



Implementation Report

Montana Fuel Tax Refunds

http://www.mdt.mt.gov/research/projects/admin/refunds.shtml

Introduction and Purpose

The primary source of funding for transportation infrastructure in every state is the taxes imposed on motor fuels. As with other kinds of taxes, tax fraud and tax evasion are a concern with fuel taxes. One aspect of the fuel tax collection system in Montana that may be susceptible to fraud is the process that requires consumers to apply for refunds of taxes paid on fuels used for tax-exempt purposes.

The purpose of this project was to examine the current refund process in Montana; estimate the current level of errors, omissions, and evasion (EOE); and examine the current Montana laws and processes for refunds.

The recommendations made by the researcher in the final report are listed below, along with the technical panel's responses to these recommendations. Finally, unmet research needs and other implementation recommendations made by the technical panel, if any, are included.

Implementation Summary

- The technical panel will develop definitions for Cardtrol and Keylock systems.
• Current forms are being modified to improve clarity.
• The development or implementation of a relational database for data storage and analysis will be pursued.
• The number of claims audited has been increased.
• Various methods of outreach are in place and will be modified, as appropriate, as changes to the program are made.

Implementation Recommendations

Recommendation 1: Allow Only Bulk Purchases for Agricultural Use

The Montana Code Annotated (MCA) could be changed to allow only fuel delivered in bulk to be eligible for agricultural refunds; this is the law in Wyoming and for gasoline in Nevada. This recommendation impacts the eligibility of all non-bulk purchases currently refunded for agricultural use, which represent 52 percent of gasoline and 57 percent of diesel agricultural purchases by number of transactions.

The total gallons of non-bulk purchases only accounts for 15 and 27 percent of the total gallons refunded for gasoline and diesel, respectively. The potential annual fiscal impact in terms of reduced refunds paid by MDT is \$314,000 for gasoline and \$229,000 for diesel.

Technical Panel Response:

The Montana code related to this recommendation was recently changed to take into consideration issues relating to the environment, safety, and theft. The researcher's recommendation was to change the current code to what it was previously. The technical panel feels the researcher did not fully understand the issues related to the most recent change in the language of law. Also, MDT does not feel the law addresses current practice. Given this and the fact that definitions for Cardtrol and Keylock do not currently exist in Montana statutes, the technical panel will develop these definitions to remedy this situation.

Recommendation 2: Eliminate Agricultural Standard Deduction for Clear Diesel

The agricultural refund form with the standard deduction could be eliminated for special fuels, including diesel.

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Diesel tax refunds for agricultural operations could still be obtained through the off-road refund form. This recommendation would eliminate fuel tax refunds MDT is currently making that could be from fuel used for on-road travel. If this recommendation were implemented, claimants currently using clear diesel in agricultural operations would switch to dyed fuel, request a refund with the off-road form, or not claim a refund. Currently, MDT refunds about \$847,000 in fuel taxes paid on clear diesel used in agriculture per year claimed using the agricultural form with the standard deduction. It is difficult to predict how much of this fuel use would switch to dyed fuel or still be refunded through the off-road refund form. Some agricultural claimants currently have a large incentive to keep their produce hauling operations in house as the fuel used could be submitted for a 60 percent refund of the state fuel tax. This recommendation could have broader economic impacts due to the removal of this incentive.

Technical Panel Response: The technical panel considers this a good recommendation; however, it is not realistic in the current economic climate as this would be perceived as a tax increase.

Recommendation 3: Eliminate Agricultural Standard Deduction for All Fuels

The agricultural refund form with the standard deduction could be eliminated for diesel and gasoline fuel. Taxes paid on gasoline and diesel used in agricultural operations would only be eligible for refunds through the off-road refund form. This would result in a more accurate estimate of off-road fuel eligible for refund through the use of mileage logs for vehicles used partially on-road and fuel-use logs for all equipment. Agricultural refunds for gasoline amount to \$2,095,000 annually. The impact of this change is difficult to quantify, since

claimants could still request refunds through the off-road refund form. It would increase the documentation burden of claimants, but would likely lead to a more just refund amount.

Technical Panel Response: The technical panel considers this a good recommendation; however, it would be perceived as a tax increase and is not realistic in the current economic climate.

Recommendation 4: For Agriculture, Allow Only Unregistered Vehicle Fuel Use

Refunds for fuel taxes could be limited for fuel used in agricultural operations to only off-road equipment. For vehicles such as trucks that can be used in agricultural operations but are registered for on-road use, the fuel would not be eligible for a refund. This limitation could be applied to gasoline, diesel, or both. Consistent with the idea that fuel tax refunds are supposed to be for taxed fuel used for off-road purposes, this change would completely eliminate paying such refunds for on-road operation of licensed vehicles engaged in agricultural operations. However, as presented here, this change also precludes payment of such refunds when/if these vehicles are used off-road. The impact of this change on the amount MDT refunds is difficult to quantify without knowledge of the agricultural use of registered vehicles. Because of the potential shift to dyed diesel and the elimination of refunds for fuel used in on-road vehicles (claimed either through mileage logs of the off-road form or the standard deduction of the agricultural form) the size and number of refund requests would likely be reduced. A benefit of this recommendation would be a reduction in the paperwork burden for the claimant and the processing burden for MDT. Finally, this recommendation restricts refunds for agricultural operations more

than other commercial sectors. In the interest of fairness, this recommendation could be expanded to eliminate refunds for licensed vehicles across all commercial sectors.

Technical Panel Response: This option is already available. However, many off-road vehicles are used in on-road situations, such as when traveling from one field to another. In addition, this recommendation would require the repeal of the Montana codes allowing for the agricultural standard deduction. This is not a realistic recommendation in the current economic climate as this would be perceived as a tax increase.

Recommendation 5: Cap the Standard Deduction for Agriculture

Aside from reducing the standard deduction to zero (see Recommendations 2-4), a limit could be placed on the amount of fuel that would be allowed for a standard deduction refund. Implementing a limit or cap on the total gallons allowed would reduce the refunds for those applicants who include large amounts of fuel used for on-road purposes. The standard deduction for agricultural refunds in Montana can be as much as 60 percent. This percentage is reduced if the ratio of gross earned farm income to gross earned income for the individual is below 50 percent. The assumption behind this is that for typical agricultural operations 60 percent of the fuel used is for off-road purposes and 40 percent is used on public roadways. The average yearly off-road fuel use per acre is 1.04 gallons of gasoline and 3.50 gallons of diesel. Extrapolating from the refund claim data, one might assume that typically 10 percent of the diesel fuel used (0.35 gallons per acre) would be clear while the rest would be dyed. Note that the average use values may differ based on the types of crops/livestock and the size of the farm. Smaller farms

are typically less efficient and use more fuel per acre for off-road activities, but they also use less total fuel so the personal travel and other on-road fuel use will be a higher proportion of their total fuel use. The ability for the claimant to still utilize the off-road refund form allows those who use higher rates to get their fair refund. Without knowing farm sizes of current applicants, it is difficult to calculate the potential financial impact.

Technical Panel Response:

The technical panel feels this recommendation is not realistic in the current economic climate as this would be perceived as a tax increase.

Recommendation 6: Augment the Agricultural Refund Form Documentation with IRS Forms

If an individual or corporation has legitimate off-road fuel use in farming operations they can obtain a tax credit on their income tax return for the federal fuel taxes paid on gasoline or diesel. For diesel, a refund can be obtained instead of a tax credit. Claimants could seek a refund by submitting copies of the federal forms to MDT as documentation for the agricultural refund form. Because the federal refund only allows off-road use, the standard deduction would be changed to 100 percent.

Documentation to justify the claim must be maintained by the individual for three years. There is some flexibility on the documentation but it must indicate gallons purchased, dates purchased, names and addresses of suppliers and gallons used.

One of the downsides of eliminating the agricultural refund form with the standard deduction (Recommendation 3) is that the claimant would have additional documentation and calculation burden in submitting the off-road

claim. For this recommendation the claimant would not have an additional burden if he or she is requesting a refund or credit for the federal tax on their federal income tax return. The claimant would be required to submit a simple MDT agricultural refund form, a copy of the IRS form that shows the gallons used (from the previous list), and fuel purchase invoices. Requiring the individual to submit invoices would accomplish two things. First, it would allow MDT to run some of the same checks for errors that it currently does. Additionally, there may be purchases that are eligible for refund of federal tax but not Montana state tax, such as fuel purchased in another state.

This approach allows MDT to take advantage of the documentation requirements and enforcement efforts of the IRS to help ensure claims are fair and correct. It would not add a significant paperwork burden on claimants who claim the federal fuel tax credit or refund. Those who do not file income taxes would have to submit the off-road refund form.

Technical Panel Response: This recommendation would require a law change; access to IRS data for verification, along with the related confidentiality issues; and form changes. This recommendation also suggests requests for refunds would be limited to within one year of purchase. Currently, individuals have up to three years to file for a refund. The technical panel feels this recommendation is not administratively feasible.

Recommendation 7: Reduce or Eliminate Reefer Refunds

Reefer refunds could be eliminated. Currently, full refunds for taxes paid on fuel used in reefers are allowed by MDT for units that have a separate tank that is not connected to the vehicle engine. If the reefer unit is connected to the engine

supply tank, it is considered a Power Take-Off Unit (PTO) and only 25 percent of the fuel tax is eligible for refund. Under this recommendation, operators of vehicles with reefer units would either use dyed diesel in a separate tank or pay tax on the clear diesel used. Note that Oregon does not allow reefer refunds even if there is a separate tank.

Impacts of acting on this recommendation include a reduction in MDT processing effort for reefer refunds, elimination of fraud associated with reefer refunds, and increased inconvenience for reefer operators as they can no longer receive a tax refund on clear diesel fuel used in their reefer tanks.

MDT refunded an average of \$221,000 per year for reefer fuel use from 2007 to 2009. If those individuals who currently submit refund forms are able to use dyed fuel, fuel taxes collected by MDT would be reduced by the amount not refunded since dyed fuel is not taxed. It would eliminate the fraud in the reefer refund process which is estimated to be at least \$5,670 per year. Note that the current MDT review and audit processes are catching \$4,453 of this error. The primary benefit would be the reduction in administrative effort required by MDT to process reefer refunds.

A potential negative effect is that at low temperatures diesel fuel can turn into a non-flowing gel. Diesel fuel with certain additives can overcome this challenge; however, dyed fuel may not be available at certain gas stations in a low temperature additive form.

An alternative option for this recommendation would be to provide a disincentive for reefer users to use clear diesel and apply for the refund. Claimants could be allowed only a proportion of the taxes paid on clear diesel used in reefer tanks. Considering

that the total reefer refunds are approximately \$221,000 and it currently takes 0.25 full-time equivalent MDT staff persons to process these refunds, one could justify lowering the refund for use of clear diesel in a reefer unit to 75 percent of the taxes paid. This would mean a reduction of approximately \$55,000 in refunds paid by MDT to offset the costs of the 0.25 full-time equivalent staff person dedicated to processing reefer refunds.

Technical Panel Response:

The technical panel feels this recommendation is not reasonable. Reefer fuel use is off-road and is a completely legitimate reason for fuel tax refunds.

Recommendation 8: Further Study of PTO

In Montana, PTO refunds amount to an average of \$417,000 per year. The percentage of the paid fuel taxes that is refunded in Montana depends on the type of vehicle and ranges from 7.5 percent to 80 percent. The percentages used by other states range from 7.5 to 30 percent depending on the type of unit and are similar to Montana with the exception of well drilling rigs (Montana returns 80 percent). Nevada is the only state with a percentage specific to well drilling rigs, which is 30 percent. Montana could consider lowering the well drilling rig allowance to 30 percent. Even with this high percentage refunded for well drilling rigs, the amount of dollars refunded based on documentation available is calculated at less than \$10,000 per year. Thus the financial impact of such a change would be small. Additionally, reducing an existing rate based on what one other state uses may not be adequate justification.

In light of the sparse information available on the characteristics of PTO refunds, it is recommended that they be further studied. First,

the proportion of dollars refunded by PTO type should be tracked by one of two options. For PTO refunds the occupation code in the Accounts Payable System database could be better utilized by specifying the vehicle type. Alternatively, a larger sample of PTO refunds could be reviewed to compile a more accurate picture. If the proportions of individual types are small, the financial impact may not warrant further study. For example, if concrete mixing trucks accounted for 10 percent of the PTO refunds (as the current data indicate), and further study could justify reducing the percent allowed from 30 to 20, this would have a financial impact of \$13,900 less in refunds annually. This financial impact may not be worth the further study and effort needed to change Montana statutes. If, however, a single PTO type had a large share of the dollars refunded, a second study could be undertaken to investigate the actual fuel used by the PTO units on these vehicles.

Technical Panel Response: The PTO issue is considered to be non-attainable; the information is just not available at this time.

Recommendation 9: Only Allow One Year from Fuel Purchase to Submit Refund

Montana could reduce the period of time applicants are allowed to apply for a refund from three years after the purchase down to 12 to 15 months, as is done in other states. This would reduce the potential for repeat claim errors. This could make processing and error checking of refunds easier as they would only contain one year's worth of fuel purchases. This could increase the number of refund applications processed each year as those applicants who previously submitted one claim every three years would submit them yearly. The total number of fuel purchases reviewed would not increase. Although the number of claims might increase, each claim would

be, on average, smaller. This would have no impact on claimants already submitting forms at least once per year (59 percent of agriculture claimants, 52 percent of PTO claimants, and 55 percent of reefer claimants). If those who submit forms less than once per year begin submitting annually, the increase in forms received by MDT would be 21 to 27 percent depending on the form type.

Note the current 36 month time period was instituted by the Montana legislature in 1999 (changed from a 14-month time period), in part to be more consistent with other fuel tax requirements. International Fuel Tax Agreement (IFTA) carriers and Special Fuel Users (SU) licensees must file a quarterly fuel tax return, but they have 36 months to request a refund of their credits from MDT. Making the change back to 14 months would result in different requirements on unlicensed claimants and IFTA/SU licensees.

Technical Panel Response: The law was changed 12 years ago from 14 months to the current three year time frame, giving all involved the same amount of time within which to submit documentation for fuel tax refunds. Changing the time limit to one year would decrease taxpayer flexibility. However, there is an advantage to reducing the allowed time frame within which tax refunds must be submitted to something less than three years. Currently, audits also must be conducted within three years. If the taxpayer waits until the last day (of the three-year period) to submit refund requests, those refunds cannot be audited. In addition, a time period less than 3 years would potentially decrease the ability to double bill as the records retention period is also three years.

Recommendation 10: Modification of Forms

Current claim forms could be modified to improve clarity,

which has the potential to reduce EOE. The significant number of rounding errors, particularly on PTO forms, could be remedied by providing more instructions on the accuracy that is expected. For example, instructions could read “all gallons should be rounded to the nearest one-tenth of a gallon.” Auto-calculating forms could be developed in which values entered would be summed and otherwise calculated automatically. This may result in a reduction in the number of math errors. However, many applicants may still obtain hard copies of the refund form and manually write in the values they calculate. This is particularly an issue for applicants who do not have Internet access.

Research staff came across refund requests that used previous versions of the various forms. As forms are modified to reflect changing tax rates and changing rules, it is important to ensure claimants are using updated forms. Form instructions could include a statement such as “if the last revised date of the form (found in the page footer) is older than three years please visit <http://www.mdt.mt.gov/publications/forms.shtml#fuel> or call 406-444-7278 to ensure you are using the most recent form.”

On the PTO form, the average miles per gallon (column 3) is to be found by dividing column 1 (total miles traveled for vehicle) by column 2 (total gallons used in vehicle). This is stated in the instructions, but the column header does not have the math instructions included as they are in other headers on this form. A line should be added to the column 3 header that reads “(1) / (2)”. This should eliminate the fuel economy error.

As discussed in Recommendation 5, the size of an agricultural operation impacts the total amount of fuel used. Even if Recommendation 5 is not implemented, the current agricultural refund form should

include a reporting of farm size in acres. This would allow for future evaluation of the fuel use by farm type. Additionally the farm size could be used to identify potentially erroneous claims. A claim would be given a red flag if the total fuel usage, for either gasoline or diesel, is greater than 1.5 times the number of acres times the number of years the claim covers.

The fiscal impact of this recommendation is difficult to estimate. The current fiscal impact of math errors on all forms is estimated to be about \$22,000. MDT currently catches almost all of these errors. The main benefit of this recommendation is reducing the potential for error, thus reducing MDT staff burden. Another benefit is increased convenience for the applicant.

Technical Panel Response: This recommendation is already being implemented. Older versions of forms are always accepted. If newer forms require additional information, those individuals will be contacted directly to obtain the required information.

Recommendation 11: Electronic Database

An electronic database could be used to track more details of current and past refunds. This would allow for more detailed analysis of refund data, automated error checking, and cross-checking for errors between applications. Currently the MDT refund process is primarily paper based. When the refund is paid, a record is established in the Accounts Payable System database with some summary information (e.g., applicant name, applicant address, fuel type, refund type, date paid, amount paid, and a number to locate the paper document). All other information is limited to the paper version. Paper records are maintained for three years. The main downside is the increased staff time required for entering this data.

The research database created for this project was used to analyze certain characteristics of fuel purchases and other details not available in the current Accounts Payable System database. This is beneficial for estimating and tracking impacts of policy decisions. Several cross checks were made to identify EOE within the sample refund forms entered into the research database. An example was the identification of individual purchases that had the same date, retailer, and amount. Several identical receipts were found that were coincidences such as one company that had a fleet of trucks with PTO units such that there were several fuel purchases each day. However, this led to the identification of one repeat claim. Cross checking will identify specific EOE and red flags to direct further investigation. The cross checking done for this research came up with a few suspicious claims. Only one turned out to have a clear error. If cross checking was implemented, it would require additional staff time to verify that an error exists.

The costs of implementing such a database would need to be considered in advance. To this end, the amount of time required to enter the detailed data into the research database for each form was about five claims per hour for agricultural and PTO claims, and three claims per hour for reefer claims, such a database could require 1,700 hours per year, or approximately 0.8 full-time equivalents. This effort could be minimized or even eliminated if claimants were allowed to electronically submit claims and keep the original receipts for audits only. Without the ability to check original receipts with the values on the claim, audit efforts should be increased.

The relational structure and suggested improvements to the research database developed for this project are provided in the [final report](#), Appendix C. The functionality

and design of such a database should be determined by MDT to ensure it meets departmental needs. The information in the appendix is only intended to provide a possible starting point should a database be developed.

Technical Panel Response: The technical panel agrees with this recommendation; however, the panel would like to conduct further research to determine if a system already exists that MDT could implement as is or with modifications. Regardless, a programming request for IT resources will be made to add it to the current queue. The preferred method of data entry is the taxpayer in lieu of submitting paper requests. MDT staff would enter the data for those who do not have computer access.

Recommendation 12: Increase Audit Numbers

The number of desk audits could be increased and/or current audits could be refocused. A target should be set for some number of desk

audits to be conducted each year of individuals submitting refund forms. Currently MDT audits approximately 3 percent of IFTA individuals and at least six special fuel users annually. An audit of an individual includes any refund claims they may have submitted. Individuals filing PTO and reefer claims are typically IFTA and/or SU. Agricultural refund claimants are rarely in one of these audited categories. There is no set number for auditing refund claimants other than those already selected from the IFTA or SU audits. Individuals submitting only agricultural refund forms are audited based on recommendations from the refund staff. Currently, a few agricultural refunds per year are recommended for audit based on the discovery of errors, missing documentation, or suspicious circumstances. Setting a fixed target for the number of refund form audits per year would encourage some random selection of refund forms beyond those with clear red flags. The number of audits should be determined based on staff availability. A small number (e.g., one or two per year) could possibly be absorbed into current workloads.

A large number would require additional staff and/or reducing the number of IFTA and SU audits. A pilot effort could determine the potential consequences of such a shift.

Technical Panel Response: This recommendation is currently being implemented.

Recommendation 13: Training/ Public Outreach

If any of the previous recommendations are implemented, the change should be incorporated into MDT's public outreach effort. MDT is currently making significant efforts in the area of training and public outreach to fuel tax refund applicants. Public outreach and training could include announcements, on-site visits or other activities.

Technical Panel Response: This recommendation is already implemented. Various methods of outreach are in place and will be modified, as appropriate, as changes to the program are made.

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