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**BEFORE THE**

**SUBCOMMITTEE ON INVESTIGATIONS AND OVERSIGHT  
COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION  
UNITED STATES HOUSE OF REPRESENTATIVES**

**CONCERNING  
THE STATUS OF EFFORTS TO REDUCE  
MOTOR FUEL TAX EVASION**

**AUGUST 10, 1994**

Mr. Chairman, Members of the Committee, I am pleased to be here today to review the role of the Federal Highway Administration (FHWA) in efforts to combat the nationwide problem of motor fuel tax evasion.

The issue of fuel tax evasion has been a matter of serious concern for the FHWA for several years. My predecessors, or their representatives, have come before this Subcommittee in prior years to both detail the extent of the problem and to report on measures taken to reduce the continuing drain on the Highway Trust Fund (HTF) due to major fuel tax evasion fraud schemes.

In the past, the issue of evasion has been focused primarily on the estimated losses to the Federal HTF and corresponding losses to State Highway and Transportation Funds. Since 85 percent of HTF revenue is derived from motor fuel taxes, this remains my primary concern. However, motor fuel tax evasion should no longer be thought of solely as a Trust Fund problem. Currently, 6.8 cents of the 18.4 cent gasoline tax and the 24.4 cent diesel tax are specifically dedicated to deficit reduction. This is a contribution of over \$9 billion annually to deficit reduction. The importance of protecting the integrity of the motor fuel tax compliance system is, therefore, critical not only to our continuing efforts to improve and maintain our national surface transportation system but to supporting our national deficit reduction strategy.

## **BACKGROUND**

Substantial revenue losses caused by motor fuel tax fraud were first discovered in the New York metropolitan area in the mid-1980s. Since that time, fuel tax evasion schemes have spread to every region of the country. Particularly disturbing is the clear evidence that many of them are masterminded and controlled by organized crime.

The magnitude of the problem remains a matter of some conjecture. In prior testimony before this Subcommittee, the FHWA stated that it believed that the current level of gasoline tax evasion was between 3 and 7 percent of gallons consumed and the level of diesel fuel tax evasion between 15 and 25 percent of gallons consumed. The FHWA further stated that due to changes in the Federal law on gasoline taxation, we were convinced that evasion had dropped to the lower end of the range, but that diesel fuel tax evasion was a continuing and growing problem.

Our view of the current situation remains that gasoline tax evasion has been curtailed due to legislative and regulatory changes. We anticipate that the changes in the diesel fuel taxation procedures and the requirement for dyeing of tax-exempt diesel fuel enacted in the Omnibus Budget Reconciliation Act of 1993 will have a major impact on reducing diesel fuel tax evasion in the future. At this time, however, we believe that diesel fuel tax evasion remains at the high end of the range.

Using a 3 percent evasion rate for gasoline and a 20 percent rate for diesel combined with the higher Federal tax rates effective October 1, 1993, the total estimated annual revenue loss from Federal fuel tax evasion would be about \$1.6 billion annually. Because of similarities in tax rates and procedures, it is likely that the States, in the aggregate, also suffer annual losses of a corresponding amount. Consequently, combined State and Federal losses may approach \$3 billion per year.

The significance of the diesel fuel losses should not be underestimated. A quick comparison of gasoline and diesel fuel losses will show why. The FHWA statistics show an on-highway consumption of 107.5 billion gallons of gasoline in 1992. Using an evasion rate of 3 percent equates to 3.2 billion gallons and a resulting tax loss of \$593 million for gasoline. On-highway diesel fuel consumption for 1992 was 20.2 billion gallons, less than one-fourth that of gasoline. However, an evasion figure of 20 percent equates to 4 billion gallons. When combined with the higher diesel tax rate of 24.4 cents a gallon compared with the gasoline rate of 18.4 cents, the result is a Federal tax loss of \$988 million. Obviously, congressional concern with the continuing erosion of diesel fuel tax revenue is well founded.

Evasion continues to be a problem. However, due in no small part to your interest and support, legal tools and financial resources are now in place and are being used to wage an increasingly effective campaign against motor fuel tax fraud on both the Federal and State level. The program we have implemented is just beginning to show the results of

coordinated, adequately funded joint Federal and State enforcement which in the future should have a substantial impact on reducing these large losses.

Throughout this entire effort, the FHWA has worked in concert with the Internal Revenue Service (IRS), the Department of Justice (DOJ), the Department of Transportation's (DOT) Office of Inspector General, State revenue agencies, the Federation of Tax Administrators, and petroleum industry groups. I have been impressed by the dedication, commitment and professionalism all participants have exhibited in this long-term effort to build a framework to strengthen and increase the interagency cooperation necessary to effectively address fuel tax compliance issues. I wish to commend them for their achievements.

### **THE JOINT FEDERAL/STATE MOTOR FUEL TAX COMPLIANCE PROJECT**

The centerpiece of our efforts to reduce fuel tax fraud is the Joint Federal/State Motor Fuel Tax Compliance Project, referred to as the "Joint Project." The Joint Project is directed by a Steering Committee chaired jointly by the FHWA and IRS and composed of representatives of State revenue agencies with the Federation of Tax Administrators and petroleum industry and user groups serving as resources to the Project. Funding for the Project first became available in FY 1990 and subsequent DOT appropriation acts of FY 1991 and FY 1992 provided additional funding. However, it was the funding provided in the Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA) which allowed the nationwide expansion of the program.

I am pleased to say that as of 1994, all of the 48 continental States and the District of Columbia are participating in the Joint Project and have joined one or more of the 9 regional task forces established by the Steering Committee. (The States of Alaska and Hawaii have also been fully briefed on the Project and have been invited to join one of the Task forces. Representatives from Alaska have attended meetings of the Northwest Task Force.) A State in each of the 9 regions serves as a "lead State" and is responsible for coordinating the administrative matters of the task force. The 9 task forces are composed of State Revenue and IRS personnel from both civil and criminal divisions and meet regularly to share information and plan joint enforcement and compliance actions.

ISTEA provides \$5 million per year in contract authority for FYs 1992-1997 from the HTF for the Project. The FHWA has allocated \$3 million annually to the States and \$2 million annually to the IRS. This funding is historic since it marks the first time HTF monies have been extended to the IRS and to State revenue agencies to assist in motor fuel tax enforcement efforts. Many costs are eligible for State reimbursement including personnel, training, travel, and equipment. For the IRS, the \$2 million annual funding allotment from the FHWA provides a sizeable supplement to the overall motor fuel tax enforcement effort, but it does not come close to reimbursing costs of expanded enforcement initiatives. Of the \$2 million, \$1.4 million is dedicated to additional examination staffing in IRS district offices in the nine lead States. The FHWA funding covers about two-thirds of

the estimated \$2.2 million for the 28 additional staff years in 16 IRS district offices. (The additional staff-years are provided by reassignment of staff rather than by new hires.) The remaining \$600,000 is dedicated to criminal investigation and used for case-related travel, overtime, equipment, training, data processing, and certain costs associated with undercover operations.

In addition to the annual \$5 million in HTF revenue authorized in ISTEPA, \$2.5 million annually was authorized from the general fund. To date, because of continuing budget constraints, the Department has not sought appropriation of the funds.

In addition to funding for State revenue agencies and the IRS, the FHWA entered into a contract with the Federation of Tax Administrators to develop and present a series of motor fuel tax training seminars. With a comprehensive course agenda covering audit and criminal investigation and State, IRS, and DOJ personnel serving as instructors, eight seminars were offered from July 1992 through March 1993. The seminars were an outstanding success, with over 600 registered participants including State, Federal, and local agency auditors, investigators, and prosecutors. The FHWA has allocated \$75,000 from Office of Policy contract research funds in FY 1994 to continue the training effort in FYs 1994 and 1995.

### **PRELIMINARY JOINT PROJECT RESULTS**

Are these efforts having any positive impact on reducing Federal and State motor fuel tax evasion? I believe the answer is a resounding "YES."

#### **o IRS Criminal Investigation Division**

During the last two fiscal years (FYs 1992 and 1993) some of the largest motor fuel tax evasion schemes have been indicted and prosecuted. These cases are the culmination of months or even years of investigative work. Most of the investigations leading to prosecution in FY 1992 were supported in part by FHWA funds provided to the IRS. The increased attention generated by the Joint Project, widespread news coverage of criminal cases and industry support have sparked a dramatic increase in the IRS criminal investigation effort. Over 100 investigations were initiated by the IRS during each of FYs 1992 and 1993. Cases are currently under investigation in all 7 IRS regions and in 27 of the 63 IRS districts. Within the last year alone, Federal fuel tax evasion criminal indictments were issued against 78 individuals with estimated fuel tax losses of over \$200 million.

#### **o IRS Examination Division**

As a direct result of the Joint Project, over \$43 million in Federal motor fuel taxes have been assessed in the IRS district offices located in the States which serve as lead States for each of the nine Task Forces established under the project. That represents more than \$35 million for the HTF that would otherwise not have been available for transportation projects. Since the project began in FY 1991, the IRS has assessed nearly \$22 in additional

fuel taxes per dollar spent on motor fuel tax audits. It is important to remember that the data reported by the IRS under the Joint Project covers only a portion of the total IRS effort in motor fuel tax enforcement.

o **State Revenue Agency Results**

The results of motor fuel enforcement activities of the States are also impressive. Based on 33 State reports for the period September 1992-March 1993, nearly \$45 million in additional State fuel tax revenue was assessed, with an average of about \$12 tax assessed per dollar spent conducting audits and examinations. Several States have used the FHWA grant money for staffing new or expanded criminal investigation efforts. State criminal indictments and enforcement activity are expected to increase in the future.

o **Statistical Information**

One of the difficulties in effectively addressing the fuel tax evasion problem has always been the dearth of statistical evidence on the scope and extent of the problem. Now that all the continental States and the District of Columbia have joined one of the nine task forces and will be accumulating statistics on the extent of evasion, the costs of enforcement, and the allocation of enforcement functions, the FHWA expects to have a far clearer picture of the fuel tax evasion problem on a national level within the next year. Preliminary results from several States already seem to show the impact of increased enforcement. The State of New Jersey's gallonage information is a case in point. In 1990, fuel reports showed gallonage on the upswing. However when organized crime became involved in fuel tax that gallonage dropped drastically. With new State legislation implemented in June 1992, and joint Federal/State enforcement actions, the gallonage jumped back up. In 1993 New Jersey's fuel tax receipts were \$30 million greater than in 1992 and as of April 1994, the revenue was \$15 million ahead of 1993. While perhaps not all of that increase can be attributed to increased enforcement, New Jersey officials believe that a significant percentage of the increase is directly related to the joint Federal/State investigations and prosecutions which were initiated as a result of the Joint Project.

For the 4-month period, January through April 1994, 11 States showed double-digit percentage increases in the reported use of special fuels. An additional six States showed double-digit increases for the first three months of the year compared to 1993. Because of the commingled effects of increased consumption and changes in tax administration, however, not all of these increases can be attributed to improved enforcement. While the trend is promising, it cannot be taken as an absolute indicator of the effect of increased fuel tax compliance activity at both the Federal and State levels.

o Outlook

Despite the impressive results from both the IRS and the States, it would be premature to declare victory in our effort to eliminate motor fuel tax evasion. In most areas of the country, the regional task forces funded by the FHWA to address the issue were only organized within the past year. Cooperative State and Federal efforts to fight motor fuel tax evasion are still in the early stages of development. However, real progress has been made by both the IRS and the States as shown by substantial tax assessments resulting from audit and examination activities, by increased numbers of indictments and convictions for criminal fraud, by the increased resources and better trained and equipped staff dedicated to motor fuel tax enforcement, and by the increased number of enforcement agencies participating in the overall fuel tax compliance effort.

### **DIESEL FUEL DYEING**

Changes in the Federal law and regulations sought by IRS and enacted by Congress in the late 1980s and early 1990s were successful in reducing the level of gasoline tax evasion. For diesel fuel, on the other hand, evidence from current investigations and testimony from those in the industry suggested a continuing, substantial, and a growing evasion problem. The magnitude of diesel fuel evasion losses fostered support for additional legislative and regulatory changes in diesel fuel collection procedures. The Omnibus Budget Reconciliation Act of 1993 included several provisions to strengthen enforcement of diesel fuel taxes, including moving the point of taxation up to the terminal level, consistent with gasoline, and requiring the dyeing of any diesel removed from the terminal without payment of the tax.

The FHWA believes that the combination of taxing diesel fuel at the terminal and the dyeing of diesel fuel destined for tax exempt uses provides the basis of an effective national strategy to fight diesel fuel tax fraud. The IRS has diligently pursued a three-phase program to implement the Congressional mandate. Phase I, now completed, consisted of information, education and outreach programs to affected industry groups and included IRS visits to all 1600 terminals. Phase II, currently underway, is the beginning of enforcement efforts and consists of training temporary volunteers within IRS ranks to do fuel inspections at terminals. Also part of Phase II is a proposed pilot project aimed specifically at on-road enforcement by contracting with States to perform the actual inspection of fuel in truck supply tanks. Phase III will consist of permanent positions for terminal inspections and expanded State partnerships for on-road fuel inspections.

### **ON-ROAD ENFORCEMENT OF DYED DIESEL FUEL**

The FHWA supports the IRS plan to contract with States to do the primary on-road test of fuel for tax enforcement purposes. While intrinsic governmental functions cannot be contracted, certain technical duties such as fuel sampling could be performed by another party on behalf of the Federal Government. While the IRS has experience in dealing with terminal operations, it has virtually no experience in on-road motor carrier enforcement.

It is practical resource management for the IRS to put its primary personnel resources at the terminal and to turn to the States to perform the on-road enforcement segment of the diesel dyeing program. Authorizing the States to perform the testing for the IRS also fits in well with State efforts to increase compliance with their fuel tax laws. Several States have already enacted legislation which "piggybacks" on the Federal diesel fuel dyeing law. More are expected to do so next year. These States will have the capability of taking State enforcement action when dyed fuel is found in the supply tanks of on-highway vehicles. The combination of State and Federal enforcement actions stemming from the same on-road inspection not only offers a double deterrent, but also provides the most efficient use of resources for both the States and Federal Government. It serves the interests of the States, IRS, and the motor carrier industry to have the fuel inspection function performed by those entities which have the most experience in on-road enforcement of laws and regulations affecting motor carriers. This experience lies almost exclusively with State agencies.

The FHWA believes that a vigorous on-road enforcement effort is a necessary deterrent to the use of dyed, untaxed fuel by motor carriers. The FHWA believes that the vast majority of motor carriers are individuals of honesty and integrity and have no desire to evade fuel taxes or any other taxes. However, in order for fuel tax evasion to be lucrative, there must be a market for the untaxed product. If motor carriers and drivers know that there is a substantial chance that fuel will be tested and, if found to have dye, that a substantial penalty will be imposed, they will take pains to insure that only a tax-paid, undyed product is used in their vehicles. The FHWA, in cooperation with the IRS and the EPA, has developed a brochure specifically targeted at the motor carrier industry describing the new dyed fuel laws. It is being distributed to motor carriers through the FHWA Office of Motor Carriers field offices.

If a motor carrier or driver innocently receives dyed fuel or clear fuel from which dye has been removed, that carrier or driver will be able to assist enforcement authorities in locating the facility from which the fuel was pumped. This will allow appropriate enforcement against that facility and any facilities up the distribution chain. The veracity of the carrier's or driver's claim of no knowledge that the fuel was dyed is best handled through the court system as are all other alleged violations of motor carrier-related laws and regulations. In addition, when the motor carrier industry becomes aware that certain fuel facilities engage in practices which may subject the carrier or driver to substantial penalties and may also result in thousand of dollars in equipment damage caused by a tampered fuel product, the trucking industry itself will be inclined to stop patronizing those facilities. This in turn will assist legitimate businesses which have suffered greatly from the actions of tax cheats who undercut prices by using the "tax" as a profit margin.

Given the seriousness of the diesel fuel tax evasion problem, the FHWA believes that funding must be directed to an on-road enforcement program. The FHWA and IRS are continuing to explore funding and administrative options for both FYs 1995 and 1996. Assuming that funds can be found, one of the options would be to funnel funds to the States through the Motor Carrier Safety Assistance Program (MCSAP). However, at this point it is

unclear whether that would fit the needs of all States, since the fuel tax enforcement agency may not be the designated MCSAP agency. Other options would be for IRS and the FHWA to use the Joint Project to fund on-road enforcement or to set up an entirely separate program similar to the Joint Project. Whatever approach is used, agreements with each State would be required by each agency to specify the inspection and enforcement procedures and responsibilities of all Federal and State parties.

### CONTINUING CONCERNS

The FHWA believes that HTF monies which have been invested in State revenue agencies and the IRS has been money well spent. Further, the FHWA is gratified to see the strong working relationship that has been forged between Federal and State fuel tax enforcement agencies as a result of the FHWA Joint Project. However, certain issues remain to be addressed.

#### o Prosecutorial and Investigative Resources

The growing criminal caseload which I described earlier is reflected in substantial increased demand for criminal investigation and prosecution resources. These demands are expected to increase in coming years as current investigations produce even more leads and new cases. The additional examination efforts, particularly in the IRS districts in the lead States, and cases generated from activities of the nine regional task forces will further increase demands. The DOT Office of Inspector General, DOJ, and IRS are striving to meet these needs as best they can within overall budget constraints. The DOT Office of Inspector General participation in the fuel tax fraud investigations contributes to safeguarding DOT interests in the enforcement of Federal motor fuel taxes, since the tax revenues fund a major part of the Department's highway and public transportation programs.

The growing caseload at the DOJ is straining resources to the extent that some prosecutions may be unable to continue on schedule. Currently, 10 percent of the Tax Division resources are committed to motor fuel enforcement cases, and this figure is increasing. Motor fuel tax fraud cases are complex, time consuming to prepare, and involve lengthy trials. The costs of staffing, travel, and related expenses can be expected to increase.

#### o New evasion schemes

The new law is a great step forward in improving fuel tax compliance. However, it does not directly address an area which the FHWA believes will become the next major fuel tax fraud scam -- blending or "cocktailing." The blending of taxed and untaxed products has both tax and environmental implications since much of the product used in fraudulent blending can be expected to be environmentally undesirable waste products. Not only does cocktailed fuel affect air quality, but the implications of tainted fuel in motor vehicle engines will be very costly to consumers. Most of this blending can be expected to occur after fuel

leaves the terminal, making investigation and enforcement more difficult. In addition to current criminal investigation techniques, effective enforcement will require the easy availability of laboratory testing and the requisite staff to do it.

Of particular concern is the blending of kerosene. Kerosene, (No. 1 diesel) is often used as a blending agent for No. 2 diesel (the fuel used in trucks). No. 2 diesel is taxed when it is dispensed from the terminal rack for on-road use. If No.2 diesel is sold without payment of the tax, it is dyed. Kerosene, however, is not taxed when it crosses the terminal rack, nor is it dyed. The law requires that when kerosene is later blended into the No. 2 diesel for on-road use, the tax be paid on the kerosene portion of the fuel. The inability to account for, or track, the kerosene blended for highway use is a serious concern. The IRS is continuing to review the current tax treatment of kerosene in light of the potential for large-scale motor fuel tax fraud.

### Closing

I am pleased to report that, assisted by the resources of the FHWA, IRS, and State revenue agencies are waging a vigorous campaign against fuel tax evasion. Their efforts are beginning to show heartening results both in audit and examination as well as criminal investigation and prosecution. The Joint Project initiative still has several years to run. I am confident that by time it ends we will have made substantial progress in curbing what has developed into a very serious threat to the HTF and State highway and transportation programs. I appreciate the opportunity to review our recent activities and invite any questions you might have.