DESCRIPTION OF THE CHAIRMAN'S MODIFICATION TO THE PROVISIONS OF THE "ENERGY POLICY TAX INCENTIVES ACT OF 2005"

Scheduled for Markup
By the
SENATE COMMITTEE ON FINANCE
on June 16, 2005

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of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's modification to the provisions of the "Energy Policy Tax Incentives Act of 2005," which is to be marked up by the Senate Committee on Finance on June 16, 2005.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Modification to the Provisions of the "Energy Policy Tax Incentives Act of 2005"* (JCX-46-05), June 16, 2005.

A. Provisions Modifying the Proposals in the Chairman's Mark

1. Modifications to item A.1 of the Chairman's Mark relating to the renewable electricity production tax credit

The Chairman's modification extends the credit period from five years to 10 years for electricity produced from qualifying open-loop biomass facilities (including agricultural livestock waste nutrient facilities), geothermal facilities, solar facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities placed in service after the date of enactment. The modification extends the credit period from five years to 10 years for electricity produced from qualifying fuel cell facilities placed in service after December 31, 2005.

The Chairman's modification clarifies that a qualifying trash combustion facility includes a new unit that increases electricity production capacity placed in service after October 22, 2004, at an existing trash combustion facility.

The Chairman's modification also includes hydropower as a qualified energy resource and permits taxpayers to claim a credit at one-half the 1.5 cents-per-kilowatt-hour (indexed for inflation rate) for electricity attributable to "incremental hydropower" produced at qualified hydroelectric facilities during the 10-year period commencing when the facility is placed in service. A qualified hydroelectric facility is a facility that produces incremental hydropower placed in service after the date of enactment and before January 1, 2009. "Incremental hydropower" is additional electricity generation achieved from increased efficiency or additions of capacity at an existing hydroelectric facility. A "qualified hydroelectric facility" is a FERC-licensed minor diversion structure less than 10 feet in height or an existing non-hydro dam to which turbines or other generating devices are added to produce energy and that does not require enlargement of the impoundment or diversion structures in connection with the installation of the turbine or other generating device. All such facilities are subject to all applicable environmental laws and licensing and regulatory requirements.

2. Modification to item A.6 of the Chairman's Mark relating to the credit for investment in clean coal facilities

The Chairman's modification increases to 7,500 megawatts the amount of power generation capacity the Secretary of Treasury, in consultation with the Secretary of Energy, is authorized to allocate to qualified clean coal projects. The Secretary of Treasury must allocate 55 percent of the total power generation capacity to credit-eligible projects that use an integrated gasification combined cycle technology and 45 percent to credit-eligible projects that use other advanced coal-based technologies. The Chairman's modification also clarifies that lignite is a qualifying coal for a clean coal facility under the proposal.

3. Modification to item B.2 of the Chairman's Mark relating to temporary expensing for equipment used in the refining of liquid fuels

The Chairman's modification requires that as a condition of eligibility for the expensing of equipment used in the refining of liquid fuels, a refinery must report to the IRS concerning its refinery operations (e.g., production and output).

4. Modification to item B.4 of the Chairman's Mark relating to the enhanced oil recovery credit for carbon dioxide injections

The Chairman's modification expands the definition of qualified enhanced oil recovery project to include "deep gas" well projects. Deep gas is natural gas produced from onshore formations deeper than 20,000 feet. Under the modified proposal, the credit phases out using a barrel of oil equivalent for natural gas calculated based on Btu content. The modified proposal also requires that other conforming modifications to the credit be made. The credit for enhanced oil recovery with respect to deep gas wells expires after December 31, 2009.

5. Modification to item C.2 in the Chairman's Mark relating to energy efficient new homes

The modification clarifies that duct sealing and infiltration reduction measures qualify as an energy-efficient building envelope component.

6. Modification to item C.3 in the Chairman's Mark relating to business energy property

The modification clarifies that an oil, natural gas, or propane furnace or hot water boiler that achieves at least 95 percent annual fuel utilization efficiency is eligible for a deduction of $450. The modification further clarifies that a natural gas, propane, or oil water heater must have an energy factor of at least 0.80 to qualify for any deduction.

7. Modification to item C.4 in the Chairman's Mark relating to nonbusiness energy property

The modification clarifies that an oil, natural gas, or propane furnace or hot water boiler that achieves at least 95 percent annual fuel utilization efficiency is eligible for a credit of $150. The modification further clarifies that a natural gas, propane, or oil water heater must have an energy factor of at least 0.80 to qualify for any credit.

The modification also allows certified home inspectors to be eligible to provide certifications of the energy efficiency performance of principal residences.

8. Modification to item C.8 in the Chairman's Mark relating to business investment tax credit for fuel cells and microturbines

For purposes of the fuel cell and microturbine investment tax credit, the modification removes the restriction that prohibits telecommunication utilities from claiming the credit.

9. Modification to item C.9 in the Chairman's Mark relating to business solar investment tax credit

The modification makes hybrid solar lighting systems eligible solar energy property for purposes of the section 48 energy credit.

10. Modification to item D.1 of the Chairman's Mark relating to the alternative vehicle credit

The Chairman's modification changes the applicable emissions standards for a hybrid vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds from Bin 8 Tier II to Bin 5 Tier II.

B. Additional Energy Tax Incentives

1. Ten-year recovery period for underground natural gas storage facilities and cushion gas

Present Law

Under present law, depreciation allowances for property used in a trade or business generally are determined under the Modified Accelerated Cost Recovery System ("MACRS"). Under MACRS, natural gas storage facilities and related equipment have a class life of 22 years and a recovery period of 15 years.

Cushion gas is the minimum volume of natural gas necessary to provide the pressure to facilitate the flow of gas from a storage reservoir to a pipeline. Recoverable cushion gas will be available for sale or other use upon abandonment of the storage reservoir, while nonrecoverable cushion gas will become obsolete with that abandonment. Under present law, the tax treatment of cushion gas depends on whether such gas is recoverable. The quantity of cushion gas that is recoverable is not subject to depreciation because it is not subject to exhaustion, wear, tear, or obsolescence. Conversely, non-recoverable cushion gas is subject to obsolescence and is therefore subject to tax depreciation. The depreciable life of non-recoverable cushion gas is also 15 years.

Description of Proposal

The proposal reclassifies underground natural gas storage facilities and nonrecoverable cushion gas as ten-year MACRS property. The present law treatment of recoverable cushion gas remains unchanged.

Effective Date

The proposal applies to property placed in service after the date of enactment, the original use of which commences with the taxpayer.

2. Modify research credit for research relating to energy

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenses for a taxable year exceed its base amount for that year. The research tax credit is scheduled to expire and generally will not apply to amounts paid or incurred after December 31, 2005.

A 20-percent research tax credit also applies to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-

base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit (see sec. 41(e)).

Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

Eligible expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses). In the case of amounts paid to a research consortium, 75 percent of amounts paid for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 for the deduction for research expenses, but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which must constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component.

Description of Proposal

The proposal modifies the present-law research credit as it applies to qualified energy research. In particular, the proposal provides that the taxpayer may claim a credit equal to 20 percent of the taxpayer's expenditures on qualified energy research undertaken by an energy research consortium. The amount of credit claimed is determined only by regard to such expenditures by the taxpayer within the taxable year. Unlike the general rule for the research credit, the 20-percent credit for research by an energy research consortium applies to all such expenditures, not only those in excess of a base amount however determined. An energy research consortium is a qualified research consortium as under present law that also is organized and operated primarily to conduct energy research and development in the public interest and to which at least five unrelated persons paid, or incurred amounts, to such organization within the calendar year. In addition, to be a qualified energy research consortium, no single person shall pay or incur more than 50 percent of the total amounts received by the research consortium during the calendar year.

The proposal also provides that 100 percent of amounts paid or incurred by the taxpayer to eligible small businesses, universities, and the Federal government for qualified energy research would constitute qualified research expenses as contract research expenses, rather than 65 percent of qualified research expenditures allowed under present law. An eligible small business for this purpose is a business in which the taxpayer does not own a 50 percent or greater interest and the business has employed, on average, 500 or fewer employees in the two preceding calendar years.

Qualified energy research expenditures are expenditures that would otherwise qualify for the research credit under present law and relate to the production, supply, and conservation of energy, including otherwise qualifying research expenditures related to alternative energy sources or the use of alternative energy sources. For example, research relating to hydrogen fuel cell vehicles would qualify under this proposal, if the research expenditures otherwise satisfy the criteria of present-law section 41. Likewise, otherwise qualifying research undertaken to improve the energy-efficiency of lighting would qualify under this proposal.

Effective Date

The proposal is effective for amounts paid or incurred after the date of enactment in taxable years ending after such date.

3. Create small agri-biodiesel producer credit

Present Law

Biodiesel income tax credit

The Code provides an income tax credit for biodiesel and qualified biodiesel mixtures, the biodiesel fuels credit. The biodiesel fuels credit is the sum of the biodiesel mixture credit plus the biodiesel credit and is treated as a general business credit. The amount of the biodiesel fuels credit is includible in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions created by the Act.

The credit may not be carried back to a taxable year ending before or on December 31, 2004. The provision does not apply to fuel sold or used after December 31, 2006.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the EPA under section 211 of the Clean Air Act and (2) the requirements of the American Society of Testing and Materials D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer or importer of the biodiesel which identifies the product produced and the percentage of the biodiesel and agri-biodiesel in the product.

The biodiesel income tax credit does not contain any incentives for small producers.

Small ethanol producer credit

Present law provides several tax benefits for ethanol and methanol produced from renewable sources that are used as a motor fuel or that are blended with other fuels (e.g., gasoline) for such a use. In the case of ethanol, a separate 10-cents-per-gallon credit for up to 15 million gallons per year for small producers, defined generally as persons whose production does not exceed 15 million gallons per year and whose production capacity does not exceed 30 million gallons per year. The alcohol fuels tax credits are includible in income. The alcohol fuels tax credit is scheduled to expire after December 31, 2010.

Description of Proposal

The proposal adds to the biodiesel fuels credit a small agri-biodiesel producer credit. The credit is a 10-cents-per-gallon credit for up to 15 million gallons of biodiesel produced by small producers, defined generally as persons whose production capacity does not exceed 60 million gallons per year.

Effective Date

The proposal is effective for taxable years ending after the date of enactment.

4. Modification to the small ethanol producer credit

Present Law

Present law provides several tax benefits for ethanol and methanol that are used as a fuel or that are blended with other fuels (e.g., gasoline) for such a use. For example, the Code provides an income tax credit for alcohol and alcohol-blended fuels. In the case of ethanol, the

Code provides an additional 10-cents-per-gallon credit for small producers, defined generally as persons whose production capacity does not exceed 30 million gallons per year.[2]

Description of Proposal

The proposal increases the limit on production capacity for small ethanol producers from 30 million gallons to 60 million gallons per year.

Effective Date

The proposal is effective for taxable years ending after the date of enactment.

5. Qualified recycling equipment credit

Present Law

There is no present law credit for qualified recycling equipment.

Description of Proposal

The proposal provides a 15-percent business tax credit for the cost of qualified recycling equipment placed in service or leased by the taxpayer. Qualified recycling equipment means equipment, including connecting piping, employed in sorting or processing residential and commercial qualified recyclable materials for the purpose of converting such materials for use in manufacturing tangible consumer products, including packaging. Such term includes equipment that is utilized at commercial or public venues, including recycling collection centers, where the equipment is utilized to sort or process qualified recyclable materials for such purpose. Such term does not include rolling stock or other equipment used to transport recyclable materials.

Qualified recyclable materials are any packaging or printed material which is glass, paper, plastic, steel, or aluminum generated by an individual or business and which has been separated from solid waste for the purposes of collection and recycling.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2005.

6. Five-year carryback of net operating losses of certain electric utility companies

Present Law

A net operating loss ("NOL") is, generally, the amount by which a taxpayer's allowable deductions exceed the taxpayer's gross income. A carryback of an NOL generally results in the

[2] Secs. 40(b)(4) and (g)(1). The alcohol fuels tax credit (which is comprised of the small ethanol producer credit, the alcohol mixture credit, and the alcohol credit) is scheduled to expire after December 31, 2010 (sec. 40(e)(1)).

refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year.

In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.[3] Different rules apply with respect to NOLs arising in certain circumstances. For example, a three-year carryback applies with respect to NOLs (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback period applies to NOLs from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area). Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction).

Section 202 of the Job Creation and Worker Assistance Act of 2002[4] ("JCWAA") provided a temporary extension of the general NOL carryback period to five years (from two years) for NOLs arising in taxable years ending in 2001 and 2002. In addition, the five-year carryback period applies to NOLs from these years that qualify under present law for a three-year carryback period (i.e., NOLs arising from casualty or theft losses of individuals or attributable to certain Presidentially declared disaster areas).

A taxpayer can elect to forgo the five-year carryback period. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the losses are subject to the rules that otherwise would apply under section 172 absent the provision.

Description of Proposal

The proposal provides a temporary extension of the NOL carryback period to five years for NOLs of certain electric utility companies arising in taxable years ending in 2003, 2004, and 2005 ("eligible NOLs"). Regardless of the taxable year in which an eligible NOL arose, refund claims resulting from the extended carryback period can be made during any taxable year ending after December 31, 2005, and before December 31, 2008. However, the amount of the refund claimed during any one taxable year may not exceed the electric utility company's investment in electric transmission property and pollution control facilities in the preceding taxable year. Taxpayers may elect to forgo the five-year carryback period provided under the proposal if an election is filed before December 31, 2008.

Effective Date

The proposal is effective for refund claims resulting from net operating losses generated in taxable years ending in 2003, 2004, and 2005.

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[3] Sec. 172.

[4] Pub. Law No. 107-147.

7. Qualifying pollution control equipment credit

Present Law

The investment credit is the sum of the rehabilitation credit, and the energy credit. The investment credit is part of the general business credit.

Description of Proposal

The proposal adds a credit for qualifying pollution control equipment to the investment credit. The qualifying pollution control equipment credit provides a 15-percent tax credit for qualifying pollution control equipment placed in service at a qualifying facility during the taxable year. Qualifying pollution control equipment means any technology that is installed in or on a qualifying facility to reduce air emissions of any pollutant regulated by the EPA under the Clean Air Act, including thermal oxidizers, scrubber systems, vapor recovery systems, low nitric oxide burners, flare systems, bag houses, cyclones, and continuous emission monitoring systems. A qualifying facility is a facility that produces not less than 1 million gallons of ethanol during the taxable year. For depreciation purposes, the basis of qualifying pollution control equipment would be reduced by 50 percent of the value of the credit.

Effective Date

The credit is available for property placed in service after date of enactment.

8. Credit for production of Indian country coal

Present Law

Present law provides two income tax incentives for businesses operating within Indian reservations: (1) accelerated depreciation with respect to certain non-gaming property used in a trade or business within an Indian reservation (sec. 168(j)); and (2) a nonrefundable income tax credit to employers on the first $20,000 of qualified wages and health care costs paid to certain members of Indian tribes (or their spouses) who work on or near an Indian reservation and who earn less than $30,000 per year (adjusted for inflation beginning in 1993) (sec. 45A). Both credits expire after December 31, 2005.

Present law does not provide a credit for the production of coal from coal reserves owned by an Indian tribe.

Description of Proposal

The proposal establishes a nontransferable credit (indexed for inflation after 2006) for "Indian Country Coal" sold to a utility or other entity that operates a utility unit. Indian Country Coal is defined as coal delivered to a purchaser by common carrier railroad or highway truck, that is produced from coal reserves owned by a Federally recognized tribe of Indians, including coal held in trust by the United States for the tribe or its members. The amount of the credit equals $1.50 per ton for coal sold in 2006 through 2010 and $2.00 per ton for coal sold after

2010. No credit is allowed for sales after 2012. The credit is allowed against the alternative minimum tax.

Effective Date

The proposal applies to Indian Country Coal sold to a utility or utility unit after December 31, 2005.

9. Wood stoves for EPA non-attainment areas

Present Law

There is no present-law tax credit related to wood stoves.

Description of Proposal

The proposal provides a $500 credit for the replacement of a non-compliant wood stove with a stove that complies with Environmental Protection Agency ("EPA") emission performance standards. In general, a non-compliant wood stove is any wood stove purchased prior to June 30, 1992. Stoves produced after June 30, 1992 must comply with EPA's "Standards of Performance for Residential Wood Heaters." The credit is only available for replacements that occur in areas designated by the EPA as non-attainment areas for particulate matter less than 2.5 micrometers in diameter or non-attainment areas for particulate matter less than 10 micrometers in diameter.

Effective Date

The credit applies to wood stoves purchased after the date of enactment and before January 1, 2009.

10. Exemption of bulk beds for farm crops from the Federal excise tax on heavy trucks and trailers

The Code imposes a 12-percent excise tax on the first retail sale of heavy trucks and trailers (chassis and bodies.[5] Under present law, the tax on the first retail sale of automobile truck bodies does not apply to any body primarily designed (1) to process or prepare seed, feed, or fertilizer for use on farms, (2) to haul feed, seed, or fertilizer to and on farms, (3) to spread feed, seed, or fertilizer on farms, (4) to load or unload feed, seed, or fertilizer on farms, or (5) for any combination of the foregoing.[6]

[5] Sec. 4051(a).

[6] Sec. 4053(2).

Description of Proposal

The proposal exempts bulk beds used for transporting farm crops to and on farms from the excise tax on the retail sale heavy trucks and trailers if sold to a person who certifies to the seller that such person is actively engaged in the trade or business of farming and the primary use of the bulk bed is to haul to and on farms farm crops grown in connection with such trade or business. The proposal provides for the recapture of the tax from the purchaser upon resale of within two years of the first retail sale, or if such purchaser makes substantial nonexempt use of the article.

Effective Date

The proposal is effective for sales after September 30, 2005.

11. National Academy of Sciences study

Present Law

Present law does not provide for a study of the health, environmental, security, and infrastructure external costs that may be associated with the use and production of energy.

Description of Proposal

The proposal requires the Secretary of Treasury to enter into an agreement, within 60 days, with the National Academy of Sciences to conduct a study to define and evaluate the health, environmental, security, and infrastructure external costs and benefits associated with energy activities that are not or may not be fully incorporated into the price of such activities, or into the Federal tax or fee or other applicable revenue measure related to such activities. The results of the study are to be submitted to Congress within two years of the agreement.

Effective Date

The proposal is effective on the date of enactment.

C. Revenue Raising Provisions

1. Treatment of kerosene for use in aviation

Present Law

In general, aviation-grade kerosene is taxed at a rate of 21.8 cents per gallon upon removal of such fuel from a refinery or terminal (or entry into the United States).[7] Aviation-grade kerosene may be removed at a reduced rate, either 4.3 or zero cents per gallon, if the aviation fuel is removed directly into the fuel tank of an aircraft for use in commercial aviation[8] or for a use that is exempt from the tax imposed by section 4041(c) (other than by reason of a prior imposition of tax),[9] or is removed or entered as part of an exempt bulk transfer.[10] These taxes are credited to the Airport and Airway Trust Fund.[11] If taxed aviation-grade kerosene is used for a nontaxable use, a claim for credit or refund may be made.[12] Such claims are paid from the Airport and Airway Trust Fund to the general fund of the Treasury.[13] All other removals and entries of kerosene used for surface transportation are taxed at the diesel tax rate of 24.3 cents per gallon,[14] and these taxes are credited to the Highway Trust Fund.[15] If aviation-grade

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[7] Sec. 4081(a)(2)(A)(iv). (An additional 0.1 cent is imposed on aviation-grade kerosene and credited to the Leaking Underground Storage Tank ("LUST" Trust Fund). Sec. 4081(a)(2)(B). The LUST Trust Fund tax is set to expire after September 30, 2005. Sec. 4081(d)(3).

[8] Sec. 4081(a)(2)(C).

[9] Sec. 4082(e). Exempt uses include use in commercial aviation as supplies for vessels or aircraft, which includes use by certain foreign air carriers and for the international flights of domestic carriers. Secs. 4082(e), 6427(l)(2), and 4221(d)(3),

[10] Sec. 4081(a)(1)(B).

[11] Sec. 9502(b)(1)(C).

[12] Sec. 6427(l)(4). Nontaxable uses include: (1) use other than as fuel in an aircraft (such as use in heating oil); (2) use on a farm for farming purposes; (3) use in a military aircraft owned by the United States or a foreign country; (4) use in a domestic air carrier engaged in foreign trade or trade between the United States and any of its possessions; (5) use in a foreign air carrier engaged in foreign trade or trade between the United States and any of its possessions (but only if the foreign carrier's country of registration provides similar privileges to United States carriers); (6) exclusive use of a State or local government; (7) sales for export, or shipment to a United States possession; (8) exclusive use by a nonprofit educational organization; (9) use by an aircraft museum exclusively for the procurement, care, or exhibition of aircraft of the type used for combat or transport in World War II; and (10) use as a fuel in a helicopter or a fixed-wing aircraft for purposes of providing transportation with respect to which certain requirements are met. Secs. 4041(f)(2), 4041(g), 4041(h), 4041(l), and 6427(l)(2)(B)(i).

[13] Sec. 9502(d)(2).

[14] Sec. 4081(a)(2)(iii).

[15] Sec. 9503(b)(1)(D).

kerosene is taxed upon removal or entry but used for surface transportation, the taxes remain in the Airport and Airway Trust Fund, and the Highway Trust Fund is not credited for the taxes on such fuel.

Description of Proposal

The proposal imposes the diesel tax rate of 24.3 cents per gallon upon the entry or removal of aviation-grade kerosene. The present law reduced-rates for removals of aviation-grade kerosene directly into the fuel tank of an aircraft apply,[16] except that in addition, under the proposal, if kerosene is removed directly into the fuel tank of an aircraft for use in aviation other than commercial aviation, the rate of tax is 21.8 cents per gallon. The rate is also 21.8 cents per gallon for the removal of aviation-grade kerosene at the following airports: Miami International Airport (T-65-FL-2159), LaGuardia (T-11-NY-1335), and Cleveland North (T-34-OH-3175).

The proposal provides that amounts may be claimed as credits or refunds for kerosene that is used for aviation purposes. If kerosene is used for noncommercial aviation, the amount is 2.5 cents; if kerosene is used for commercial aviation, the amount is 20 cents; if kerosene is used for a use that is exempt from tax (as determined under present law), the amount is 24.3 cents. Present law rules with respect to claims apply, except for claims with respect to kerosene used in noncommercial aviation, which are payable to the ultimate vendor only. To be eligible to receive a payment, a vendor must be registered and must show either that the price of the fuel did not include the tax and the tax was not collected from the purchaser, the amount of tax was repaid to the ultimate purchaser, or the written consent of the purchaser to the making of the claim was filed with the Secretary.

Under the proposal, all taxes collected at the 24.3 cents per gallon rate (under section 4081) initially are credited to the Highway Trust Fund. The proposal requires the Secretary to transfer at least monthly from the Highway Trust Fund into the Airport and Airway Trust Fund amounts equivalent to 21.8 cents per gallon for claims made with respect to kerosene used for noncommercial aviation purposes and 4.3 cents per gallon for claims made with respect to kerosene used for commercial aviation purposes. The proposal requires that transfers be made on the basis of estimates by the Secretary, with proper adjustments to be made subsequently to the extent prior estimates were in excess of or less than the amounts required to be transferred. Transfers are required to be made with respect to taxes received on or after October 1, 2005, and before October 1, 2011.

[16] For example, for kerosene removed directly into the fuel tank of an aircraft for use in commercial aviation by a person registered for such use, the rate of tax is 4.3 cents per gallon. Kerosene removed directly into the fuel tank of an aircraft for an exempt use is not taxed. For purposes of these reduced rates**,** it is intended that the following airports be included on the Secretary's expanded list of airports that include a secured area in which a terminal is located: Los Angeles International Airport (T-95-CA-4812) and Federal Express Corporation Memphis (T-62-TN-2220).

Effective Date

The provision is effective for fuels or liquids removed, entered, or sold after September 30, 2005.

2. Repeal of ultimate vendor refund claims with respect to diesel and kerosene used for farming purposes

Present Law

Ultimate purchaser refunds for nontaxable uses

In general, the Code provides that if diesel fuel or kerosene on which tax has been imposed is used by any person in a nontaxable use, the Secretary is to refund (without interest) to the ultimate purchaser the amount of tax imposed.[17] The refund is made to the ultimate purchaser of the taxed fuel by either income tax credit or refund payment.[18] Not more than one claim may be filed by any person with respect to fuel used during its taxable year. However, there are exceptions to this rule.

An ultimate purchaser may make a claim for a refund payment for any quarter of a taxable year for which the purchaser can claim at least $750.[19] If the purchaser cannot claim at least $750 at the end of quarter, the amount can be carried over to the next quarter to determine if the purchaser can claim at least $750. If the purchaser cannot claim at least $750 at the end of the taxable year, the purchaser must claim a credit on the person's income tax return.

As discussed below, these ultimate purchaser refund rules do not apply to diesel fuel or kerosene used on a farm. The Code precludes the ultimate purchaser from claiming a refund for such use. Instead, the refund claims are made by registered ultimate vendors as described below.

Special ultimate vendor rule for fuel used on a farm for farming purposes

In the case of diesel fuel or kerosene used on a farm for farming purposes refund payments are paid to the ultimate, registered vendors ("registered ultimate vendor") of such fuels. Thus a registered ultimate vendor that sells undyed diesel fuel or undyed kerosene to any of the following may make a claim for refund: (1) the owner, tenant, operator of a farm for use by that person on a farm for farming purposes; and (2) a person other than the owner, tenant, or operator of a farm for use by that person on a farm in connection with cultivating, raising or harvesting. The registered ultimate vendor is the only person who may make the claim with

[17] Sec. 6427(l)(1).

[18] Generally, refund payments are only made to governmental units and tax-exempt organizations. Sec. 6427(k). The quarterly payment claim rules for ultimate purchasers are an exception to this rule.

[19] Sec. 6427(i)(2).

respect to diesel fuel or kerosene used on a farm for farming purposes. The purchaser of the fuel cannot make the claim for refund.

Registered ultimate vendors may make weekly claims if the claim is at least $200 ($100 or more in the case of kerosene).[20] If not paid within 45 days (20 days for an electronic claim), the Secretary is to pay interest on the claim.

Description of Proposal

The proposal repeals ultimate vendor refund claims in the case of diesel fuel or kerosene used on a farm for farming purposes. Thus, refunds for taxed diesel fuel or kerosene used on a farm for farming purposes are paid to the ultimate purchaser under the rules applicable to nontaxable uses of diesel fuel or kerosene.

Effective Date

The proposal is effective for sales after September 30, 2005.

3. Refunds of excise taxes on exempt sales of taxable fuel by credit card

Present Law

Under the rules in effect prior to 2005, in the case of gasoline on which tax had been paid and sold to a State or local government, to a nonprofit educational organization, for supplies for vessels or aircraft, for export, or for the production of special fuels, the wholesale distributor that sold such gasoline was treated as the only person who paid the tax and thereby was the proper claimant for a credit or refund of the tax paid. A "wholesale distributor" included any person, other than an importer or producer, who sold gasoline to producers, retailers, or to users who purchased in bulk quantities and accepted delivery into bulk storage tanks. A wholesale distributor also included any person who made retail sales of gasoline at 10 or more retail motor fuel outlets.

Under a special administrative exception to these rules, a sale of gasoline charged on an oil company credit card issued to an exempt person described above is not considered a direct sale by the person actually selling the gasoline to the ultimate purchaser if the seller receives a reimbursement of the tax from the oil company (or indirectly from an intermediate vendor). Thus, the person that actually paid the tax, in most cases the oil company, is treated as the only person eligible to make the refund claim.[21]

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[20] Sec. 6427(i)(4)(A).

[21] Notice 89-29, 1989-1 C.B. 669.

The American Jobs Creation Act of 2004 ("AJCA")[22] modified the pre-existing statutory rules with respect to certain sales. Under AJCA, if a registered ultimate vendor purchases any gasoline on which tax has been paid and sells such gasoline to a State or local government or to a nonprofit educational organization, for its exclusive use, such ultimate vendor is treated as the only person who paid the tax and thereby is the proper claimant for a credit or refund of the tax paid.[23] However, AJCA did not change the special administrative oil company credit card rule described above.[24]

In addition, under AJCA, refund claims made by such an ultimate vendor may be filed for any period of at least one week for which $200 or more is payable. Any such claim must be filed on or before the last day of the first quarter following the earliest quarter included in the claim. The Secretary must pay interest on refunds unpaid after 45 days. If the refund claim was filed by electronic means, and the ultimate vendor has certified to the Secretary for the most recent quarter of the taxable year that all ultimate purchasers of the vendor are certified for highway exempt use as a State or local government or a nonprofit educational organization, refunds unpaid after 20 days must be paid with interest.[25]

In the case of diesel fuel or kerosene used in a nontaxable use, the ultimate purchaser is generally the only person entitled to claim a refund of excise tax.[26] However, in the case of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, aviation-grade kerosene, and certain nonaviation-grade kerosene, an ultimate vendor may claim the refund if the ultimate vendor is registered and bears the tax (or receives the written consent of the ultimate purchaser to claim the refund).[27]

Description of Proposal

The proposal replaces the oil company credit card rule with a new set of rules applicable to certain credit card sales. The new rules apply to gasoline, diesel fuel, and kerosene. Under the proposal, if a purchase of taxable fuel is made by means of a credit card issued to an ultimate purchaser that is either a State or local government or, in the case of gasoline, a nonprofit educational organization, for its exclusive use, a credit card issuer who is registered and who

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[22] Pub. L. No. 108-357.

[23] AJCA, sec. 865(a), effective January 1, 2005. See Code sec. 6416(a)(4)(A).

[24] In Notice 2005-4, 2005-2 I.R.B. 289, the Treasury Department confirmed that it would continue to apply the oil company credit card rule until March 1, 2005. On February 28, 2005, the Treasury Department issued Notice 2005-24, 2005-12 I.R.B. 1, modifying Notice 2005-4. Notice 2005-24 stated that the oil company credit card rule will remain in effect until it is modified by a statutory change or by future guidance.

[25] Sec. 6146(a)(4)(B).

[26] Sec. 6427(l)(1).

[27] See secs. 6427(l)(4)(B), (l)(5)(B), and (l)(5)(C), and sec. 6416(a)(1)(A), (B), and (D).

extends such credit to the ultimate purchaser with respect to such purchase shall be the only person entitled to apply for a credit or refund if the following two conditions are met: (1) such registered person has not collected the amount of the tax from the purchaser, or has obtained the written consent of the ultimate purchaser to the allowance of the credit or refund; and (2) such registered person has either repaid or agreed to repay the amount of the tax to the ultimate vendor, has obtained the written consent of the ultimate vendor to the allowance of the credit or refund, or has otherwise made arrangements that directly or indirectly assure the ultimate vendor of reimbursement of such tax. It is anticipated that such indirect arrangements may consist of the contractual undertaking of the relevant oil company to the credit card company that it will cover over the tax to the ultimate vendor, and the corresponding contractual undertaking of the oil company to the ultimate vendor.

If a credit card issuer is not registered, or if either condition (1) or (2) above is not met, then the credit card issuer must collect an amount equal to the tax from the ultimate purchaser, and only the ultimate purchaser may claim a credit or payment from the IRS.[28] Thus, tax-paid fuel must not be sold tax free to an exempt entity by means of a credit card unless the credit card issuer is registered. An unregistered credit card issuer that does not collect an amount equal to the tax from the exempt entity is liable for present-law penalties for failure to register.[29] It is intended that the IRS will review the registration of a registered credit card issuer that has engaged in multiple violations of the requirements of the proposal.

A credit card issuer entitled to claim a refund under the proposal is responsible for supplying all the appropriate documentation currently required from ultimate vendors. The present-law refund amount and timing rules applicable to ultimate vendors, including the special rules for electronic claims, apply to refunds to credit card issuers under the proposal.[30]

The proposal also conforms present-law penalty provisions to the new rules.

The proposal does not change the present-law rules applicable to non-credit card purchases.

Effective Date

The proposal is effective for sales after December 31, 2005.

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[28] See sec. 6421(c).

[29] See secs. 6719, 7232, and 7272.

[30] See sec. 6416(a)(4)(B). Present law would continue to apply to the timing of ultimate purchaser claims. Under present law, claims by an ultimate purchaser are generally made on an annual basis. However, claims aggregating over $750 may be made quarterly. See secs. 6421(d) and 6427(i)(2).

4. Recertification of exempt status

Present Law

If gasoline is sold to any person for an exempt use, an ultimate purchaser that has borne the tax is entitled to claim a refund.[31] However, a registered ultimate vendor is the appropriate person to claim a refund of Federal excise taxes on gasoline sold to a State or local government or to a nonprofit educational organization.[32]

In general, in order to claim a refund of Federal excise taxes on gasoline (and on other articles subject to manufacturers excise taxes under Chapter 32 of the Code) sold to a State or local government or to a nonprofit educational organization, for its exclusive use, a claimant must submit a statement indicating that it possesses evidence of the exempt use giving rise to the overpayment of tax.[33] Such evidence consists of a certificate executed and signed by the ultimate purchaser. The ultimate purchaser certificate must be signed by the ultimate purchaser and must identify the article, show the name and address of the ultimate purchaser, and state the exempt use made or to be made of the article. In the case where the certificate sets forth the use to be made of the article, rather than its actual use, it must show that the ultimate purchaser has agreed to notify the claimant if the article is not in fact used as specified in the certificate.[34]

However, if the article to which the claim relates has passed through a chain of sales from the claimant to the ultimate purchaser, a certificate from the ultimate vendor is sufficient. The ultimate vendor certificate contains the exempt sales information, and a statement that it possesses the ultimate purchaser certificates and will forward them to the claimant within three years from the date of the statement. An ultimate vendor statement may be made covering no more than 12 consecutive calendar quarters.[35]

In general, an ultimate purchaser is the proper party to claim a refund of Federal excise tax on diesel fuel or kerosene used by any person in a nontaxable use.[36] However, in the case of diesel or kerosene used by a State or local government, the ultimate vendor is the proper person

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[31] Sec. 6421(c).

[32] Sec. 6416(a)(4)(A).

[33] Treas. Reg. sec. 48.6416(b)(2)-3(a)(5).

[34] Treas. Reg. sec. 48.6416(b)(2)-3(b)(1)(i) and (ii). The certificate must also contain a statement that the ultimate purchaser understands that it and any other party may, for fraudulent use of the certificate, be subject under section 7201 to a fine of not more than $10,000, or imprisonment for not more than five years, or both, together with the costs of prosecution.

[35] Treas. Reg. sec. 48.6416(b)(2)-3(b)(1)(i) and (iii).

[36] Sec. 6427(l)(1). In the case of diesel fuel or kerosene, a nontaxable use is any use which is exempt from the tax imposed by section 4041(a)(1) other than by reason of a prior imposition of tax. Sec. 6427(l)(2).

if such vendor is registered and has borne the tax.[37] A registered ultimate vendor claiming a refund under this provision must provide a statement that it has in its possession an unexpired exemption certificate of the purchaser and that the claimant has no reason to believe any information in the certificate is false.[38]

A State or local government includes any political subdivision of a State, or the District of Columbia.[39] A nonprofit educational organization means an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on, and which is either exempt from income tax under section 501(a) or is a school operated as an activity of an organization described in section 501(c)(3) which is exempt from income tax under section 501(a).[40]

Description of Proposal

Under the proposal, additional documentation requirements are imposed with respect to purchases of taxable fuel and certain other articles on a nontaxable basis by State or local governments and nonprofit educational organizations, and with respect to refunds or credits by any person with respect to such purchases. The proposal covers Federal excise taxes on sales of gasoline, diesel fuel, kerosene, compressed natural gas (except if sold for use on school buses or intracity buses), heavy trucks and trailers, and tires (except for tires sold for use on qualified buses). The proposal does not cover Federal excise taxes on sales of coal, recreational equipment (bows and arrows, sport fishing equipment and firearms), and vaccines.

In addition to present-law documentation requirements, in order for a State or local governmental entity to claim exemption from tax on sales of such covered articles, or for any person to claim a credit or refund based upon the State or local governmental status of the purchaser of such articles, the State must certify that the article is sold to a State or local government for the exclusive use of a State or local government. In the case of articles sold to a qualified volunteer fire department, as defined in section 150(e)(2),[41] the State must so certify, and the article must be sold for the exclusive use of the qualified volunteer fire department.

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[37] Sec. 6427(l)(5)(C).

[38] Treas. Reg. sec. 48.6427-9(e)(1)(vi).

[39] Sec. 4221(d)(4); Treas. Reg. sec. 48.6416(b)(2)-2(d).

[40] Sec. 4221(d)(5); Treas. Reg. sec. 48.6416(b)(2)-2(e).

[41] In general, as defined in section 150(e)(2), a qualified volunteer fire department is any organization organized and operated to provide firefighting or emergency medical services for persons in an area that is not provided with any other firefighting services, and which is required by written agreement with the political subdivision to furnish firefighting services in such area.

In order for a nonprofit educational organization to claim exemption from tax on such articles, or for any person to claim a credit or refund of tax on such articles based upon the nonprofit educational status of an organization, the State in which such organization is providing educational services must certify that such organization is in good standing.

The Secretary may prescribe forms for such certifications.

Effective Date

The proposal is effective for sales after December 31, 2005.

5. Reregistration in event of change in ownership

Present Law

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[42] An assessable penalty for failure to register is $10,000 for each initial failure, plus $1,000 per day that the failure continues.[43] A non-assessable penalty for failure to register is $10,000.[44] A criminal penalty of $10,000, or imprisonment of not more than five years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.[45] Treasury regulations require that a registrant notify the Secretary of any change (such as a change in ownership) in the information a registrant submitted in connection with its application for registration within 10 days of the change.[46] The Secretary has the discretion to revoke the registration of a noncompliant registrant.

Description of Proposal

The proposal requires that upon a change in ownership of a registrant, the registrant must reregister with the Secretary, as provided by the Secretary. A change in ownership means that after a transaction (or series of related transactions), more than 50 percent of the ownership interests in, or assets of, a registrant are held by persons other than persons (or persons related thereto) who held more than 50 percent of such interests or assets before the transaction (or series of related transactions). The proposal does not apply to companies, the stock of which is regularly traded on an established securities market. The penalties for failure to reregister are the

[42] Sec. 4101; Treas. Reg. sec. 48.4101-1(a) and (c)(1).

[43] Sec. 6719.

[44] Sec. 7272(a).

[45] Sec. 7232.

[46] Treas. Reg. sec. 48.4101-1(h)(1)(v).

same as the present law penalties for failure to register. The proposal applies to changes in ownership occurring prior to the date of enactment.

Effective Date

The proposal is effective for actions or failures to act after the date of enactment.

6. Registration of operators of deep-draft vessels

Present Law

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[47] Treasury regulations define a vessel operator as any person that operates a vessel within the bulk transfer/terminal system, excluding deep-draft ocean-going vessels.[48] Accordingly, operators of deep-draft ocean-going vessels are not required to register. A deep-draft ocean-going vessel is a vessel that is designed primarily for use on the high seas that has a draft of more than 12 feet.[49]

An assessable penalty for failure to register is $10,000 for each initial failure, plus $1,000 per day that the failure continues.[50] A non-assessable penalty for failure to register is $10,000.[51] A criminal penalty of $10,000, or imprisonment of not more than five years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.[52]

In general, gasoline, diesel fuel, and kerosene ("taxable fuel") are taxed upon removal from a refinery or a terminal.[53] Tax also is imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing. The tax does not apply to any removal or entry of a taxable fuel transferred in bulk (a "bulk transfer") by pipeline or vessel to a terminal or refinery if the person removing or entering the taxable fuel, the operator of such pipeline or

[47] Sec. 4101; Treas. Reg. sec. 48.4101-1(a) and (c)(1).

[48] Treas. Reg. sec. 48.4101-1(b)(8).

[49] Sec. 4042(c)(1).

[50] Sec. 6719.

[51] Sec. 7272(a).

[52] Sec. 7232.

[53] Sec. 4081(a)(1)(A).

vessel, and the operator of such terminal or refinery are registered with the Secretary as required by section 4101.[54] Transfer to an unregistered party subjects the transfer to tax.

Description of Proposal

In general, the proposal provides that a deep-draft ocean-going vessel is a vessel for purposes of the registration requirements. Under the proposal, operators of deep-draft ocean-going vessels are required to register and, if a deep-draft ocean-going vessel is used as part of a bulk transfer, the operator of such vessel must be registered in order for the bulk transfer exemption to apply. An operator of a deep-draft ocean-going vessel is not required to register under the proposal for purposes of section 4101, including for purposes of the bulk transfer exemption, to the extent such vessel is used to enter taxable fuel into the United States for consumption, use, or warehousing.

Effective Date

The proposal is effective on the date of enactment.

7. Reconciliation of on-loaded cargo to entered cargo

Present Law

The Trade Act of 2002 directed the Secretary to promulgate regulations pertaining to the electronic transmission to the Bureau of Customs and Border Protection ("Customs") of information pertaining to cargo destined for importation into the United States or exportation from the United States, prior to such importation or exportation.[55] The Department of the Treasury issued final regulations on October 31, 2002. The regulations require the advance and accurate presentation of certain manifest information prior to lading at the foreign port and encourage the presentation of this information electronically. Customs must receive from the carrier the vessel's Cargo Declaration (Customs Form 1302) or the electronic equivalent within 24 hours before such cargo is laden aboard the vessel at the foreign port.[56]

Certain carriers of bulk cargo, however, are exempt from these filing requirements. Such bulk cargo includes that composed of free flowing articles such as oil, grain, coal, ore and the like, which can be pumped or run through a chute or handled by dumping.[57] Thus, taxable fuels are not required to file the Cargo Declaration within 24 hours before such cargo is laden aboard

[54] Sec. 4081(a)(1)(B). The sale of a taxable fuel to an unregistered person prior to a taxable removal or entry of the fuel is subject to tax. Sec. 4081(a)(1)(A).

[55] Sec. 343(a) of Pub. L. No. 107-210 (2002).

[56] 19 CFR sec. 4.7(b)(2).

[57] 19 CFR sec. 4.7(b)(4)(i)(A).

the vessel at the foreign port. Instead the Cargo Declaration must be filed within 24 hours prior arrival in the United States.

Description of Proposal

The proposal provides that not later than one year after the date of enactment of this paragraph, the Secretary of Homeland Security, together with the Secretary of the Treasury, is to establish an electronic data interchange system through which Customs shall transmit to the Internal Revenue Service information pertaining to cargoes of taxable fuels (as defined in section 4083) that Customs has obtained electronically under its regulations adopted to carry out the Trade Act of 2002 requirement. For this purpose, not later than one year after the date of enactment, all filers of required cargo information for such taxable fuels, as defined, must provide such information to Customs through its approved electronic data interchange system.

Effective Date

The proposal is effective upon date of enactment.

8. Gasoline blend stocks and kerosene

Present Law

Gasoline blend stocks

In general

A "taxable fuel" is gasoline, diesel fuel (including any liquid, other than gasoline, which is suitable for use as a fuel in a diesel-powered highway vehicle or train), and kerosene.[58] Under the regulations, "gasoline" includes all products commonly or commercially known or sold as gasoline and are suitable for use as a motor fuel, and that have an octane rating of 75 or more. Gasoline also includes, to the extent provided in regulations, gasoline blend stocks and products commonly used as additives in gasoline. By regulation, the Treasury has identified certain products as gasoline blend stocks, [59] however, the term "gasoline blend stocks" does not include any product that cannot be blended into gasoline without further processing or fractionation ("off-spec gasoline").

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[58] Sec. 4083(a).

[59] Treas. Reg. sec. 48.4081-1(c)(3)(ii). The term "gasoline blend stocks" means alkylate; butane; catalytically cracked gasoline; coker gasoline; ethyl tertiary butyl ether (ETBE); hexane; hydrocrackate; isomerate; methyl tertiary butyl ether (MTBE); mixed xylene (not including any separated isomer of xylene); natural gasoline; pentane; pentane mixture; polymer gasoline; raffinate; reformate; straight-run gasoline; straight-run naphtha; tertiary amyl methyl ether (TAME); tertiary butyl alcohol (gasoline grade) (TBA); thermally cracked gasoline; and toluene. Treas. Reg. sec. 48.4081-1(c)(3)(i). Effective January 1, 2005, transmix containing gasoline was removed from the definition of gasoline blend stocks. Internal Revenue Service, Notice 2005-4 (December 15, 2004).

An excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not registered with the IRS to receive untaxed fuel, unless there was a prior taxable removal or entry.[60] The tax does not apply to any removal or entry of taxable fuel transferred in bulk to a terminal or refinery if the person removing or entering the taxable fuel the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.[61]

Gasoline blend stock exemptions

If certain conditions are met, the removal, entry, or sale of gasoline blend stocks is not taxable. Generally, the exemption from tax applies if a gasoline blend stock (1) is not used to produce finished gasoline (2) is received at an approved terminal or refinery (3) or in bulk transfer to an industrial user.[62]

Gasoline blend stocks not used to produce finished gasoline.–Pursuant to Treasury regulation, no tax is imposed on nonbulk removals from a terminal or refinery, or nonbulk entries into the United States of any gasoline blend stocks if (1) the person liable for the tax is a taxable fuel registrant, and (2) such person does not use the gasoline blend stocks to produce finished gasoline. In connection with a sale, no tax is imposed on the nonbulk removal or entry if (1) the person liable for the tax is a gasoline registrant and (2) at the time of sale such party has an unexpired certificate from the buyer, and knows of no false information in the certificate.[63]

Any sale (or resale) of a gasoline blend stock that was not subject to tax on nonbulk removal or entry is taxable unless the seller has an unexpired certificate from the buyer and has no reason to believe that any information in the certificate is false.

The certificate to be provided by a buyer of gasoline blend stocks contains a statement that the gasoline blend stocks covered by the certificate will not be used to produce finished gasoline, identifies the type (or types of blend stocks) covered by the certificate and provides that the buyer will not claim a credit or refund for any gasoline covered by the certificate. The certificate is signed under penalties of perjury by a person with authority to bind the buyer. The certificate expires on the earliest of one year from the effective date of the certificate, the date a new certificate is provided to the seller or the date the seller is notified by the IRS or the buyer that the buyer's right to provide a certificate has been withdrawn.

Gasoline blend stocks received at an approved terminal or refinery.–Treasury regulations provide that tax is not imposed on the removal or entry of gasoline blend stocks that are received

[60] Sec. 4081(a)(1).

[61] Sec. 4081(a)(1)(B).

[62] Treas. Reg. sec. 48.4081-4.

[63] Treas. Reg. sec. 48.4081-4(b)(1) and (2).

at a terminal or refinery if the person liable for tax is a taxable fuel registrant, has an unexpired notification certificate from the operator of the terminal or refinery where the gasoline blend stocks are received; and has no reason to believe that any information in the certificate is false.[64] A notification certificate is used to notify another person of the taxable fuel registrant's registration status.

Bulk transfer to an industrial user.–Tax is not imposed if upon removal of the gasoline blend stocks from a pipeline or vessel, the gasoline blend stocks are received by a taxable fuel registrant that is an industrial user. [65] An industrial user means any person that receives gasoline blend stocks by bulk transfer for its own use in the manufacture of any product other than finished gasoline.

Refunds or credits for tax imposed on gasoline blend stocks not used for producing gasoline

If any gasoline blend stock or additive is not used by a person to produce gasoline and that person establishes that the ultimate use of the gasoline blend stock or additive is not used to produce gasoline, then the Secretary is to pay (without interest) to such person, an amount equal to the aggregate amount of tax imposed on such person with respect to such gasoline or blend stock.[66]

If gasoline is used in an off-highway business use, the ultimate purchaser of the gasoline is entitled to a credit or refund for the excise taxes imposed on the fuel. "Off-highway business use" means any use by a person in a trade or business of such person otherwise than as a fuel in a highway vehicle that meets certain requirements.[67] Gasoline for this purpose includes gasoline blend stocks.[68]

The Code also provides for a refund of tax for tax-paid fuel sold to a subsequent manufacturer or producer if the subsequent manufacturer or producer uses the fuel, for nonfuel purposes, as a material in the manufacture or production of any other article manufactured or produced by him.[69]

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[64] Treas. Reg. sec. 48.4081-4(b)(1)

[65] Treas. Reg. sec. 48.4081-4(d).

[66] Sec. 6427(h)(1).

[67] Sec. 6421(a) and (e).

[68] Sec. 6421(e)(1) and sec. 4083(a)(2)(B).

[69] Sec. 6416(b)(3)(B).

Kerosene

Definition of kerosene

By regulation, kerosene is defined as the kerosene described in ASTM Specification D 3699 (No. 1-K and No. 2-K), ASTM Specification D 1655 (kerosene-type jet fuel), and military specifications MIL-DTL-5624T (Grade JP-5) and MIL-DTL-83133E (Grade JP-8). Kerosene does not include any liquid that is an excluded liquid.[70]

An "excluded liquid" is (1) any liquid that contains less than four percent normal paraffins, or (2) any liquid that has a distillation range of 125 degrees Fahrenheit or less, sulfur content of 10 ppm or less, and minimum color of +27 Saybolt. These liquids are commonly known as "mineral spirits" and are obtained by distillation of crude oil. Mineral spirits are used for a wide variety of purposes, such as in dry-cleaning fluids, paint thinners, varnishes, photocopy toners, inks, adhesives, and as general purpose cleaners and degreasers.

Exemptions

Diesel fuel and kerosene that is to be used for a nontaxable purpose will not be taxed upon removal from the terminal if it is dyed to indicate its nontaxable purpose. Kerosene received by pipeline or vessel to satisfy a feedstock purpose is exempt from the dyeing requirement.[71] Pursuant to Treasury regulations, nonbulk removals of kerosene for a feedstock purpose by a registered feedstock user also are exempt.[72] The person receiving the kerosene must be registered with the IRS and provide a certificate noting that the kerosene will be used for a feedstock purpose in order for the exemption to apply. Pursuant to the Treasury regulations, tax also does not apply upon the removal or entry of kerosene if the person otherwise liable for tax is a taxable fuel registrant and such person uses the kerosene for a feedstock purpose.[73]

"Feedstock purpose" means the use of kerosene for nonfuel purposes in the manufacture or production of any substance (other than gasoline, diesel fuel or special fuels subject to tax).[74] Thus, for example, kerosene is used for a feedstock purpose when it is used as an ingredient in the production of paint and is not used for a feedstock purpose when it is used to power machinery at a factory where paint is produced.

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[70] Treas. Reg. sec. 48.4081-1(b).

[71] Sec. 4082(d)(1).

[72] Treas. Reg. sec. 48.4082-7(c).

[73] Treas. Reg. sec. 48.4082-7(c).

[74] Treas. Reg. sec. 48.4082-7(b).

Refunds and payments for nontaxable uses of kerosene

If tax-paid kerosene is used by any person in a nontaxable use, the Secretary is required to pay (without interest) to the ultimate purchaser of such fuel an amount equal to the aggregate amount of tax imposed on such fuel. For this purpose, a nontaxable use is any use which is exempt from the tax imposed by section 4041(a)(1) other than by reason of prior imposition of tax. Claims relating to kerosene used on a farm for farming purposes and by a State are made by registered ultimate vendors. Claims relating to undyed kerosene sold from a blocked pump[75] or sold for blending with heating oil to be used during periods of extreme or unseasonable cold are also made by registered ultimate vendors. Special rules apply with respect to aviation-grade kerosene.

The Code also provides for a refund of tax for tax-paid fuel sold to a subsequent manufacturer or producer if the subsequent manufacturer or producer uses the fuel, for nonfuel purposes, as a material in the manufacture or production of any other article manufactured or produced by him.[76]

Description of Proposal

Gasoline blend stocks

The proposal partially repeals exemptions provided in Treas. Reg. sec. 48.4081-4, which, under certain conditions, exempts from tax gasoline blend stocks that are not used to produce finished gasoline or that are received at an approved terminal or refinery. Under the proposal, tax is imposed on all nonbulk entries and removals of gasoline blend stocks, regardless of whether they will be used to produce finished gasoline or received at an approved terminal or refinery. The proposal does not change the exemption for bulk transfers to registered industrial users.

Kerosene and mineral spirits

The proposal requires that with respect to fuel entered or removed after September 30, 2005, the Secretary include mineral spirits in the definition of kerosene. Thus, for entries and removals after September 30, 2005, mineral spirits are taxed and exempt from tax in the same manner as kerosene.

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[75] A blocked pump is a fuel pump that is used to dispense undyed kerosene that is sold at retail for use by the buyer in any nontaxable use; is at a fixed location; is identifed with a legible and conspicuous notice stating "Undyed Untaxed Kerosene, Nontaxable Use Only," and cannot reasonably be used to dispense fuel directly into the fuel supply tank of a diesel-powered highway vehicle or diesel-powered train; or is locked by the vendor after each sale and unlocked only in response to a request by a buyer for undyed kerosene for use other than as a fuel in a diesel-powered highway vehicle or diesel-powered train.

[76] Sec. 6416(b)(3)(B).

Effective Date

The proposal is effective for fuel removed or entered after September 30, 2005.

9. Nonapplication of export exemption to delivery of fuel to motor vehicles removed from United States

Present Law

A manufacturer's excise tax is imposed upon

1. The removal of any taxable fuel from a refinery or terminal;

2. The entry of any taxable fuel into the United States for consumption, use or warehousing; or

3. The sale of any taxable fuel to any person who is not registered, unless there was a prior taxable removal or entry.[77]

The term "taxable fuel" means gasoline, diesel fuel and kerosene.

Special provisions under the Code provide for a refund of tax to any person who sells gasoline to another for exportation.[78] Section 6421(c) provides "If gasoline is sold to any person for any purpose described in paragraph (2), (3), (4), or (5) of section 4221(a), the Secretary shall pay (without interest) to such person an amount equal to the product of the number of gallons so sold multiplied by the rate at which tax was imposed on such gasoline by section 4081." Section 4221 provides, in pertinent part, "Under regulations prescribed by the Secretary, no tax shall be imposed under this chapter. . . on the sale by the manufacturer. . . of an article–. . . for export, or for resale by the purchaser to a second purchaser for export. . . but only if such exportation or use is to occur before any other use . . .."

It is the IRS administrative position that the exemption from manufacturers excise tax by reason of exportation does not apply to the sale of motor fuel pumped into a fuel tank of a vehicle that is to be driven, or shipped, directly out of the United States.[79]

A duty-free sales facility that meets certain conditions may sell and deliver for export from the customs territory of the United States duty-free merchandise. Duty-free merchandise is merchandise sold by a duty-free sales facility on which neither Federal duty nor Federal tax has been assessed pending exportation from the customs territory of the United States. The statutes covering duty-free facilities do not contain any limitation on what goods may qualify for duty-free treatment.

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[77] Sec. 4081(a)(1).

[78] Secs. 6421(c) and 4221(a)(2).

[79] Rev. Rul. 69-150, 1969-1 C.B. 286.

The issue of whether fuel sold from a duty-free facility and placed into the tank of an automobile that is then driven out of the country is exported fuel has been litigated in the courts.[80] The cases involved the same operator of a duty-free facility seeking a refund of excise tax. The facility is near the Canadian border and is configured in such a way that anyone leaving the facility must depart the United States and enter into Canada. Both the Federal Circuit and the Sixth Circuit of Appeals are in accord with the IRS position and ruled that the operator of the duty-free facility did not have standing to pursue a claim for refund.[81]

Description of Proposal

The proposal reaffirms the long-standing IRS position taken in Rev. Rul. 69-150 and restates present law by amending the Code definition of export to exclude the delivery of a taxable fuel into a fuel tank of a motor vehicle that is shipped or driven out of the United States. It also imposes a tax on the sale of taxable fuel at a duty-free sales enterprise unless there was a prior taxable removal, or entry of such fuel.

Effective Date

The proposal applies to sales or deliveries made after the date of enactment.

10. Impose assessable penalty on dealers of adulterated fuel

Present Law

Diesel fuel, gasoline, and kerosene are taxable fuels. Diesel fuel is defined as (1) any liquid (other than gasoline) which is suitable for use as a fuel in a diesel-powered highway vehicle or a diesel powered train, (2) transmix, and (3) diesel fuel blend stocks identified by the Secretary.[82] As a defense to Federal and State excise tax liability, some taxpayers have contended that certain diesel fuel mixtures or additives do not meet the requirements of (1) above because they are not approved as additives or mixtures by the EPA. In addition, under present law, untaxed fuel additives, including certain contaminants, may displace taxed diesel fuel in a mixture.

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[80] See, *Ammex Inc. v. United States*, 52 Fed. Cl. 303 (2002) (on cross-motions for summary judgment, the court found that plaintiff established standing to proceed to trial pursuant to sec. 6421(c) respecting its gasoline purchases only); and *Ammex Inc. v. United States*, 2002 U.S. Dist. LEXIS 25771 (E.D. Mich. July 31, 2002) (granting defendant's motion for summary judgment), reconsideration denied, *Ammex, Inc. v. United States*, 2002 U.S. Dist. LEXIS 22893 (E.D. Mich. Oct. 22, 2002). Although the Claims Court ruled that Ammex had standing to challenge the excise tax on gasoline, it subsequently held that Ammex was not entitled to a payment pursuant to sec. 6421(c) because it failed to prove at trial that it did not pass the tax on to its customers. *Ammex Inc. v. United States*, 2003 U.S. Claims LEXIS 63 (Fed. Cl. Mar. 26, 2003). The Claims Court finding that the plaintiff had standing was reversed on appeal.

[81] See, *Ammex Inc. v. United States*, 384 F.3d 1368 (Fed. Cir. 2004) *cert. denied* 125 S.Ct. 1697 (2005); and *Ammex Inc. v. United States*, 367 F.3d 530 (6th Cir. 2004) *cert. denied* 125 S.Ct. 1695 (2005).

[82] Sec. 4083(a)(3)(A).

The Code provides that any person who, in connection with a sale or lease (or offer for sale or lease) of an article, knowingly makes any false statement ascribing a particular part of the price of the article to a tax imposed by the United States, or intended to lead any person to believe that any part of the price consists of such a tax, is guilty of a misdemeanor.[83] Another Code provision provides that any person who has in his custody or possession any article on which taxes are imposed by law, for the purpose of selling the article in fraud of the internal revenue laws or with design to avoid payment of the taxes thereon, is liable for "a penalty of $500 or not less than double the amount of taxes fraudulently attempted to be evaded."[84]

Description of Proposal

The proposal adds a new assessable penalty. Under the proposal, any person other than a retailer who knowingly transfers for resale, sells for resale, or holds out for resale for use in a diesel-powered highway vehicle (or train) any liquid that does not meet applicable EPA regulations (as defined in section 45H(c)(3))[85] is subject to a penalty of $10,000 for each such transfer, sale or holding out for resale, in addition to the tax on such liquid, if any. Any retailer who knowingly holds out for sale (other than for resale) any such liquid, is subject to a $10,000 penalty for each such holding out for sale, in addition to the tax on such liquid, if any.

The penalty is dedicated to the Highway Trust Fund.

Effective Date

The proposal is effective for any transfer, sale, or holding out for sale or resale occurring after the date of enactment.

11. Oil Spill Liability Trust Fund

Present Law

In general, a five-cent-per-barrel tax was imposed on crude oil received at a United States refinery and imported petroleum products received for consumption, use, or warehousing. The Fund's tax applied after December 31, 1989, and before January 1, 1995. The tax was effective only if the unobligated balance in the Fund was less than $1 billion.

Description of Proposal

The proposal reinstates the Oil Spill Liability Trust Fund tax. The tax applies on April 1, 2007, or if later, the last day of any calendar quarter for which the Secretary estimates that, as of

[83] Sec. 7211. Such a violation is punishable by a fine not to exceed $1,000, or by imprisonment for not more than one year, or both.

[84] Sec. 7268.

[85] Section 45H(c)(3) refers to "the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency."

the close of that quarter, the unobligated balance in the Oil Spill Liability Trust fund is less that $2 billion.

The tax will be suspended during a calendar quarter if the Secretary estimates that, as of the close of the preceding calendar quarter, the unobligated balance in the Oil Spill Liability Trust Fund exceeds $3 billion. The tax terminates after December 31, 2014.

Effective Date

The proposal is generally effective on April 1, 2007.

12. Leaking Underground Storage Tank Trust Fund

Present Law

The Code imposes an excise tax, generally at a rate of 0.1 cents per gallon, on gasoline, diesel, kerosene, and special motor fuels (other than liquefied petroleum gas and liquefied natural gas).[86] The taxes are deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund. The tax expires on October 1, 2005.

Diesel fuel and kerosene that is to be used for a nontaxable purpose will not be taxed upon removal from the terminal if it is dyed to indicate its nontaxable purpose.

The Code requires the LUST Trust Fund to reimburse the General Fund for certain refund and credit claims related to the nontaxable use of fuel (only to the extent attributable to the LUST Trust fund financing rate).[87]

Description of Proposal

Under the proposal, the LUST Trust Fund tax is extended at the current rate through September 30, 2011. Further, dyed fuel is subject to the LUST tax and without refund. Under the proposal, the LUST Trust Fund is no longer required to reimburse the General Fund for claims and credits related to the nontaxable use of fuel.

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[86] For qualified methanol and ethanol fuel the rate is 0.05 cents per gallon (sec. 4041(b)(2)(A)(ii). Qualified methanol or ethanol fuel is any liquid at least 85 percent of which consists of methanol, ethanol or other alcohol produced from coal (including peat) (sec. 4041(b)(2)(B)).

[87] Specifically, section 9508(c)(2) requires the LUST Trust Fund to reimburse the General Fund from time to time for claims paid pursuant to sections 6420 (relating to amounts paid in respect of gasoline used on farms), section 6421 (relating to amounts paid in respect of gasoline used for certain nonhighway purposes or by local transit systems), and section 6427 (relating to fuels not used for taxable purposes) and income credits allowed under section 34 for the purposes previously mentioned. No income tax credit is allowed for any amount payable under section 6421 or 6427 if a claim for such amount is timely filed and is payable under such section (sec. 34(b)).

Effective Date

The extension of the trust fund is effective October 1, 2005. The taxation of dyed fuel is effective for fuel entered or removed after December 31, 2005.