Penalty Compliance Program matures, the IRS has become more consistent in applying penalties and working the cases.

We also determined that penalty cases were not immediately worked. For example, on April 1, 2006, penalty cases for 83 taxpayer entities covering 2,272 tax periods were assigned to 3(d). As of April 2008 (2 years later), examinations had not been started for approximately 912 (40 percent) of these tax periods, representing 31 taxpayer entities. However, because no statute for assessment limits timeframes for processing non-taxable information returns, there is no timeliness issue.

In addition, a significant number of the cases identified for potential assessment of a penalty that were worked to closure resulted in no penalty being assessed. Of the 645 (593 + 52) cases worked to closure, 593 (92 percent) resulted in no penalty being assessed to the taxpayer. Figure 3 presents a breakdown of the status and examination results for the 2,272 tax periods.

Figure 3: Analysis of Penalty Cases Worked by 3(d) on the ExFIRS Penalty Compliance Team

Penalty Case Status	Tax Periods	Percentage	Amount Assessed
Examinations Not Started	912	40%	N/A
Closed With No Penalty	593	26%	\$0
Closed With Penalties	52	2%	\$310,000
Examinations in Process	715	32%	N/A
Totals	2,272	100%	\$310,000

Source: IRS ExFIRS program documentation.

Management explained that many of the cases closed with no penalty assessed were not cases where compliance reviews had been initiated. Generally, these were taxpayer entities where only one or two potentially noncompliant tax periods were identified, and 3(d) completed an internal cursory review and determined it was not an efficient use of resources to pursue penalty cases. However, our review of the penalty case data determined the 593 tax periods are associated with 28 taxpayer entities, only 4 of which had fewer than 3 tax periods. In addition, only 13 (46 percent) of the 28 taxpayer entities had fewer than 10 tax periods each. For



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example,

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Congress enacted Internal Revenue Code Section 6725 in order to promote proper and timely reporting of taxable fuel disbursements under the ExSTARS, which is essential to the Department of the Treasury's ability to monitor and enforce the excise fuels taxes. As a result, Internal Revenue Code Section 6725 authorizes the IRS to assess a penalty of \$10,000 per failure per vessel on taxpayers for failure to file a report or to furnish information required in a report required by the ExSTARS system. However, no penalty is imposed upon a taxpayer showing reasonable cause. Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining its tax obligations but is unable to comply with those obligations.

The Internal Revenue Manual states that penalties exist to encourage voluntary compliance by supporting the standards of behavior expected by the Internal Revenue Code, including defining standards of compliant behavior and remedial consequences for noncompliance, and providing monetary sanctions against taxpayers who do not meet the standards. Voluntary compliance exists when taxpayers conform to the law without compulsion or threat, and penalties support voluntary compliance by assuring compliant taxpayers that tax offenders are identified and penalized.

Although administration of excise penalties is not a new initiative for the Specialty Programs organization, the implementation of the ExSTARS Penalty Compliance Program and administration of Internal Revenue Code Section 6725 penalties were new initiatives, which the IRS promptly implemented in Fiscal Year 2006. When the Program was initially implemented, specific policies and procedures for working the penalty cases had not been completed, management did not clearly understand the full intent of the law regarding the penalties, and the impact to the organization for resolving disputed assessments had not been properly considered. IRS management subsequently sought guidance about legal intent and requirements and acted expeditiously to establish the Appeals Settlement Position process for handling the disputed cases and developed detailed procedures for working penalty cases. Management's primary focus in implementing the penalty provisions was to use the penalties as a tool to bring taxpayers into compliance with the electronic filing requirements rather than as remedial consequences or monetary sanctions against taxpayers for noncompliance.

If the IRS does not administer penalties uniformly (guided by the applicable statutes, regulations, and procedures) taxpayers might be unnecessarily burdened, and overall confidence in the tax



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system is jeopardized. In addition, when penalties are not assessed and collected for noncompliance, critical funding for the nation's Highway Trust Fund is lost.

Recommendation

Recommendation 5: The Commissioner, SB/SE Division, should ensure the Excise Tax Program applies the penalty for failure to file timely and accurate information documents consistently to all taxpayers.

Management's Response: Management agreed that penalties should be administered in a consistent manner. The Excise Tax Program has taken actions since 2006 to strengthen the penalty program and will continue efforts in this area. An ExSTARS Compliance Manager position was established and four analysts were hired and trained to staff the Penalty Compliance team. Management developed procedural guidelines, quality reviews, and managerial oversight to assure consistent application of penalties for failure to file timely and accurate information documents to all taxpayers. The IRS has proactively educated taxpayers about information reporting requirements, including mandatory electronic reporting, implemented processes for considering reasonable cause penalty relief, and established an Appeals Settlement Procedure. For these reasons, management stated that no additional corrective actions are planned.

Office of Audit Comment: The issues raised in the audit report were identified during the initiation of the penalty program. As the program matures, penalties are being administered more consistently. We agree that additional corrective actions are not needed at this time.

Failure to File Penalty Payments Are Not Transferred to the Highway Trust Fund

Our review of 16 taxpayer accounts that were assessed a penalty as authorized by Internal Revenue Code Section 6725 (i.e., for failure to file a report or to furnish information required in a report required by the ExSTARS) determined that the IRS collected approximately \$1.7 million in penalty assessments as of September 10, 2008. However, the payments were deposited in the general fund and not transferred to the Highway Trust Fund as required.

The Internal Revenue Code states that any penalty amount designated to be assessed and ultimately collected under Internal Revenue Code Section 6725 is to be appropriated to the Highway Trust Fund.¹⁰ The monies collected are not being transferred to the Highway Trust Fund because there is no process in place to certify the collected penalty monies or to directly transfer the funds to the Highway Trust Fund. In addition, IRS and Department of the Treasury

¹⁰ I.R.C. § 9503 (b) (5).



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personnel responsible for the transfer of the funds were not aware of the legislation requiring such action.

By not having procedures in place to ensure the transfer of collected penalty monies to the Highway Trust Fund, FHWA programs did not have access to the approximately \$1.7 million in receipts.

Recommendation

Recommendation 6: The Commissioner, SB/SE Division, should ensure the Excise Tax Program coordinates with the Chief Financial Officer to establish procedures to ensure that funds collected from the assessment of the failure to file timely and accurate information documents and/or any other ExFIRS compliance-related penalties are transferred to the Highway Trust Fund.

Management's Response: Management agreed with this recommendation. The Excise Tax Program has coordinated with the Chief Financial Officer to ensure that collected amounts of assessed ExFIRS penalties are properly certified and transferred to the Highway Trust Fund. The certification issue was discussed with representatives of the Department of the Treasury, the Financial Management Service, and the Bureau of Public Debt, and yielded a procedure for certifying penalty amounts to the Highway Trust Fund. The IRS Excise Tax Certification Letter to the Highway Trust Fund, issued February 17, 2009, included amounts for penalties collected from 2006 through 2008. By September 15, 2009, a subsequent revenue certification will include penalty amounts collected that had not been previously certified, and the revenue certifications will be completely current, including any penalty amounts assessed that have been collected.

Office of Audit Comment: While the IRS agreed with this recommendation and has taken corrective action, it commented that it had reservations about the validity of the outcome measure "Increased Revenue – Actual; \$1.7 million" due to the very small case sample upon which it relies. Management stated that a random statistical sample of penalties assessed and subject to reasonable cause abatement and full penalty appeals consideration might have had less significant dollar results.

The outcome we are reporting is an actual amount, not a projection based on a sample. We reviewed 16 taxpayer accounts that were assessed a penalty and determined that the IRS collected approximately \$1.7 million in penalty assessments as of September 10, 2008, but the payments were not transferred to the Highway Trust Fund as required.



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Improvements Are Needed to Effectively Measure Results of Compliance Program Activities

The IRS developed the ExFIRS to identify areas with the highest risk for motor fuel excise tax noncompliance. Program results are reported on weekly or monthly reports containing information such as the number of terminals converted from the paper/original electronic data transmission format to the new electronic data transmission format and the status, age, and results of compliance cases. In addition, the SB/SE Division Excise Tax organization conducts a quarterly survey (with results reported on an annual basis) of taxpayers with closed cases to assess customer service. However, these measures do not provide information regarding program effectiveness in addressing the areas with the highest risk for motor fuel excise tax noncompliance. Measures and outcomes such as return on investment, change in compliance rate, and change in excise tax gap would provide better motor fuel excise tax evasion program effectiveness information.

The Government Performance and Results Act of 1993 stipulates that each program activity will establish performance goals, measure performance, compare actual performance to the goals, and report on program performance. The Joint IRS and FHWA Strategy to Address Fuel Tax Noncompliance executed on January 12, 2006, states that one of the elements of the envisioned strategy includes development of program measures for the components of the motor fuel tax evasion program to assess the successes and identify opportunities to redirect resources, if necessary.

Specific performance measures and program outcomes had not been established for the motor fuel tax compliance program because IRS management believed the established measures sufficiently measure program results. Without the implementation of effective program measures and outcomes, the IRS increases the risk of not being able to determine program effectiveness, increase compliance, and facilitate a decrease in the overall excise tax gap.

Recommendation

Recommendation 7: The Commissioner, SB/SE Division, should ensure that performance measures and outcomes such as return on investment, compliance rate, and change in excise tax gap are developed and used to assess program effectiveness in improving fuel tax compliance.

Management's Response: Management agreed in principle with this recommendation, and plans to partner with the Office of Research, Analysis, and Statistics to assess the proper use of measures that are consistent with other operations within the IRS. The Excise Tax Program has established and currently maintains program measures necessary to manage compliance resources, monitor enforcement results and assure program effectiveness. By October 15, 2010, management will evaluate the adequacy of existing program measures.



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Management disagreed with the recommendation to use estimated compliance rates and estimated changes in the motor fuels excise tax gap as performance measures. While such measures can be used as long-term strategic goals, management stated they should not be used as performance measures. This is because these measures show the amount of tax that is paid voluntarily and timely, but not the true tax liability. The estimated tax gap and compliance rate for a particular tax year lags several years behind the performance fiscal year, making it impossible to use these as timely performance measures. Moreover, both the tax gap and the associated compliance rates are influenced by external factors, such as changes in the overall economic conditions, further complicating use of these estimates as performance measures.

Office of Audit Comment: Congress authorized the IRS to use Highway Trust Fund monies to expand enforcement efforts, supplement examinations and criminal investigations, and develop an excise fuel reporting system (i.e., ExFIRS). Because this program and the ExFIRS system are funded by Highway Trust Fund money, we believe measures and outcomes such as return on investment, compliance rate, and change in excise tax gap are necessary to assess program effectiveness in using Highway Trust Fund money and in improving fuel tax compliance.

Reports on Program Results Are Not Fully Representative or Timely Submitted

The IRS prepared and issued legislatively mandated annual status reports to the DOT and included the information agreed to in the Memorandum of Understanding between the IRS and the DOT. However, IRS management did not use data from the official IRS tax accounts available via the Integrated Data Retrieval System (hereafter referred to as the IRS computer system) but rather data from another system used to report enforcement revenue for the report. In addition, updated information for multiple fiscal years is not presented in the annual status reports. As a result, the failure to file penalty information provided is not fully representative of program results. For example, in the annual status reports, the IRS reported total failure to file penalties assessed for Fiscal Years 2006 and 2007 of \$6,670,000 and \$1,110,000, respectively. As of September 10, 2008, the IRS computer system reported net annual penalty assessment amounts of \$1,705,000 and \$310,000, respectively, a difference of \$4,965,000 (\$6,670,000 - \$1,705,000) and \$800,000 (\$1,110,000 - \$310,000), respectively. Figures 4 and 5 present the differing penalty amounts. The annual status reports also do not incorporate the amount of abatements, assessments collected, and funds transferred to the Highway Trust Fund. In addition, the status reports are due to the DOT no later than September 30 of each year. However, the IRS did not issue the Fiscal Years 2006 and 2007 annual status reports until April 6, 2007, and March 28, 2008, respectively.



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Figure 4: Analysis of Fiscal Year 2006 Penalty Information Presented in the Annual Status Report

Fiscal Year 2006	Annual Status Report to the DOT	IRS Computer System
Assessments	\$6,670,000	\$6,670,000
Abatements	\$0	\$0
Net Assessments as of September 30, 2006	\$6,670,000*	\$6,670,000
The information below is not included in the annual status report.		
Abatements After September 30, 2006	\$0	\$4,965,000
Net Assessments as of September 10, 2008**	\$6,670,000	\$1,705,000
Amount of Assessments Collected	\$0	\$1,705,000
Amount of Collected Monies Transferred to the Highway Trust Fund	\$0	\$0

Source: IRS Annual Status Report to the DOT for Fiscal Year 2006, the IRS computer system, and the Chief Financial Officer's office.

* This amount reported in the Annual Status Report is not broken down to reflect assessments and abatements.

** Date of the Treasury Inspector General for Tax Administration analysis.



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Figure 5: Analysis of Fiscal Year 2007 Penalty Information Presented in the Annual Status Report

Fiscal Year 2007	Annual Status Report to the DOT	IRS Computer System
Assessments	\$1,340,000 Proposed	\$310,000
Abatements	\$230,000	\$0
Net Assessments as of September 30, 2007	\$1,110,000	\$310,000
The information below is not included in the annual status report.		
Abatements After September 30, 2007	\$0	\$0
Net Assessments as of September 10, 2008*	\$1,110,000	\$310,000
Amount of Assessments Collected	\$0	\$63,319
Amount of Collected Monies Transferred to the Highway Trust Fund	\$0	\$0

Source: IRS Annual Status Report to the DOT for Fiscal Year 2007, the IRS computer system, and the Chief Financial Officer's office.

* Date of the Treasury Inspector General for Tax Administration analysis.

In addition, only \$40,000 (1 percent) of the \$3,870,000 in assessments reflected in the ExFIRS program documentation for Fiscal Year 2008 (as of September 10, 2008) has been recorded in the IRS computer system.

The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users¹¹ requires the IRS to issue annual status reports to the DOT no later than September 30 of each year. The status reports describe the projects, enforcement activities and results, and provide summary information on electronic filing results, as well as the number of ExFIRS-generated field referrals. Office of Management and Budget Circular A-123 requires that management controls be established to ensure that programs and resources are protected from waste, fraud, and mismanagement and that timely, reliable, and complete information is obtained, maintained, reported, and used for decision making.

¹¹ Pub. L. 109-59 (2005).



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IRS management indicated that they did not submit the annual status reports in a timely manner because they prepare the reports based on fiscal year-end information and provide a draft copy of the report to the FHWA for review, resulting in several months' time to complete the reports. The IRS also has not prepared the annual status reports based on information reported in the IRS computer system. As a result, the IRS has provided information in its annual status reports to the DOT that does not fully represent program results.¹² Without timely and complete information, program results might not be fully transparent and management might not be able to make sound decisions to achieve the agency's strategic goals and objectives to maximize its return on information technology investments. In addition, without fully representative information, stakeholders will not have an accurate understanding of the program status and accomplishments.

Recommendations

The Commissioner, SB/SE Division, should ensure that:

Recommendation 8: Penalty information contained in the annual status report to the DOT is based on information obtained from the Integrated Data Retrieval System.

Management's Response: Management did not agree with this recommendation. The IRS Master File accounts supply the data for both the Information Data Retrieval System and the Enforcement Revenue Information System. The Information Data Retrieval System reports single account results, while the Enforcement Revenue Information System reports cumulative results. The Enforcement Revenue Information System is, therefore, a more suitable reporting tool for delivering complete fiscal year results in the annual fuel tax evasion activities report delivered to the Department of Transportation. To maintain consistency with other IRS external reporting, the IRS will continue to use the Enforcement Revenue Information System data to report net ExFIRS penalty assessments included in the two primary Master File components, Business Master File and Individual Master File.

Office of Audit Comment: While we did not independently validate the cumulative results reported in the Enforcement Revenue Information System, our comparison of the annual status report information and taxpayer account information obtained from the Integrated Data Retrieval System identified inconsistencies. Therefore, we believe the Integrated Data Retrieval System is a better source for reporting program results.

Recommendation 9: Excise Tax Program management enhances the annual status reports to show penalty assessments, abatements, funds collected, and transfers for multiple years to clearly identify program trends for the Highway Trust Fund, providing greater program transparency and a more accurate reflection of program results.

¹² Appendix IV provides a summary of the outcome measures.



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Management's Response: Management agreed with this recommendation. The IRS is currently working with the FHWA and the DOT to develop a mutually agreeable report format that will incorporate penalty assessments and abatements. The IRS will use this format in the next report.

Office of Audit Comment: While management agreed with this recommendation and is working to revise the report format, they questioned the justification for the outcome measure "Reliability of Information – Actual; 5,765,000." Management stated that the annual report accurately reflected Fiscal Year-end aggregate data required by the FHWA because the additional levels of detail and analysis we recommended have not been requested by the FHWA.

The IRS is required to establish management controls to ensure that timely, reliable, and complete information is obtained, maintained, reported, and used for decision making. By not providing the detailed information in its annual status report, the IRS did not report complete and reliable program results to the FHWA. Figure 5 shows that the 2007 Fiscal Year-end aggregate data are not accurate, and we believe the amount of the outcome measured reported to be valid.

Recommendation 10: Excise Tax Program management issues the annual status report to the DOT by September 30 as required by law.

Management's Response: Management agreed in principle with this recommendation. However, the IRS does not have complete data or information for its activities for the year as of September 30. In conjunction with the DOT, the IRS has determined that submitting a report on September 30 would not provide a complete or useful picture of the activity through the entire year and, therefore, the IRS does not submit the reports until it has complete information. Management stated they will accelerate data analysis in order to deliver future reports by November 30.

Office of Audit Comment: Accelerating the data analysis should improve the timeliness of the annual status reports. However, the IRS should continue to look for process improvements to allow issuance of the report by September 30 as required, or work with DOT to get the annual reporting requirements changed.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the ExFIRS has been effectively implemented to enhance tax enforcement activities and increase Highway Trust Fund revenue. To accomplish this objective, we:

- I. Determined whether corrective actions identified by management to address prior Treasury Inspector General for Tax Administration recommendations in the SB/SE Division's ExFIRS program have been effectively implemented.
 - A. Reviewed the associated Joint Audit Management Enterprise System reports to identify the current status of the corrective actions for the prior Treasury Inspector General for Tax Administration recommendations. Appendix VII presents the prior recommendations and the corrective actions taken by management.
 - B. Obtained and reviewed documentation to verify that closed corrective actions have been effectively completed.
- II. Assessed whether the ExFIRS has been effectively used to improve compliance activities.
 - A. Evaluated the effectiveness of the SB/SE Division's efforts to increase compliance with electronic filing requirements mandated by the American Jobs Creation Act of 2004.¹
 - B. Evaluated the effectiveness of the process established for gathering data to track and analyze the movement of fuel.
 - C. Evaluated the effectiveness of the fuel strategies developed in support of enforcement activities targeting motor fuel excise tax evasion.
 - D. Obtained a walkthrough of the ExFIRS data matching and analysis process including the criteria for identifying exceptions, analyzing the exception data, and either eliminating or referring leads for examination.
 - E. Determined whether performance measures were established to assess the results of the motor fuel tax examinations.
 - F. Evaluated the effectiveness of the penalty assessments and collections process in ensuring penalties are properly and timely assessed, tracked, reported, and paid over to the Highway Trust Fund.

¹ Pub. L. No. 108-357, 118 Stat. 1418 (2004).



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1. Obtained and reviewed the most recent penalty case data to determine the total number of potential cases considered for penalty assessments and the status of the cases.
 2. Determined how cases identified for penalty compliance reviews are worked by interviewing management, reviewing established procedures, and reviewing the case files for cases selected for review.
 3. We identified a judgmental sample of 10 cases for review and obtained and reviewed the closing agreements and examiners' activity records. We selected three penalty cases involving taxpayer entities with a large number of tax periods for which the IRS chose to expedite resolution using the Fast Track Mediation Alternative Dispute Resolution process. The IRS used the results of these three cases to establish the penalty procedures. For the seven remaining cases selected for review, we identified large and small closed cases based on the number of tax periods. The cases were closed no change, with full Federal Government concession, or partial Federal Government concession.
- III. Used the Integrated Data Retrieval System² and an ExFIRS Program Office prepared spreadsheet/management report showing penalties and motor fuel tax cases (i.e., allegations) identified by the fuel strategies to determine the amount of assessments on the identified cases. We further researched penalty cases on the Integrated Data Retrieval System to determine the extent and timing of assessments actually made and/or the extent and timing of any offsetting abatements. Because we did not use the information to make projections, we did not validate the data on these systems.

² See Appendix VIII for a glossary of terms.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
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Director, Specialty Programs, Small Business/Self-Employed Division SE:S:SP
Chief, Excise Tax Operations, Small Business/Self-Employed Division SE:S:SP:EX
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National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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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 Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Actual; \$1.7 million (see page 16).

Methodology Used to Measure the Reported Benefit:

Our review of 16 taxpayer accounts assessed a penalty authorized by Internal Revenue Code Section 6725¹ (i.e., for failure to file a report or to furnish information required in a report required by the ExSTARS) determined that the IRS collected approximately \$1.7 million in penalty assessments as of September 10, 2008. However, the payments were not transferred to the Highway Trust Fund as required. By not having procedures in place to ensure the transfer of collected penalty monies to the Highway Trust Fund, FHWA programs did not have access to the approximately \$1.7 million in additional funds.

Type and Value of Outcome Measure:

- Reliability of Information – Actual; 5,765,000 (see page 19).

Methodology Used to Measure the Reported Benefit:

The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users² requires the IRS to issue annual status reports to the DOT no later than September 30 of each year. The status reports describe the projects, enforcement activities and results, and provide summary information on electronic filing results as well as the number of ExFIRS-generated field referrals. In the annual status reports, the IRS reported that failure to file penalties were assessed for Fiscal Years 2006 and 2007 totaling \$6,670,000 and \$1,110,000, respectively. However, because the IRS Integrated Data Retrieval System is not the source for the report information and updated information for multiple years is not presented in the annual status reports, the failure to file penalty information provided is not fully representative of program results. As of September 10, 2008, the IRS Integrated Data Retrieval System reported Fiscal

¹ 26 U.S.C. Sec. 6725.

² Pub. L. No. 109-59 (2005).



The Fuel Excise Tax Compliance Program Has Made Significant Progress, but Program Improvements Are Needed to Increase Highway Trust Fund Revenue

Years 2006 and 2007 net annual penalty assessment amounts of \$1,705,000 and \$310,000, respectively, a difference of \$4,965,000 and \$800,000, respectively. Figure 1 presents the differing net penalty amounts.

**Figure 1: Net Penalty Assessments
Fiscal Years 2006 and 2007**

Fiscal Year	Annual Status Report to the DOT	IRS Computer System	Reported Assessment Amount Difference
2006 (as of September 30, 2006)	\$6,670,000	\$6,670,000	
2006 (as of September 10, 2008)	\$6,670,000	\$1,705,000	\$4,965,000
2007 (as of September 30, 2007)	\$1,110,000	\$310,000	
2007 (as of September 10, 2008)	\$1,110,000	\$310,000	\$800,000
Total Difference			\$5,765,000

Source: IRS Annual Status Report to the DOT for Fiscal Years 2006 and 2007 and the IRS Integrated Data Retrieval System.



The Fuel Excise Tax Compliance Program Has Made Significant Progress, but Program Improvements Are Needed to Increase Highway Trust Fund Revenue

Appendix V

Legislative Changes That Impact Fuel Tax Compliance

Legislative changes have been enacted over the years to move the points of taxation on motor fuels with efforts to reduce evasion of tax. More recent legislation has been enacted in response to environmental concerns, dependency on foreign oil, and limited supply of fossil fuels. These changes expanded the scope and administration of the National Fuel Excise Tax Program. Several of the major changes are listed below.

- The Tax Reform Act of 1986¹ generally moved the point of taxation on gasoline from registered producer, which included registered wholesale distributors, to the earlier of the removal or sale of gasoline by the terminal operator.
- The Revenue Act of 1987² moved the diesel fuel tax from the retailer to the registered producer, which included registered wholesale distributors.
- The Omnibus Budget Reconciliation Act of 1993³ changed the point of taxation for diesel fuel from the registered wholesale distributor to the removal from the bulk transfer/terminal⁴ system. This Act provided that diesel fuel was exempt from tax only if it was indelibly dyed under IRS regulations.
- The Taxpayer Relief Act of 1997⁵ extended the diesel fuel excise tax rules to kerosene. Kerosene is generally taxed when it is removed from a terminal rack unless indelibly dyed.
- The American Jobs Creation Act of 2004⁶ changed the tax treatment of kerosene used in aviation, required diesel fuel to be dyed by mechanical injection (under Department of the Treasury regulations), expanded the number of assessable penalties related to taxable fuel, instituted electronic filing in several areas, and expanded the scope of incentives for renewable and alternative fuels.

¹ Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 16 U.S.C., 19 U.S.C., 25 U.S.C., 26 U.S.C., 28 U.S.C., 29 U.S.C., 42 U.S.C., 46 U.S.C., and 49 U.S.C.).

² Pub. L. No. 100-203 (1987).

³ Pub. L. No. 103-66 (1993).

⁴ See Appendix VIII for a glossary of terms.

⁵ Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

⁶ Pub. L. No. 108-357, 118 Stat. 1418 (2004).



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- The Energy Tax Incentives Act of 2005⁷ contains enacted legislation involving water emulsion diesel, renewable diesel, the reinstatement of the oil spill tax, and expanded the scope of the Leaking Underground Storage Tank tax.
- The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users⁸ enacted provisions for volumetric alternative fuels credit, tax exemptions for aerial applicators and fixed wing aircraft engaged in forestry, treatment of kerosene used in aviation, re-registration rules for change of ownership, and penalties with respect to certain adulterated fuels.

Note: These changes are not all inclusive.

⁷ Pub. L. No. 109-58 (2005).

⁸ Pub. L. No. 109-59 (2005).



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Appendix VI

Subsystems of the Excise Files Information Retrieval System

The ExFIRS is an umbrella system made up of six subsystems that support the collection of motor fuel industry information, automated analysis of this information, and identification of areas with the highest risk for nonpayment of excise taxes.

1. Excise Summary Terminal Activity Reporting System – A repository of monthly information documents from fuel terminal operators and carriers detailing the receipts and disbursements of liquid products passing through a taxable fuel storage and distribution facility. The information documents can be filed on paper or electronically,¹ with certain filings statutorily required to be made electronically. Return information is provided to the States in accordance with appropriate disclosure laws.
2. Excise Tax Registration Authentication System – A centralized database containing information relating to the Application for Registration (For Certain Excise Tax Activities) (Form 637). It provides centralized data entry (key entry and scanned), monitoring, and reporting of all Form 637 registrants. Some registrants are required to be registered because of their status (e.g., refiners and terminal operators) while other taxpayers are required to be registered to obtain a benefit (e.g., certain ultimate vendors of diesel fuel).
3. Excise Fuel Online Network – An integrated case processing and tracking system used by the fuel compliance officers and group managers for the Dyed Diesel Fuel Program.
4. Excise Tax Online Exchange – A repository of State records housed by the IRS. The data come from the States but are available to other States and the IRS, under disclosure agreements.
5. Excise Tax Agent Center – A system that automates the processes used to work cases/returns selected for review. A case will move from classification, to the group manager, to the revenue agent who will conduct the review. Revenue agents and managers will work/review cases and save work in progress on the user workstation and on the ExFIRS.
6. Excise Management Information System Data Warehouse and Operational Database – A database that provides a common data management solution, from disparate legacy databases and information stores, created from a variety of sources. It contains information gathered

¹ Pub. L. No. 108-357, 118 Stat. 1418 (2004).



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from the various ExFIRS subsystems, as well as IRS sources and United States Customs Service import information, pertaining to taxable commodities.



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Appendix VII

Prior Audit Report Recommendations Relating to the Compliance Program and Associated Corrective Actions Completed

In a prior audit report,¹ we made seven recommendations (four compliance program and three systems development). The IRS identified eight corrective actions in response to the recommendations and reported that the corrective actions had been completed and closed as of September 7, 2006. Five of the eight corrective actions related to the compliance program recommendations. The remaining three corrective actions relate to the ExFIRS system development activities and will be reviewed in a separate audit.

We recommended that the Commissioner, SB/SE Division, should:

1. Work with the Chief Information Officer to determine which executive steering committee will be responsible for the ExFIRS Project while the Project is being developed and include a representative from the FHWA on the executive steering committee. When the ExFIRS Project moves to operations and maintenance status, the FHWA should be involved with program management and executive oversight and be provided periodic status reports as requested by the FHWA to assess the progress of the ExFIRS Project and support continued funding. The planned revisions to the Memorandum of Understanding between the IRS and the FHWA should include these requirements.

Corrective action: In November 2005, the IRS began including representatives from the FHWA in the ExFIRS system development executive steering committee meetings.

Corrective action: Bi-monthly conference calls and quarterly meetings were held with the FHWA to identify, discuss, and resolve ongoing issues, problems, and/or concerns. Beginning in February 2007, monthly meetings were held with representatives from the FHWA and the IRS' Fuel Territory, Excise program, and ExFIRS program personnel where several aspects of the Excise Tax Program as well as fuel tax evasion-related efforts initiated by the DOT are discussed. The IRS also submits annual status reports to the Secretary of the DOT describing the DOT-funded projects and enforcement activities and results. In addition, the IRS provides information on electronic filing and the number of ExFIRS-generated field referrals. A Memorandum of Understanding between the IRS and the FHWA was signed in January 2006 and included requirements governing communications (e.g., requiring that

¹ *The Excise Files Information Retrieval System Has Not Been Effectively Implemented* (Reference Number 2006-20-001, dated October 2005).



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bi-monthly conference calls and quarterly meetings be conducted to identify, discuss, and resolve ongoing issues, problems, and/or concerns).

2. Develop a plan and schedule as soon as possible for initiating an examination program based on identified discrepancies between the information documents and the tax returns.

Corrective action: On November 28, 2005, the IRS established the Excise Compliance Operations organization. In addition, the National Fuel Territory organization was established to monitor and improve compliance for the excise tax on fuels with plans to use forensic accounting techniques to ensure fuel tax compliance. The IRS also identified seven motor fuel strategies to better understand areas of fuel tax compliance and noncompliance. Using these strategies, fuel policy analysts began conducting matching analysis of ExSTARS and United States Customs Service data to Quarterly Federal Excise Tax Return (Form 720) filings and referring leads for field examinations in April 2006. As of April 2008, approximately \$134,789,712 had been assessed.

3. Develop a schedule for converting all filers to the new data transmission format and begin assessing the \$10,000 penalty for failure to file complete and accurate information documents, as authorized by the American Jobs Creation Act of 2004.²

Corrective action: During Fiscal Years 2006 and 2007, the IRS implemented broad-based and individual outreach and education initiatives for businesses filing paper returns to ensure awareness of the new electronic filing requirements and a smooth transition to the new electronic filing format. In addition, letters were issued to the fuel industry regarding failure to file and failure to register penalties and the schedule for conversion to the new electronic filing format. Onsite visitations were made to ExSTARS software vendors and third-party transmitters regarding compliance. The ExFIRS Compliance Team also began performing penalty reviews educating taxpayers regarding excise tax filing requirements and using information from the ExSTARS to identify excise tax non-filers and assessing penalties for noncompliance.

4. Clarify whether or not an objective of the ExSTARS is to eliminate the requirement for duplicate filing of fuel transaction data by the motor fuel industry to both the IRS and the States by either identifying and addressing the issues that prevent single point of filing or removing the stated objective from the Motor Fuel Excise Tax Electronic Data Interchange Guide (Publication 3536).

Corrective action: Certain IRS publications state that the ExFIRS might facilitate single point of filing in those States having the same tax point as the Federal Excise Tax. To avoid

² Pub. L. No. 108-357, 118 Stat. 1418 (2004).



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any confusion in this area, references to single point of filing were removed from the publications.

However, during the course of the audit, we notified IRS management that the IRS web site made reference to single point of filing. When we discussed the issue with IRS management, they took appropriate action and removed the reference to single point of filing from the IRS web site.



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Appendix VIII

Glossary of Terms

Appeals Mediation Process	A process involving an Appeals Officer who has been trained in mediation, the Taxpayer, and IRS Examination and/or Collection Division personnel that is used to help facilitate communication and resolve unagreed issue(s).
Dyed Diesel Fuel Program	A program that exempts diesel fuel and kerosene from tax if the fuel is dyed red (usually at a refinery or terminal) under Department of the Treasury regulations and used for prescribed nontaxable off-road purposes, such as in refrigeration units on trailers, off-road diesel-powered equipment, and home heating.
Examination Returns Control System	A system that provides detailed management information on tax returns under examination and tracks employee time spent on the cases.
Excise Tax e-File and Compliance System	A system that supports electronic filing of the Quarterly Federal Excise Tax Return (Form 720), Heavy Highway Vehicle Use Tax Return (Form 2290), and Claim for Refund of Excise Taxes (Form 8849).
Integrated Data Retrieval System	An IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.
Joint IRS and FHWA Strategy to Address Fuel Tax Noncompliance	The United States Senate Appropriations Committee, in Report 108-342, requested that the Secretaries of the Departments of the Treasury and Transportation develop and submit a strengthened motor fuel tax evasion compliance and enforcement strategy. The strategy is to include coordinated joint operational initiatives to prevent, detect, and shut down motor fuel tax evasion schemes across the country.



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Joint Operations Center	A data center the IRS is responsible for establishing for the joint collection, analysis, and sharing of information on fuel distribution and compliance or noncompliance with fuel taxes between the appropriate State agencies and the IRS.
Memorandum of Understanding	A document that expresses mutual accord on an issue between two or more parties. It identifies the contracting parties, spells out the subject matter of the agreement and its objectives, summarizes the essential terms of the agreement, and is signed by the contracting parties.
Refinery	A facility used to produce taxable fuel and from which taxable fuel may be removed by pipeline, by vessel, or at a rack.
Return on Investment	The net profit or loss in an accounting period divided by the capital investment used during the period, usually expressed as an annual percentage return.
Tax Gap	The difference between the annual Federal tax obligation and the amount of tax that taxpayers pay voluntarily and timely.
Taxpayer Advocate Service	An independent organization within the IRS that helps taxpayers resolve problems with the IRS and recommends changes to prevent problems.
Terminal	A storage and distribution facility for taxable fuel that is supplied by pipeline or vessel and from which taxable fuel may be removed at a terminal rack.
Terminal Rack	A mechanism capable of delivering taxable fuel into a means of transport other than a pipeline or vessel.
Trust funds	Accounts established by law to hold receipts, such as specific taxes or revenue, collected by the Federal Government for financing special programs.
Vessel	A watercraft, other than a seaplane on the water, used or capable of being used as a means of transportation on water (e.g., a ship).



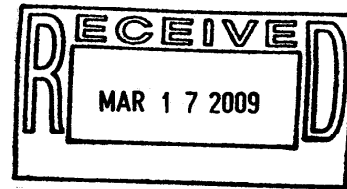
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Appendix IX

Management's Response to the Draft Report



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



March 17, 2009

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

Christopher Wagner *Fanis R. Funk for*
Commissioner, Small Business/Self-Employed Division

SUBJECT:

Draft Audit Report – The Fuel Excise Tax Compliance Program Has Made Significant Progress, but Program Improvements Are Needed to Increase Highway Trust Fund Revenue (Audit #200820006)

Thank you for the opportunity to review your draft report titled “The Fuel Excise Tax Compliance Program Has Made Significant Progress, but Program Improvements Are Needed to Increase Highway Trust Fund Revenue.”

We agree in principle with all but one of the recommendations in this report. We strongly agree that a credible estimate of the fuel tax gap would be beneficial to tax administration and policy makers. In a meeting with Treasury Inspector General for Tax Administration (TIGTA) officials on January 14, 2009, the IRS Director of the Office of Research, Analysis, and Statistics (RAS), who is responsible for developing estimates of the tax gap, emphasized that a valid estimate of motor fuel excise tax gap does not currently exist. For this reason, we do not agree with the estimated tax gap for fuel taxes cited in the report. The report excerpts the following statement from the Federal Highway Administration (FHWA) Office of Transportation Policy Studies website: “Motor fuel excise tax evasion is estimated to be from \$1 billion annually to as much as 25 percent of total revenues.” The FHWA includes a disclaimer on the website stating that no accurate estimate of the tax gap for fuel taxes exists. Rather than continue to use questionable statements about the size of the potential compliance problem, we believe a statement to the effect that no credible motor fuel excise tax gap estimate currently exists would effectively underscore the need to develop such estimates.

Fuel transaction reporting through the Excise Summary Terminal Reporting System (ExSTARS) and compliance research within the Joint Operations Center for National Fuel Compliance (JOC) will provide an important component to the development of a credible estimation methodology in the future. We intend to continue efforts with our Federal and state partners, including the FHWA, to determine the feasibility of estimating the motor fuels tax gap. We will also evaluate the adequacy of Excise Tax



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Program measures for managing compliance resources, monitoring enforcement results and assuring program effectiveness.

We have taken significant action since 2006 to strengthen the penalty program and will continue our efforts in this area. The Treasury Excise Working Group has assisted us in developing a procedure for properly certifying collected amounts of assessed penalties and transferring them to the Highway Trust Fund. We will enhance the fiscal year end data provided in our annual report for the FHWA to ensure the report contains information on the amount of prior year penalties that are abated during the appeals process. In addition we will complete the report by November 30, each year in the future.

The Excise Tax Program will continue its work with oil industry representatives to implement information reporting at refineries. We will continue to capture data reflecting fuel strategy cases and aggregate it in a monthly report for management. We do not agree that the use of the Integrated Data Retrieval System (IDRS) is the proper system to use in reporting out our program efforts. We believe the Excise Tax Program should be consistent with other IRS operations and will continue use of the Enforcement Revenue Information System (ERIS) for reporting.

We have detailed in the attachment those actions we will undertake to address the recommendations.

If you have any questions, please call me at (202) 622-0600 or John Imhoff, Director, Specialty Programs, Small Business/Self-Employed Division, at (215) 861-1176.

Attachment



The Fuel Excise Tax Compliance Program Has Made Significant Progress, but Program Improvements Are Needed to Increase Highway Trust Fund Revenue

Attachment

The **Commissioner Small Business/Self-Employed Division** should ensure that:

RECOMMENDATION 1:

The Excise Tax Program continues to work with oil industry representatives to implement information reporting at the refineries. If these efforts are unsuccessful, the Excise Tax Program should pursue regulatory options by working with the Department of the Treasury and/or the Office of Legislative Affairs to propose regulations/legislation requiring oil companies to file information documents reporting the products received at and transported from refineries.

CORRECTIVE ACTIONS:

We agree to work with oil industry representatives to implement information reporting at the refineries. IRS Chief Counsel advises that existing Internal Revenue Code Section 4101(d) allows the Secretary of the Treasury to require information reporting by refiners, as taxable fuel registrants. Although sustained implementation efforts will remain contingent in the future upon IRS strategic priorities and funding, we are currently partnering with industry and identifying refinery reporting requirements. We will develop a strategy document by October 15, 2009, outlining potential actions for implementing information reporting at refineries.

IMPLEMENTATION DATE:

October 15, 2009

RESPONSIBLE OFFICIAL:

Director, Specialty Programs, SB/SE Division

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Specialty Programs, SB/SE Division will advise the Commissioner, SB/SE Division of any delays in accomplishing this corrective action.

RECOMMENDATION 2:

The Excise Tax Program works with the FHWA to validate the amount of the motor fuel excise tax gap and the compliance rate.

CORRECTIVE ACTIONS:

We agree in principle with this recommendation since a credible estimate of the motor fuel excise tax does not exist. The tax gap consists of three mutually exclusive types of noncompliance: filing, reporting, and payment noncompliance. Each component of the tax gap requires a different estimation strategy. We have taken steps through the Excise Summary Terminal Reporting System (ExSTARS) and within the Joint Operations Center for National Fuel Compliance (JOC) to ensure reporting of fuel transactions and develop methodologies to estimate the tax gap. However, IRS will need to assess whether additional data are needed. Along with the Office of Research, Analysis and Statistics, we will work with federal and state partners, including FHWA, to determine the feasibility of developing the methodologies needed to estimate motor fuel excise tax gap.



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IMPLEMENTATION DATE:

October 15, 2010

RESPONSIBLE OFFICIAL:

Director, Specialty Programs, SB/SE Division

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Specialty Programs, SB/SE Division will advise the Commissioner, SB/SE Division of any delays in accomplishing this corrective action.

RECOMMENDATION 3:

The Examination Returns Control System tracking the fuel strategy cases is updated to allow tracking of cases identifiable by multiple strategies.

CORRECTIVE ACTIONS:

We agree in principle with this recommendation. However, at this time, only one tracking code may be entered to the Examination Returns Control System (ERCS) on each controlled tax period. It would not be cost effective to make a significant computer programming change to ERCS to allow entry of multiple tracking codes for the limited number of multiple coded excise tax returns annually. (Fewer than 800 Forms 720 with multiple tracking codes were received during FY 2008.)

During 2008, the Excise Tax Program developed a Fuel Strategy Feedback Sheet to capture the completed case results of field operations. The feedback sheet lists all fuel strategies and is used to record the associated tax adjustment amounts for each. It is also used to gather case information to evaluate the effectiveness of each fuel strategy in order to improve issue identification. Results from the feedback sheets are aggregated in a monthly progress report about fuel strategies for SB/SE management. We will continue to use the Fuel Strategy Feedback Sheets to compile and evaluate data on returns evidencing multiple fuel strategies.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 4:

The Excise Tax Program works with the FHWA and completes the element in the Joint IRS and FHWA Strategy to Address Fuel Tax Noncompliance to develop program measures for the components of the motor fuel evasion program to assess the successes and identify opportunities to redirect resources, if necessary.



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CORRECTIVE ACTIONS:

We agree with this recommendation. The Excise Tax Joint Operations Center (JOC) has already taken actions to complete this recommendation. The JOC has established strategic data analysis and compliance initiatives to identify and address motor fuel tax evasion activities. The IRS and FHWA meet bi-monthly to discuss JOC analysis and initiatives. The IRS includes the results of fuel tax evasion efforts and associated resource management in its annual report to FHWA.

IMPLEMENTATION DATE:

Completed

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 5:

The Excise Tax Program applies the penalty for failure to file timely and accurate information documents consistently to all taxpayers.

CORRECTIVE ACTIONS:

We agree that penalties should be administered in a consistent manner. The Excise Tax Program has taken actions since 2006 to strengthen the penalty program and we will continue our efforts in this area. For this reason, we believe no corrective actions are needed. An ExSTARS Compliance Manager's position was established in January 2007. Between May 2007 and June 2008, we hired and trained four analysts to staff the Penalty Compliance team. We have developed procedural guidelines, quality reviews and managerial oversight to assure consistent application of penalties for failure to file timely and accurate information documents to all taxpayers. During August 2008, Internal Revenue Manual (IRM) section 4.24.9, "Excise Tax Penalty Procedures" was approved and distributed. We have proactively educated taxpayers about information reporting requirements, including mandatory electronic reporting. We have implemented processes for considering reasonable cause penalty reliefs and have established an Appeals Settlement Procedure (ASP). The ASP approved in May 2008, addresses previously closed cases for which the taxpayer has requested reasonable cause penalty abatement of penalties. The settlement procedure now applies to penalties applied under Internal Revenue Code (IRC) Section 6725 and may be expanded in the future.

IMPLEMENTATION DATE:

Completed

RESPONSIBLE OFFICIAL:

N/A



The Fuel Excise Tax Compliance Program Has Made Significant Progress, but Program Improvements Are Needed to Increase Highway Trust Fund Revenue

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CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 6:

The Excise Tax Program coordinates with the Chief Financial Officer to establish procedures to ensure that funds collected from the assessment of the failure to file timely and accurate information documents and/or any other ExFIRS compliance-related penalties are transferred to the Highway Trust Fund.

CORRECTIVE ACTIONS:

We agree with this recommendation. The Excise Tax Program has coordinated with the Chief Financial Officer to ensure that collected amounts of assessed ExFIRS penalties are properly certified and transferred to the Highway Trust Fund. We addressed the certification issue with representatives of Treasury Department, Financial Management Services (FMS) and the Bureau of Public Debt in the Treasury Excise Working Group during 2008. These group discussions yielded a procedure for certifying penalty amounts to the Highway Trust Fund. The IRS Excise Tax Certification Letter to the Highway Trust Fund, issued February 17, 2009, included amounts for penalties collected from 2006 through 2008. By September 15, 2009, a subsequent revenue certification will include penalty amounts collected that had not been previously certified, and the revenue certifications will be completely current, including any penalty amounts assessed that have been collected.

IMPLEMENTATION DATE:

September 15, 2009

RESPONSIBLE OFFICIAL:

Director, Office of Revenue Systems, Chief Financial Officer

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Office of Revenue Systems will advise the Associate Chief Financial Officer for Revenue of any delays in accomplishing this corrective action.

RECOMMENDATION 7:

Performance measures and outcomes such as return on investment, compliance rate, and change in excise tax gap are developed and used to assess program effectiveness in improving fuel tax compliance.

CORRECTIVE ACTIONS:

We agree in principle with this recommendation. We will partner with the Office of Research, Analysis, and Statistics to assess the proper use of measures that are consistent with other operations within the IRS. The Excise Tax Program has established and currently maintains program measures necessary to manage compliance resources, monitor enforcement results and assure program effectiveness. By October 15, 2010 we will evaluate the adequacy of existing program measures. We disagree with the recommendation to use estimated compliance rates and estimated changes in the motor fuels excise tax gap as performance measures. While such measures can be used as long term strategic



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goals, they should not be used as performance measures. This is because these measures show the amount of tax that is paid voluntarily and timely, but not the true tax liability. The estimated tax gap and compliance rate for a particular tax year lags several years behind the performance fiscal year, making it impossible to use these as timely performance measures. Moreover, both the tax gap and the associated compliance rates are influenced by external factors, such as changes in the overall economic conditions, further complicating use of these estimates as performance measures.

IMPLEMENTATION DATE:

October 15, 2010

RESPONSIBLE OFFICIAL:

Director, Specialty Programs, SB/SE Division

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Specialty Programs, SB/SE Division will advise the Commissioner, SB/SE Division of any delays in accomplishing this corrective action.

RECOMMENDATION 8:

Penalty information contained in the annual status report to the DOT is based on information obtained from the Integrated Data Retrieval System.

CORRECTIVE ACTIONS:

We do not agree with this recommendation. The IRS Master File accounts supply the data for both the Information Data Retrieval System (IDRS) and the Enforcement Revenue Information System (ERIS). The IDRS reports single account results, while ERIS reports cumulative results. The ERIS is, therefore, a more suitable reporting tool for delivering complete fiscal year (FY) results in the annual fuel tax evasion activities report delivered to the Department of Transportation (DOT). To maintain consistency with other IRS external reporting, we will continue to use the ERIS data to report net ExFIRS penalty assessments included in the two primary Master File components, Business Master File and Individual Master File.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 9:

Excise Tax Program management enhances the annual status reports to show penalty assessments, abatements, funds collected, and transfers for multiple years to clearly identify program trends for the Highway Trust Fund, providing greater program transparency and a more accurate reflection of program results.



The Fuel Excise Tax Compliance Program Has Made Significant Progress, but Program Improvements Are Needed to Increase Highway Trust Fund Revenue

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CORRECTIVE ACTIONS:

We agree with this recommendation. The IRS is currently working with FHWA and DOT to develop a mutually agreeable report format which will incorporate penalty assessments and abatements. We will use this format in the next report.

IMPLEMENTATION DATE:

December 15, 2009

RESPONSIBLE OFFICIAL:

Director, Specialty Programs, SB/SE Division

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Specialty Programs, SB/SE Division will advise the Commissioner, SB/SE Division of any delays in accomplishing this corrective action.

RECOMMENDATION 10:

Excise Tax Program management issues the annual status report to the DOT by September 30 as required by law.

CORRECTIVE ACTIONS:

We agree in principle with this recommendation. However, we do not have complete data or information for our activities for the year as of September 30. In conjunction with the DOT, we have determined that submitting a report on September 30 would not provide a complete or useful picture of our actions through the entire year, and, therefore, we do not submit the reports until we have the complete information. We will accelerate data analysis in order to deliver future reports by November 30.

IMPLEMENTATION DATE:

December 15, 2009

RESPONSIBLE OFFICIAL:

Director, Specialty Programs, SB/SE Division

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Specialty Programs, SB/SE Division will advise the Commissioner, SB/SE Division of any delays in accomplishing this corrective action.

Outcome Measures

We have reservations about the validity of the first outcome measure "Increased Revenue – Actual; \$1.7", due to the very small case sample upon which it relies. A random statistical sample of penalties assessed and subject to reasonable cause abatement and full penalty appeals consideration might have had less significant dollar results.



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We question the justification for the second outcome measure, "Reliability of Information – Actual; 5,765,000", because the annual report accurately reflected Fiscal Year End (FYE) aggregate data required by the FHWA. This is because the additional levels of detail and analysis have been recommended by TIGTA auditors but have not been requested by the recipient agency.