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LEGISLATION REVIEW AND RECOMMENDATIONS TO REDUCE EVASION OF KENTUCKY ROAD FUND REVENUES.

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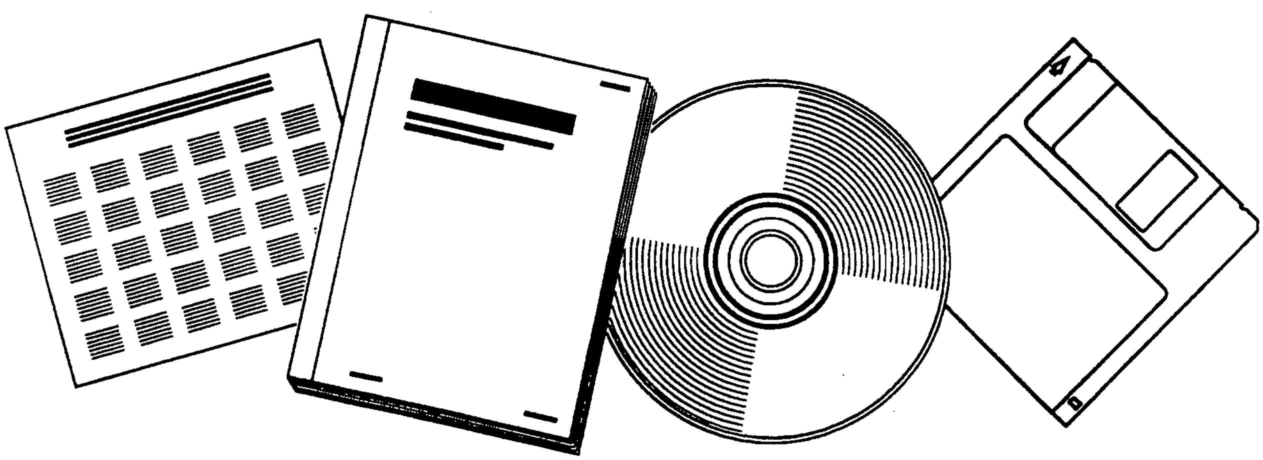

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Legislation Review and Recommendations to Reduce Evasion of Kentucky Road Fund Revenues.

KYSPR-93-153

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in cooperation with Kentucky Transportation Cabinet

and

Federal Highway Administration
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16. Abstract

The Federal Highway Trust and the Kentucky road fund were established to provide earmarked resources for maintaining and building federal and state roadways. Two major sources of the revenues for the Kentucky road fund are the motor fuels tax and vehicle licensing and registration fees/taxes. Evasion of the road fund revenues reduces the fiscal resources available to build and maintain roads. This report reviews state statues to identify the anti-evasion strategies that have been adopted in the southern region. Recommendations are provided to address evasion of the motor fuel tax, vehicle registration, and the ad valorem property tax.

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LEGISLATION REVIEW AND RECOMMENDATIONS TO REDUCE EVASION OF KENTUCKY ROAD FUND REVENUES

Executive Summary

Introduction

Kentucky, like other states, is facing fiscal challenges in providing expanding public services demanded by citizens. One danger of constrained fiscal resources and shortsighted political horizons is the tendency to neglect the investment and maintenance of long-term infrastructures like highways. The Kentucky road fund protects against these dangers by providing earmarked resources for the state's roadways, insuring that basic infrastructure needs are met. However, evasion of road fund revenues decreases the funds available to meet the needs of Kentucky's transportation infrastructure. For these reasons, the Kentucky Transportation Cabinet is interested in developing policy recommendations intended to mitigate evasion of road fund revenues.

This report compliments the final report "The Motor Fuel Tax Evasion Issue in Kentucky, 1996" (KYSPR 93-153) which identifies potential concerns in the nature and causes of road fund tax evasion. This current study constitutes an informal report that is complimentary to research report KTC-96-16. Moreover, it provides additional detail regarding the legislative action that addresses fuel tax evasion in the southern region. This report also develops estimates of the revenues lost through evasion in vehicle registration and licensing in the Commonwealth.

The Federal Highway Trust and the Kentucky road fund were established to provide earmarked resources for maintaining and building federal and state roadways. Two major sources of the revenues for the Kentucky road fund are the motor fuels tax and vehicle licensing and registration fees/taxes.

Evasion of these revenues diminishes the resources available to maintaining and building state roadways. There are three studies that have estimated the fuel tax revenue lost through evasion. The U.S. Department of Transportation estimated that evasion of the gasoline tax is between three and seven percent of the gallons consumed nationally, while diesel fuel tax evasion is 15 to 25 percent of gallons consumed nationally. Evidence of fuel tax evasion is provided in the Council of State Governments (CSG) study that estimated nearly 1.2 billion dollars of aggregate state fuel tax revenue was evaded in fiscal year 1993. Estimates of the fuel tax evasion occurring in Kentucky are provided in the KTC final report *The Motor Fuel Tax Evasion Issue in Kentucky* (1996). This study estimates that approximately 28 million dollars of Kentucky fuel tax revenue was evaded in fiscal year 1993.

Estimates of revenue lost through evasion of vehicle registration and licensing are less common. The CSG report estimated that between 421 to 654 million dollars of aggregate state revenue from licensing and registration were evaded in fiscal year 1993. Similar analysis is applied to obtain the evasion losses of Kentucky vehicle registration and the associated ad valorem taxes as reported in Appendix B. The estimation predicts that over 239 thousand vehicles were unregistered in Kentucky in 1994, resulting in a road fund revenue loss that approach 50 million dollars.

Southern States Legislation on Motor Fuels Taxes

Implementation of policies designed to reduce evasion of the road fund revenues, generally require changes to state law. This study reviews the statutes and legislation of states in the southern region and identifies those states that have adopted anti-evasion policies. This report focuses on legislation that affects the licensing of petroleum distributors, fuel tax administration, and fuel tax enforcement.

The petroleum distribution process in the United States is complex. Crude petroleum can be produced domestically or imported to the refinery. The refinery processes the crude into diesel and gasoline products. The refined petroleum can then be sold to the wholesaler or exported. The wholesalers then sell the fuel to retailers where it can be sold to consumers. The complex nature of the petroleum distribution process in the United States creates difficulties in administering and enforcing a state motor fuels tax. As a result, states impose bonding and licensing requirements on the "wholesaler" or "dealer" to provide additional protection against fuel tax fraud. Some states have simplified the administration and enforcement of the motor fuels tax by changing the point at which the tax is assessed and collect. Table E.1 indicates the point at which the fuels tax is assessed and collected by the states in the southern region.

Table E. 1 Collection Point for Motor Fuel Excise Tax

Southern Region	Refiner/ Blender at the Rack	Importer at the Rack	Distributor/ Supplier at the Rack	Distributor/ Supplier	Dealers/ Wholesalers	Retail Dealers
Alabama					X	
Arkansas			X			
Delaware			X			
Florida	X	X				
Georgia				X		
Kentucky					X	
Louisiana[1]	X	X			X	
Maryland[2]		X			X	
Mississippi[3]			X			
N. Carolina	X	X				
Oklahoma			X			
S. Carolina	X	X				
Tennessee[4]	X	X	X			
Texas			X			
Virginia						X
W. Virginia					X	

The Kentucky process of taxation collection occurs at the dealer level, which is synonymous with taxation at the wholesaler level for the other southern region states. This level of taxation allows the licensed dealer to sell fuel to other licensed dealers therefore passing on

[1] In Louisiana gasoline is taxed at the rack, diesel fuel is taxed at wholesaler level.
[2] Point of taxation based on classification of license.
[3] Imported gasoline taxed at first point in state, diesel taxed at supplier level.
[4] Point of taxation at the rack effective January 1,1998. Imported gasoline taxed first point in state.

the tax burden. This practice increases the number of tax collectors involved, which has been associated with taxation avoidance and evasion.

Penalties and Punishments

The penalties for failure to make reports, keep records, or pay the motor fuel tax constitute two types, criminal and civil. Table E.2 identifies the specific types of fines, fees, and penalties imposed by states in the southern region.

Table E. 2 Penalties for Conviction of Motor Fuel Tax Fraud

Southern Region	Criminal Penalty	Civil Penalty
Alabama	Misdemeanor and shall be punished by a fine of not less than $50 or more than $300. Each month that payment due a new misdemeanor is applied.	All excise tax due plus interest and penalties. Interest at the federal rate.
Arkansas	None	All excise tax due plus penalties.
Delaware	Class E felony and shall be punished by a fine of not more than $11,500 or by imprisonment not exceeding 5 years, or both.	All excise tax due plus interest at 1% per month and a penalty of $5.75 per day to a maximum of $28.75.
Florida	Felony of the third degree and shall be punished a fine of not more than $5,000 or by imprisonment not exceeding 5 years, or both. State reserves the right upon conviction to revocate or suspend fuel tax license.	All excise tax due plus interest and penalties. Penalty is 10% per month to a maximum of 50%.
Georgia	Misdemeanor and shall be punished by a fine of not less than $1,000 nor more than $10,000 or by imprisonment for a term not less than 30 days nor more than 12 months, or both.	All excise tax due plus interest and penalties. Penalty is10% of unpaid taxes plus $50.
Kentucky	Class A misdemeanor and shall be punished by a fine of $500 or by imprisonment for a term not less than 90 days nor more than 12 months, or both.	All excise tax due plus interest and penalties. Penalty is a minimum of $10 or 2% per month to a maximum of 20%, which ever is greater.
Louisiana	Misdemeanor and shall be punished by a fine of $500 or by imprisonment for one year, or both.	All excise tax due plus interest, penalties, and cost accrued. State can attach, seize or sequester any gasoline, motor fuel, or lubricating oil subject to tax.
Maryland	Misdemeanor and shall be punished by a maximum fine of $1,000 or imprisonment not exceeding 6 months, or both. Revocation of license after non-compliance of 60 days.	All excise tax due plus a penalty of at least $10 or 10% of tax due, which ever is greater. Seizure of all assets and fuel if excise tax not paid.
Mississippi	Misdemeanor and shall be punished by a fine of not less than $50 or more than $100.	All excise tax due plus interest and penalties. Penalty can be 3 times amount of excise tax due.
North Carolina	Class 1 misdemeanor and shall be punished for a term not less than 1 day or more than 45 days community punishment.	All excise tax due plus interest and penalties. Minimum penalty is $50.

Southern Region	Criminal Penalty	Civil Penalty
Oklahoma	Felony and shall be punished by a fine of not more than $10,000 or 3 years in the state penitentiary, or both.	All excise tax due plus interest and penalties. Penalty is equal to 100% of the excise tax due. Interest is 1.25% per month.
South Carolina	Felony and shall be punished by a fine of not more than $5,000 or imprisonment not exceeding 5 years, or both.	All excise tax due plus interest and penalties. Interest is ½ % per month.
Tennessee	Revocation of license. Class E felony and shall be punished by a fine of not more than $3,000 or imprisonment for not less than 1 year nor more than 6 years, or both for evasion of excise tax.	All excise tax due plus interest and penalties.
Texas	Felony in the third degree and shall be punished by a fine of $10,000 or imprisonment for not less than 2 years nor more than 10 years in the state penitentiary, or both.	All excise tax due plus interest and penalties. Penalty is 50% of excise tax due.
Virginia	Class 1 misdemeanor and shall be punished by a fine of not more than $2,500 or imprisonment of not more than 12 months, or both.	All excise tax due plus interest and penalties. Penalty is a minimum of $10 or 6% of excise tax due per month not to exceed 30%, whichever is greater.
West Virginia	Misdemeanor and shall be punished by a fine of not less than $100 nor more than $1,000 or imprisonment of 6 months in jail, or both.	All excise tax due plus interest and penalties. Penalty of 5% of excise tax due per month.

A civil statutory or legislated penalty is common throughout the southern states. The penalty is generally based on the motor fuel tax due plus associated fines, fees and interest. The fine in Kentucky is in the moderate category when compared to the other southern region states.

In the southern states, a wide variety of penalties is associated with the criminal aspects of the motor fuel tax. Recently, a change has occurred in this portion of the motor fuel tax legislation. Commonly, a misdemeanor penalty was associated with the failure to pay motor fuel tax. In the last few years this minimal deterrent to fraud has evolved toward felony punishment. Some of the southern region legislatures are looking carefully at motor fuel tax evasion and reinterpreting the failure to pay as a felonious crime. This trend has led to harsher penalties and punishments intended to deter fraud.

Nonetheless, many of the southern region states still consider evasion of the motor fuel tax as a misdemeanor crime. States that utilize misdemeanor punishment impose a maximum jail term of twelve months and a maximum criminal fine of $1,000 for evasion or failure to pay the motor fuel tax. Kentucky imposes a singular criminal penalty of a Class A misdemeanor. The fine associated is $500 with a possible jail term of three to twelve months.

Liability for Motor Fuel Tax

The responsibility for motor fuel taxation payments can be seen in two aspects. The first is the corporation as an entity, and the second is the corporation as a group of individuals who hold tax liability. Legislation regarding the corporate liability for states in the southern region is shown in Table E.3.

Table E. 3 Liability for Motor Fuel Taxation

Southern Region	Corporate Liability and Individual Personal Liability	No Distinction in Liability
Alabama	Corporation officers hold personal liability.	
Arkansas	Corporation officers hold personal liability.	
Delaware	Corporation officers hold personal liability.	
Florida	Corporation officers hold personal liability.	
Georgia	Corporation officers hold personal liability.	
Kentucky		No distinction between person and corporation.
Louisiana	Corporation officers hold personal liability.	
Maryland	Corporation officers hold personal liability.	
Mississippi	Corporation officers hold personal liability.	
North Carolina	Responsible corporate officer that includes the president and the treasurer of the corporation and any other officers assigned the duty of filing the tax returns.	
Oklahoma	Corporation officers hold personal liability.	
South Carolina	A person, officer, or employee of corporation held responsible.	
Tennessee	Corporation officers hold personal liability if acting as trustee of motor fuel tax.	
Texas		No distinction between person and corporation.
Virginia	All officers, directors, and controlling owners of corporation held responsible.	
West Virginia	All officers, directors, trustees, or members of corporation held responsible.	

Dyed Fuel Programs

The Omnibus Budget Reconciliation Act of 1993 mandated in the administration of the federal motor fuels tax, a dyed fuel program. Some states have chosen to implement similar programs at the state level.

Table E. 4 Dyed Fuel Programs in the Southern Region

Southern Region	Dyed Fuel Program at State Level	
Alabama		No dyed fuel program.
Arkansas	Off-road fuel dyed at rack. Penalty is misdemeanor.	
Delaware		No dyed fuel program.
Florida	Mirrors federal program. Penalty is $10 per gallon of tank capacity or $1,000, which ever is greater.	
Georgia[5]		No dyed fuel program.
Kentucky		No dyed fuel program.
Louisiana	Mirrors federal dyed program. Dealer is responsible for dyeing fuel that is used for non-taxable purposes. Criminal penalty is misdemeanor.	
Maryland		No dyed fuel program.
Mississippi		No dyed fuel program.
North Carolina	Mirrors federal program. Penalty is class 2 misdemeanor.	
Oklahoma[6]	Mirrors federal program.	
South Carolina		No dyed fuel program.
Tennessee	Mirrors federal program.	
Texas		No dyed fuel program.
Virginia		No dyed fuel program.
West Virginia	Mirrors federal program. Penalty is $10 per gallon of tank capacity or $1,000, which ever is greater.	

Recommendations

Recommendations are presented to address evasion of the motor fuel excise tax, vehicle registration, and the ad valorem property tax. These recommendations are summarized in Table E.5. The fuel tax recommendations embody changes in legislation to reduce non-compliance and increase personal liability for the payment of collected fuel tax revenues. In general, the vehicle registration and licensing recommendations focus on enhanced visibility of compliant registration and increased penalties associated with delinquent vehicle registration. Unregistered vehicles also escape assessment of the ad valorem property tax representing a major revenue loss to the state road fund.

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[5] Looking at mirror of federal program in 1998.
[6] Refund is available for non-taxable use of clear fuel when tax is initially paid at the rack.

Table E. 5 Recommendations to Reduce Road Fund Evasion

Vehicle Licensing   1. Redesign license plates and registration materials to enhance the visibility of unregistered vehicles.   2. Adopt legislation that changes the penalties associated with driving an unregistered vehicle.   3. Adopt a minimal fee for unregistered vehicle citations issued by law enforcement.   4. Periodic re-issuance of license plates and/or other highly visible registration materials.
Fuel Tax   1. Change the criminal penalty associated with motor fuel tax from a misdemeanor to a felony.   2. Adopt legislation that holds corporate officers personally liable for the fuel tax submission and payment.   3. Change the point of taxation from the dealer level to at the rack.   4. Work with interstate cooperative organizations to coordinate enforcement of fuel tax evasion.

The reduction of tax evasion is only one of many priorities for Kentucky. Policy makers should consider the recommendations here in context of other state priorities.

Tax evasion of the road fund revenues is an elusive and burgeoning threat. Methods of evasion are constantly evolving and adapting to new methods of tax enforcement. However, the recommendations provided above are methods of reducing tax evasion of road fund revenues. Reduction of road fund revenue evasion enhances the fiscal resources available to build and maintain state roadways, increases citizen support of government, and insures that everyone pays "a fair share".

Introduction

In an environment of citizen pressure for higher provision of public services and resistance to increased taxes, some states have initiated procedures to address the evasion of state taxes. The reduction of tax evasion increases state revenues while bolstering citizen perceptions that all citizens are paying their share to support public services.

Kentucky, like other states, is facing fiscal challenges in providing expanding public services demanded by citizens. One danger of constrained fiscal resources and shortsighted political horizons is the tendency to neglect the investment and maintenance of long-term infrastructures like highways. The Kentucky road fund was established as protection against these dangers by providing earmarked resources to the state's roadways and thereby insuring that basic infrastructure needs are met. However, evasion of road fund revenues decreases the funds available to meet the needs of Kentucky's transportation infrastructure. For these reasons, the Kentucky Transportation Cabinet is interested in developing policy recommendations intended to mitigate evasion of road fund revenues.

This report compliments the final report "The Motor Fuel Tax Evasion Issue in Kentucky, 1996" (KYSPR 93-153) which identifies potential concerns in the nature and causes of road fund tax evasion and provides state policy makers and administrators with potential solutions. This current report does not constitute a formal part of the preceding final report, KTC-96-16. Instead, this current study is a report that compliments the 1996 final report by providing additional detail regarding the legislative action to address the evasion of fuel taxes by the states in the southern region. In addition, this report develops estimates of the revenues lost through evasion of vehicle registration and licensing in the Commonwealth.

The first section of this report provides a basic background on the road fund revenues and previous studies that have examined the evasion of road fund sources. Chapter Two reviews the southern states' legislation passed to address fuel tax issues. Chapter Three describes policy recommendations and conclusions. Discussions of the Kentucky motor vehicle registration process and evasion estimates for automobile registrations are provided in Appendices A and B.

Chapter 1: Background

Road Fund Revenues

The Federal Highway Trust began in 1956 to promote the growth and development of a federal interstate highway system. The Trust receives a variety of earmarked revenues from a variety of sources. The most common revenue source is the federal excise tax on gasoline and diesel, which is 18.3 and 24.3 cents to the gallon, respectively.[7]

The Kentucky road fund was established to provide earmarked resources for maintaining and building state roads. Like the Federal Highway Trust, the Kentucky road fund receives a variety of earmarked revenues. The two major sources are the motor fuels tax and vehicle licensing and registration, comprising 34 percent and 36 percent of the fund revenues in 1994.

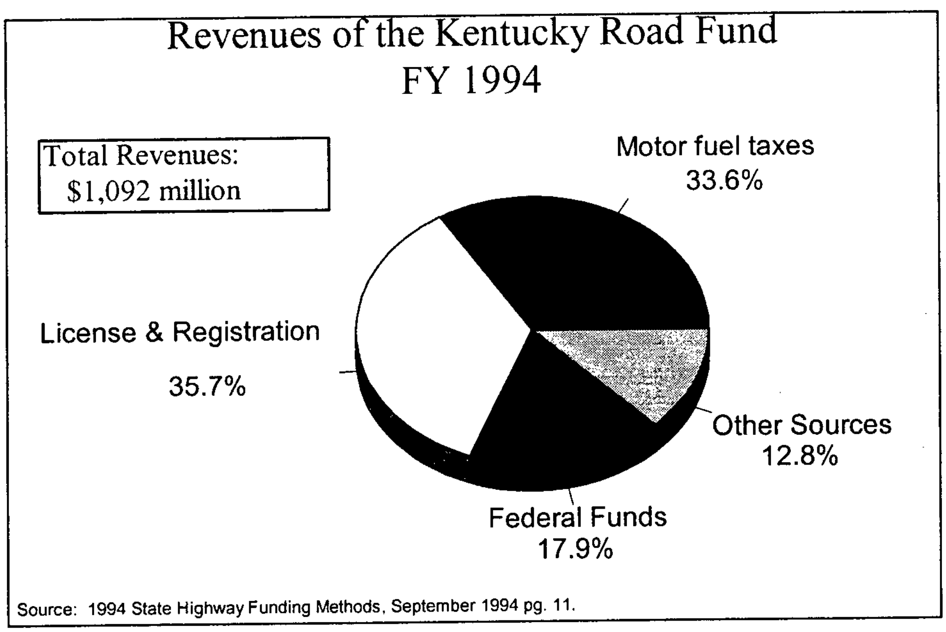

Figure 1

[7] Internal Revenue Code: Section 4081, Subtitle D. Miscellaneous Excise Taxes

Other revenues are federal funds and miscellaneous fees and taxes. The composition of the Kentucky road fund in 1994 is illustrated in Figure 1.

Evasion of Road Fund Revenues

Evasion of the motor fuel tax was generally not perceived as a critical problem until the last decade when investigative journalism exposed evasion schemes that were stealing millions of dollars of fuel tax revenues. Prior to that time federal revenue officials suspected some evasion of fuel tax revenues, but the severity of the evasion loss was grossly underestimated.[8] At this time federal officials began an aggressive enforcement of the fuels tax.

Table 1 Evasion Categories of Road Fund Revenue

	Motor Fuels Tax	Vehicle Licensing & Registration
Failure to file information	Failure to report the sale or exchange of motor fuels to government authorities so tax is never assessed.	Failure to complete or apply for required licenses and permits before operating a vehicle.
Filing of false information	Falsification or misrepresentation of information influencing the amount of tax assessments paid.	Falsification of vehicle value by underreporting value or vehicle attributes. This alters the amount of fees charged.
Filing false exemptions	Representing taxed activities as non taxed activities resulting in a reduction of taxes payable.	Not applicable. States rarely exempt licensing and registrations fees
Failure to pay assessed taxes	Refusal to pay the tax levied on the reported sale of motor fuels.	Refusal to pay the registration fees for a vehicle.
Source: Denison & Hackbart *The Motor Fuel Tax Evasion Issue in Kentucky (Final Report KTC-96-16)* Kentucky Transportation Center, July 1996		

There is a wide range of methods in the evasion of road fund revenues. Generally, the evasion of the fuel tax can be classified into four general categories as are discussed in Table 1.

[8] FHWA Fuel Tax Evasion, June 1, 1992 p 2.

Some of the more infamous methods of evasion include daisy chains, fuel blending, cocktailing, and bootlegging[9].

Federal Government and Road Fund Evasion

The Intermodal Surface Transportation Efficiency Act (ISTEA) is arguably the most influential legislation affecting road fund revenues to the Federal Highway Trust. This legislation inacted a specific provision regarding the administration and enforcement of the federal motor fuels tax. This legislation required the research of a dyed diesel fuel program designed to enhance the detection of evasion. A dyed-fuel policy was later mandated as part of the Omnibus Budget Reconciliation Act (OBRA) 1993. ISTEA also provides fiscal resources to the states in order to enforce the motor fuels tax. States have benefited from special efforts of the Federal Highway Administration to mitigate the road fund evasion. These efforts focus on multistate strategies to combine efforts of enforcement and are partially motivated through ISTEA provisions that provide supplementary anti-evasion funding and encourage interstate cooperation.

In 1993, Congress transferred the liability of federal tax collection from wholesalers to producers of petroleum products (OBRA 1993). The fuel tax would be collected at the "terminal" or rack when the fuel is transferred to the wholesaler. Collecting the tax at the rack reduces evasion because enforcement officers can focus on fewer entities responsible for remitting the tax. This means that it is easier for the IRS to determine if the proper taxes are being reported and remitted, making it difficult to evade the fuels tax by filing false information or forming daisy chain corporations. As previously mentioned, OBRA 1993 also requires that a

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[9] For description of these terms see Denison & Hackbart *The Motor Fuel Tax Evasion Issue in Kentucky (Final*

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dye and marker be mixed with the fuel that is to be used for tax exempt purposes enhancing the detection of fraudulent use of tax exempt fuels.

Federal Studies

In the wake of the high profile fuel tax frauds of the 1980s, Congress passed legislation (ISTEA) that required the Federal Highway Administration to assess the severity of the motor fuel tax evasion. The results of their analysis are reported in the "Fuel Tax Evasion and the Joint Federal/State Motor Fuel Tax Compliance Project" FHWA-PL-92-028, U.S. Department of Transportation, June 1, 1992. By the federal estimates, the evasion of gasoline tax is believed to be between three and seven percent of gallons consumed. The range for diesel fuel tax evasion is more severe affecting between 15 and 25 percent of gallons consumed.

The Joint Federal/ State Motor Fuel Tax Compliance Project (Joint Project) publishes a fuel tax evasion report semiannually on the implementation of the ISTEA legislation. These reports contain evaluations and recommendations for reducing evasion of the motor fuels tax. The Joint Project also publishes a quarterly newsletter that reports fuel tax enforcement activities, regional task force activities, and changes in state fuel tax administration.

CSG Study

The Council of State Governments in association with CGPA initiated a general investigation of motor fuels tax evasion from the states' perspective and published *Road Fund Tax Evasion: A State Perspective*. The study utilized survey responses from state motor fuel administrators and empirical models to estimate the aggregate state revenues lost in 1993 due to evasion of motor fuels taxes.

The survey component of the study was comprised of three surveys. One survey broadly addressed evasion of the major revenue sources for states. The other two surveys addressed evasion of motor fuels taxes and vehicle registration in considerable detail. The survey on motor fuels tax evasion was sponsored in cooperation with the Kentucky Transportation Center. The study used perceptions of the principal fuel tax administrators to derive estimates of evaded fuel taxes and vehicle licensing. By applying these perceptions to the state collections of motor fuels, the aggregate loss of state revenue is estimated to be $1.2 billion[10].

The empirical component of the CSG report consists of econometric models that predict the volume of fuel consumed within each state. This estimation is compared to the sum of the taxed and non-taxed gallons of fuel for each state. The difference between the estimated and reported consumption of fuel is considered evasion. Several models were considered to estimate the true "consumption" of fuel, and each model predicted similar levels of evasion. The average of all the model estimates is $952 million in aggregate state revenues lost through evasion of fuel taxes.[11] Similar estimates were derived for the evasion of vehicle licensing and registration. The survey estimate is $654 million while the statistical model estimates $421 million in evaded fees.[12]

KY Study

The CSG estimates of the aggregate state evasion loss are reasonable and consistent with federal estimates. However, these estimates represent aggregate state evasion loss and provide little information about evasion severity in Kentucky. Therefore, the Kentucky Transportation

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[10] Council of State Governments & Council of Governors' Policy Advisors. *Road Fund Tax Evasion: A State Perspective, Full Report.* 1996. Pg. 57.
[11] IBID.
[12] IBID.

Cabinet initiated a study to specifically examine the issues of fuel tax evasion in Kentucky. This report has been previously mentioned in earlier portions of this chapter.

The study attempts to clarify and assess the motor fuel tax evasion issue in Kentucky. Specifically, it provides background information on the federal highway trust and the Kentucky road fund. It also describes Kentucky's involvement with the federal government and the states in the southern region. The severity of fuel tax evasion is estimated for Kentucky in context of other national estimates of evasion. In addition, a chapter describes the federal and state initiatives that have emerged to address the fuel tax evasion issue. Future challenges in fuel tax enforcement are also discussed.

Summary

This chapter provides a basic background of the issues of road fund tax evasion. Tax evasion is an elusive and burgeoning problem. Methods of tax evasion are continually changing and adapting to new methods of tax enforcement. However, there are strategies that can reduce the potential loss of revenues in the road fund. The fight against fuel tax evasion is fought on three fronts: federal, regional, and individual state level. The federal government is working to improve compliance to the federal motor fuels tax through ISTEA, complementary legislation and other organizations. Regions of states are coordinating to reduce evasion that occurs due to inadequate information regarding the transfer of fuels across state lines. The goal of this report is to propose an appropriate course of action for Kentucky in addressing the evasion of road fund taxes. This goal is assisted through the review of legislation discussed in the following chapter. Chapter Three presents conclusions and policy recommendations for the reduction of motor fuel tax evasion and vehicle registration.

Chapter 2: Southern States' Legislation on Motor Fuel Taxes

The Kentucky Transportation Center and the Council of State Governments report mentioned in the preceding chapter identified policies designed to reduce evasion of the road funds. Some policies have focused on modifying the administration and collection of the motor fuels tax in an effort to eliminate potential evasion problems. Other policies have focused on enforcement to improve compliance to the motor fuels tax. Most often, implementation of these policies first requires changes to state law. This chapter reviews the statutes and legislation of states in the southern region to identify states that have adopted these policies. This report focuses on legislation that affects the licensing of petroleum distributors, fuel tax administration, and fuel tax enforcement.

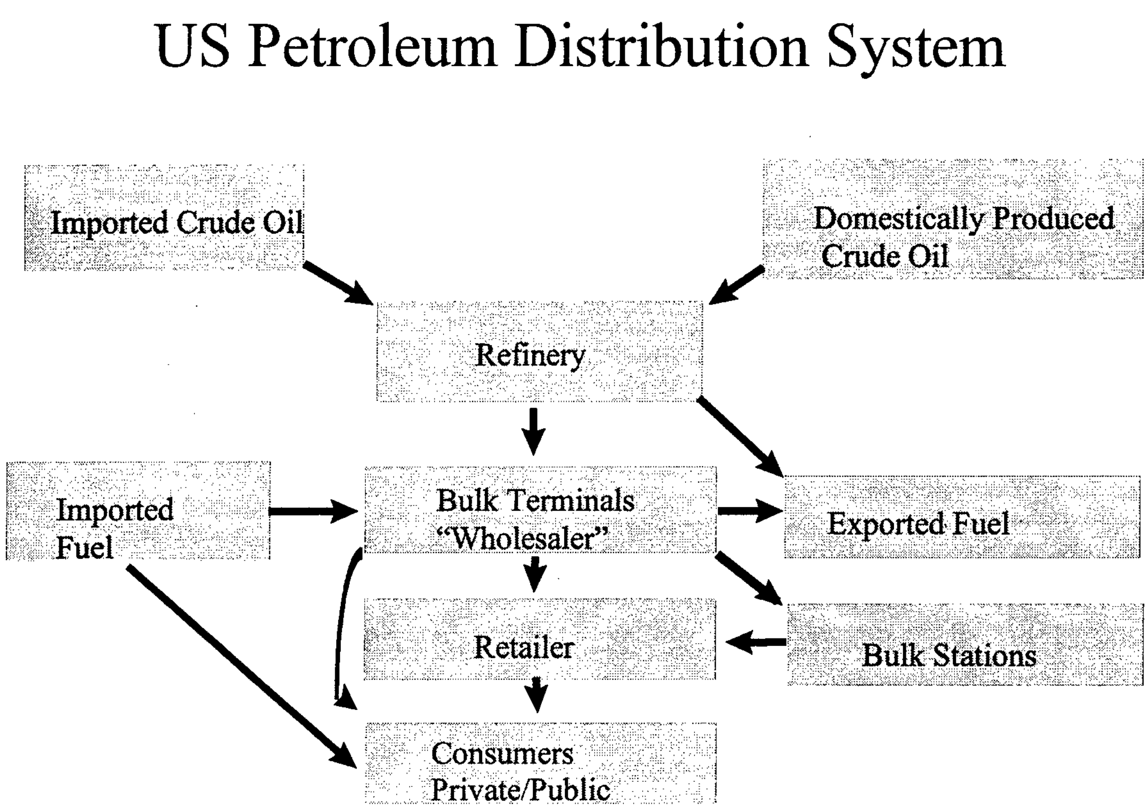
An objective of this report is the consolidation of the southern region states legislation and statutes on licensing, penalties and punishments associated with the motor fuel tax. To achieve this, the complete state statutes and legislation were obtained through the use of the Internet source PetroChem[13] and a review of printed statutory law. The information in these statutes and legislation were then assembled into tables that follow in this chapter. The content of the tables was verified and corrected as necessary through phone consultation with each of the respective states' revenue administrators.

The petroleum distribution process in the United States is complex. Figure 2 attempts to simplify the petroleum distribution process. Crude petroleum can be produced domestically or imported to the refinery. The refinery processes the crude into diesel and gasoline products. The refined petroleum can then be sold to the wholesaler or exported. The wholesalers then sell the

[13] Web site is located at http://www.pertrochem.net.

fuel to retailers where it can be sold to consumers. There are exceptions to this generic process as illustrated in Figure 2.

Figure 2



Licensing of Motor Fuel Tax Collectors

Each state requires the parties charged with collecting the fuel tax to be licensed. This section describes and identifies the process and legislation used to license the motor fuel tax collectors. The collectors of the motor fuel tax are usually described as the distributors, suppliers, wholesalers, or dealers of motor fuel. Licensing insures that consumers of the fuel ultimately bear the burden of the fuel tax.

This chapter describes different components of the motor fuel tax collection system. The following terms are defined to clarify the discussion of the petroleum distribution process.

- "Wholesale level" is the level at which the motor fuel is sold among licensed suppliers, distributor, wholesalers, and dealers who do not pay tax on those transactions.
- "First point of sale" is the point at which any person purchases fuel in bulk quantity for resale or personal use.
- "At the rack" is the point at which motor fuel is purchased at the refinery or supply station.
- "Retail Dealer/At the Pump" is the point at which the motor fuel is transferred to the consumer.
- "Excise tax" is synonymous with motor fuel tax.

Licensing Requirements

All states in the southern region mandate the use of permits or licenses for individuals and corporations that collect motor fuels tax. The license or permit provides the states with an administrative process to account for the number of gallons of motor fuel sold in the state. This allows for differentiation of taxable and non-taxable fuel for tax collection purposes. The foremost utilization of this process is the regulation of motor fuel voluminous buyers and sellers.

The license or permit is required for importation, exportation, or distribution of motor fuels. This encompasses all aspects of both fuel transportation and sales. The level at which the permit or license occurs varies among the individual states and is dependent upon the point at which taxation occurs.[14]

A minimal administrative fee is generally incorporated into the license or the permit. The administrative fees vary among the states with a minimum of five dollars and a maximum of fifty dollars. Some of the southern region states differentiate between a permit and a license. The

[14] See Table #1

permit system commonly combines the motor fuel tax and a state fee while the license has an administrative fee only. The process in Kentucky is a licensing system; however, no fee is associated with this license.[15]

Bond Requirements

A surety bond is required within the licensing requirement and is posted at the time the license is issued. The bond is an obligatory form of insurance for the financial rating and reputation of the individual or corporation. Most bonds are conditional upon the prompt filing of true reports by the licensee, allowing discretion of the authorizing authority in the licensing process. In this process all bonds must be obtained from a bonding company authorized to do surety business in the state.

In the southern region states, the value of the surety bond varies from a high of a two-million dollar bond, to a low of a one-thousand dollar bond. The variation in value is associated with the perception of the surety bond in the state. The higher value bonds are interpreted as a guarantee of payment in the occurrence of a license holder default or evasion of the tax. Other states perceive the bond as a form of customary insurance and may require only a minimal bond. In the majority of the states, a surety bond that is equal to at least three times the value of the tax during an average month is generally required. Kentucky bases the value of the surety bonds on an amount not to exceed three month's motor fuel tax liability or $5,000, whichever is greater.[16]

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[15] KRS 138.320
[16] KRS 138.330

Fuel Tax Administration and Collection

Administration

A department or cabinet of revenue administers the collection of motor fuel taxation in most of the southern region states. Nonetheless, the individual states vary on who and how the administration takes place. For example, the State of Alabama administers its motor fuel tax through the Department of Revenue while the State of Arkansas utilizes its Department of Highway and Transportation. The common trait among the states is that the tax collection administration is clearly defined.

The process of administration varies from state to state, however; all states require payment of the motor fuel tax in the month following collection for all points of sale. The day of the month is frequently set between the 15th and the 25th of the month. The Commonwealth of Kentucky requires payment on the 25th day of the month following collection. The form of payment that the state requires is by certified, cashier or business' check. Business checks are only accepted if the dealer has shown a good previous record of compliance and is of sound financial condition.[17] Many of the southern states have the same payment requirement system as Kentucky.

Point of Taxation

In the administration of a motor fuels tax, the primary success of the process is based on the point of taxation. Critical in this process, the point of taxation can assist in tax collection and deter evasion. This juncture clearly defines for whom the tax collection encumbrance lies. Prevalent in the last two years is the change in the point of collection and taxation. Prior to 1995, most of the southern region states collected motor fuel tax at the wholesaler level. This process is now changing to the "at the rack" point of taxation.

Table 2 identifies the point in the petroleum distribution chain where the tax is collected by the states in the southern region. Currently, eleven of the sixteen states that form the southern region tax at the rack. This point of taxation is commonly referred to as at the refinery or supply terminal sale. Historically, as the number of taxable parties' increase, tax collection efficiency decreases. To combat this problem, many southern region states are resorting to the tax at the rack system. This change has reduced the number of taxpayers involved and has reduced collection costs as states are challenged with tightening fiscal constraints.

Table 2 Collection Point for Motor Fuel Excise Tax

Southern Region	Refiner/ Blender at the Rack	Importer at the Rack	Distributor/ Supplier at the Rack	Distributor/ Supplier	Dealers/ Wholesalers	Retail Dealers
Alabama					X	
Arkansas			X			
Delaware			X			
Florida	X	X				
Georgia				X		
Kentucky					X	
Louisiana[18]	X	X			X	
Maryland[19]		X			X	
Mississippi[20]			X			
N. Carolina	X	X				
Oklahoma			X			
S. Carolina	X	X				
Tennessee[21]	X	X	X			
Texas			X			
Virginia						X
W. Virginia					X	

Source: Compiled by authors from various state legislative and statutory data, 1997.

[17] KRS 138.280

[18] In Louisiana gasoline is taxed at the rack, diesel fuel is taxed at wholesaler level.

[19] Point of taxation based on classification of license.

[20] Imported gasoline taxed at first point in state, diesel taxed at supplier level.

[21] Point of taxation at the rack effective January 1,1998. Imported gasoline taxed first point in state.

The Kentucky process of taxation collection occurs at the dealer level, which is synonymous with taxation at the wholesaler level for the other southern region states. This level of taxation allows the licensed dealer to sell fuel to other licensed dealers therefore passing on the tax burden. This practice extends the time period prior to taxation of the motor fuel. This practice increases the number of tax collectors involved, which has been associated with taxation avoidance and evasion. The dealer level of taxation also produces an investment potential and generates interest revenue for the dealer. The dealer can invest the collected fuel tax during the 30-day period prior to the tax payment remission to the state. Dealer's gain from this ability to invest state tax money while the state awaits payment. The system creates a "revenue expenditure" for the state that directly benefits the tax-collection dealer.

As can be seen with the dealer level tax collecting, the issue is who should be gaining from the taxation of motor fuels. The argument can be made that licensed tax collecting dealers should be compensated for this encumbrance. In Kentucky, compensation for tax collection is offered as a reduction in motor fuel tax liability when the tax payment is made in a timely manner. This includes a 2.25% reduction in the net tax for evaporation, shrinkage, unaccountable losses, collection costs, bad debt, and handling and reporting of the tax.[22] Given this consideration, if the objective is that motor fuel dealers should profit from tax collection, then the current Kentucky system provides for this objective. If the goal is that the Commonwealth of Kentucky should maximize its profits from taxation, then the current system is unable to accomplish this goal.

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[22] KRS 138.270

Penalties and Punishments

The penalties for failure to make reports, keep records, or pay the motor fuel tax constitute two types, criminal and civil. Referring to Table 3, the two types of penalties bring with them fines, fees, and penalties.

Table 3 Penalties for Conviction of Motor Fuel Tax Fraud

Southern Region	Criminal Penalty	Civil Penalty
Alabama	Misdemeanor and shall be punished by a fine of not less than $50 or more than $300. Each month that payment due a new misdemeanor is applied.	All excise tax due plus interest and penalties. Interest at the federal rate.
Arkansas	None	All excise tax due plus penalties.
Delaware	Class E felony and shall be punished by a fine of not more than $11,500 or by imprisonment not exceeding 5 years, or both.	All excise tax due plus interest at 1% per month and a penalty of $5.75 per day to a maximum of $28.75.
Florida	Felony of the third degree and shall be punished a fine of not more than $5,000 or by imprisonment not exceeding 5 years, or both. State reserves the right upon conviction to revocate or suspend fuel tax license.	All excise tax due plus interest and penalties. Penalty is 10% per month to a maximum of 50%.
Georgia	Misdemeanor and shall be punished by a fine of not less than $1,000 nor more than $10,000 or by imprisonment for a term not less than 30 days nor more than 12 months, or both.	All excise tax due plus interest and penalties. Penalty is10% of unpaid taxes plus $50.
Kentucky	Class A misdemeanor and shall be punished by a fine of $500 or by imprisonment for a term not less than 90 days nor more than 12 months, or both.	All excise tax due plus interest and penalties. Penalty is a minimum of $10 or 2% per month to a maximum of 20%, which ever is greater.
Louisiana	Misdemeanor and shall be punished by a fine of $500 or by imprisonment for one year, or both.	All excise tax due plus interest, penalties, and cost accrued. State can attach, seize or sequester any gasoline, motor fuel, or lubricating oil subject to tax.
Maryland	Misdemeanor and shall be punished by a maximum fine of $1,000 or imprisonment not exceeding 6 months, or both. Revocation of license after non-compliance of 60 days.	All excise tax due plus a penalty of at least $10 or 10% of tax due, which ever is greater. Seizure of all assets and fuel if excise tax not paid.
Mississippi	Misdemeanor and shall be punished by a fine of not less than $50 or more than $100.	All excise tax due plus interest and penalties. Penalty can be 3 times amount of excise tax due.
North Carolina	Class 1 misdemeanor and shall be punished for a term not less than 1 day or more than 45 days community punishment.	All excise tax due plus interest and penalties. Minimum penalty is $50.
Oklahoma	Felony and shall be punished by a fine of not more than $10,000 or 3 years in the state penitentiary, or both.	All excise tax due plus interest and penalties. Penalty is equal to 100% of the excise tax due. Interest is 1.25% per month.

Southern Region	Criminal Penalty	Civil Penalty
South Carolina	Felony and shall be punished by a fine of not more than $5,000 or imprisonment not exceeding 5 years, or both.	All excise tax due plus interest and penalties. Interest is ½ % per month.
Tennessee	Revocation of license. Class E felony and shall be punished by a fine of not more than $3,000 or imprisonment for not less than 1 year nor more than 6 years, or both for evasion of excise tax.	All excise tax due plus interest and penalties.
Texas	Felony in the third degree and shall be punished by a fine of $10,000 or imprisonment for not less than 2 years nor more than 10 years in the state penitentiary, or both.	All excise tax due plus interest and penalties. Penalty is 50% of excise tax due.
Virginia	Class 1 misdemeanor and shall be punished by a fine of not more than $2,500 or imprisonment of not more than 12 months, or both.	All excise tax due plus interest and penalties. Penalty is a minimum of $10 or 6% of excise tax due per month not to exceed 30%, whichever is greater.
West Virginia	Misdemeanor and shall be punished by a fine of not less than $100 nor more than $1,000 or imprisonment of 6 months in jail, or both.	All excise tax due plus interest and penalties. Penalty of 5% of excise tax due per month.

Source: Compiled by authors from various state legislative and statutory data, 1997.

Civil penalty

A civil statutory or legislated penalty is common throughout the southern states. The penalty is based on the motor fuel tax due plus associated fines, fees and interest.

Civil Fines and Fees

The fines and fees range from a minimal daily fine, such as Delaware's $5.75 per day[23], to a fine as high as three times the tax due as seen in Mississippi[24]. The majority of fines and fees are levied against the portion of unpaid motor fuel tax. The fines and fees are usually assessed in a percentage format that contains a minimum and maximum amount allowed by statute or legislative law.

[23] State of Delaware Motor Fuel and Special Fuel Tax Law Chapter 51.
[24] Mississippi State Tax Commission Motor Fuel Taxes Chapter 27-57-333.

The fine in Kentucky is in the moderate category when compared to the other southern region states. The fine is a minimum of $10 or 2% of the tax due per month to a maximum fine of 20% whichever is greater.[25] When this is compared to the State of West Virginia, Kentucky's fine is minimal. In West Virginia the fine is 5% of the tax due per month that the tax is delinquent[26], two and one half times greater than that of Kentucky.

Civil Interest Penalties

Interest on the motor fuel tax due varies widely among the states. The most common interest rate is at least 1% per month or 12% annually. Interest accrues against the balance of the outstanding motor fuel tax due and is not subject to a maximum amount in the majority of states. The southern region states vary in their interest rates charged with some of the states utilizing the federal tax rate as their interest rate penalty. The Kentucky interest rate is based on the adjusted prime rate charged by banks and is comparable to the other southern states.[27]

Criminal Penalties

In the southern states, a wide variety of penalties is associated with the criminal aspects of the motor fuel tax. Recently, a change has been seen in this portion of the motor fuel tax legislation and statutes. Commonly, a misdemeanor penalty was associated with the failure to pay motor fuel taxation. In the last few years this minimal deterrent to fraud has been undergoing a complete change. Many of the southern region legislatures are looking carefully at motor fuel tax evasion and re-interpreting the failure to pay as a felonious crime. This has led to harsher penalties and punishments legislated into law. This new legislation, where initiated, is

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[25] KRS 131.180
[26] West Virginia Gasoline and Special Fuel Excise Tax Section S11-14.

intended as a maximum deterrent to fraud. The goal is the reporting and payment of motor fuel tax in an appropriate and timely manner.

Misdemeanor Penalties

Most of the southern region states consider the evasion of motor fuel tax a misdemeanor crime. States that utilize misdemeanor punishment impose a maximum jail term of twelve months and a maximum criminal fine of $1,000 for evasion or failure to pay the motor fuel tax. The states allow themselves the opportunity to impose one or both of these penalties. Some of the states will additionally revoke or suspend the license or permit of the liable party. In a unique interpretation of the misdemeanor penalty, the State of Alabama imposes a new misdemeanor charge for each month that the motor fuel tax is not paid.[28]

Kentucky imposes a singular criminal penalty of a Class A misdemeanor. The fine associated is $500 with a possible jail term of not less than 90 days nor more than 12 months. Both the fine and jail term may be imposed.[29] This punishment is similar to the other southern region states that utilize a misdemeanor criminal penalty.

Felonious Penalties

With a change in legislative thought toward criminal penalties associated with motor fuel tax evasion, some states in the southern region are introducing felony consequence for such tax evasion. The felony statute is designed to maximize punishment and deter tax evasion. In this new thought lies a minimal fine of $5,000 and imprisonment in a state penitentiary of not less

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[27] KRS 131.183
[28] Alabama Department of Revenue Motor Fuel Tax Sections 40-12-190.
[29] KRS 138.990.

than one year. The structure of the felony legislation or statute is to deter evasion prior to its occurrence with the understanding of imprisonment if the evasion occurs.

States such as Delaware, Florida, Oklahoma, South Carolina, and Texas have implemented these new laws to reduce the incidence of tax evasion. Tennessee is also joining the new movement as it attempts to introduce felony legislation for motor fuel tax evasion. Georgia has stated that it will be looking into felony legislative law in 1998. The new legislation effectiveness will not be known for a few years. For all the states involved, the new felony laws are yet to be tried as they are applied to motor fuel tax evaders. This leaves a lack of data to determine the success of theses innovative laws.

Liability for Motor Fuel Tax

The responsibility for motor fuel taxation payments can be seen in two respects, the first is the corporation as an entity and the second is the corporation as a group of individuals who hold tax liability. The southern region states legislation defining the corporate liability is shown in Table 4.

Corporation as an Entity

As a singular entity, a few of the states do not differentiate between the individuals who are the officers of the corporation and the corporation. In this type of taxation, responsibility is with the corporation only. Individuals do not ultimately hold any responsibility for the corporation's activities in the payment of the motor fuel tax. In the southern region, only Texas and Kentucky do not hold the officers of the corporation liable.[30]

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[30] KRS 138.224 states that the licensed dealer is ultimately liable for the tax. Corporate officer individual liability is not distinguished.

Table 4 Liability for Motor Fuel Taxation

Southern Region	Corporate Liability and Individual Personal Liability	No Distinction in Liability
Alabama	Corporation officers hold personal liability.	
Arkansas	Corporation officers hold personal liability.	
Delaware	Corporation officers hold personal liability.	
Florida	Corporation officers hold personal liability.	
Georgia	Corporation officers hold personal liability.	
Kentucky		No distinction between person and corporation.
Louisiana	Corporation officers hold personal liability.	
Maryland	Corporation officers hold personal liability.	
Mississippi	Corporation officers hold personal liability.	
North Carolina	Responsible corporate officer that includes the president and the treasurer of the corporation and any other officers assigned the duty of filing the tax returns.	
Oklahoma	Corporation officers hold personal liability.	
South Carolina	A person, officer, or employee of corporation held responsible.	
Tennessee	Corporation officers hold personal liability if acting as trustee of motor fuel tax.	
Texas		No distinction between person and corporation.
Virginia	All officers, directors, and controlling owners of corporation held responsible.	
West Virginia	All officers, directors, trustees, or members of corporation held responsible.	

Source: Compiled by authors from various state legislative and statutory data, 1997.

Corporation as a Group of Individuals

In the southern region, the majority of states hold the officers of the corporation ultimately responsible for the activities of that entity. Criminal and civil laws for total motor fuel tax liability lie with the officers. The states have interpreted this as a safeguard for unethical and illegal business activities. An example of a wide definition of corporate officer's liability is seen in the State of West Virginia. This interpretation holds that all officers, directors, trustees, or members of the corporation are ultimately liable for any outstanding tax debt.

Dyed Fuel Programs

In an attempt to reduce the evasion of motor fuel taxes, seven southern region states have implemented a state dyed fuel program as indicated in Table 5. This program dyes non-taxable fuel prior to dispensing of the fuel. In most cases, the dying occurs at the refinery or the supply terminal. In the State of Louisiana, the licensed wholesaler in diesel fuel is required to dye all

Table 5 Dyed Fuel Programs in the Southern Region

Southern Region	Dyed Fuel Program at State Level	
Alabama		No dyed fuel program.
Arkansas	Off-road fuel dyed at rack. Penalty is misdemeanor.	
Delaware		No dyed fuel program.
Florida	Mirrors federal program. Penalty is $10 per gallon of tank capacity or $1,000, which ever is greater.	
Georgia[31]		No dyed fuel program.
Kentucky		No dyed fuel program.
Louisiana	Mirrors federal dyed program. Dealer is responsible for dyeing fuel that is used for non-taxable purposes. Criminal penalty is misdemeanor.	
Maryland		No dyed fuel program.
Mississippi		No dyed fuel program.
North Carolina	Mirrors federal program. Penalty is class 2 misdemeanor.	
Oklahoma[32]	Mirrors federal program.	
South Carolina		No dyed fuel program.
Tennessee	Mirrors federal program.	
Texas		No dyed fuel program.
Virginia		No dyed fuel program.
West Virginia	Mirrors federal program. Penalty is $10 per gallon of tank capacity or $1,000 which ever is greater.	

Source: Compiled by authors from various state legislative and statutory data, 1997.

[31] Looking at mirror of federal program in 1998.

[32] Refund is available for non-taxable use of clear fuel when tax is initially paid at the rack.

fuel used for non-taxable purposes while gasoline is dyed at the rack. The dye is added at the first point of sale whether that is at the rack or at the wholesaler level. The Secretary of Revenue may change the dying color from time to time.[33] Most dyed motor fuel programs are mirror images of the federal dyed fuel program.[34] The objective of the program is to insure that taxes are paid on all taxable fuel.

The majority of southern region states regulate the use of dyed fuel to non-taxable uses only and assess a per-gallon fine for a vehicle that is propelled upon a highway with non-taxable dyed fuel. The states that do not have an independent dyed fuel program, from that of the federal program, assess a penalty on any person who is assessed a fine by the Internal Revenue Service for using non-taxable dyed fuel upon a highway. In the Commonwealth of Kentucky, a separate penalty for the use of non-taxed fuel upon the highway is not utilized.

Summary

In an attempt to reduce and/or eliminate motor fuel tax evasion, the southern region states have legislated different laws. As the states have modified their view of the evasion problem, innovations such as felony penalties, corporate officer's liability and dyed fuel programs have been implemented to address the ever-increasing concerns of state revenue officers. States that have implemented these innovative programs are producing the necessary changes to reduce tax evasion and maximize the utilization of the current taxation policies.

[33] Louisiana Administrative Provisions Chapter 47.
[34] See U.S.C. 4082

Chapter 3: Recommendations/ Conclusions

This Chapter identifies the severity of the road fund revenue evasion for the Commonwealth and then provides recommendations to reduce the potential for road fund revenue evasion.

Severity of Road Fund Evasion

The Kentucky Transportation Center report, "The Motor Fuel Tax Evasion Issue in Kentucky," provided estimates of the motor fuel tax revenue losses due to evasion. This estimate was based on the perception of revenue administrators responsible for enforcing the Kentucky fuel tax and the combined perceptions of the fuel tax administrators in the southern states. The average estimated revenue loss due to motor fuel tax evasion in Kentucky was about 30 million dollars in fiscal year 1993.[35]

The Kentucky Transportation Center report discussed in the preceding paragraph did not provide estimates of revenues lost to evaded registration of motor vehicles. An estimate of the dollars lost due to evaded vehicle registration is important in that license and registration fees comprise about 36 percent of the Kentucky road fund.[36] Empirical estimates of evaded vehicle registrations are derived and discussed in Appendix A. The revenue losses due to the evaded vehicle registrations range from 32 - 49 million dollars.[37]

These estimates provide some indication of the severity of evasion occurring in the Commonwealth in regard to the road fund revenues. By combining the fuel tax and registration evasion estimates, there is potentially 79 million dollars in road fund revenues that are lost

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[35] Denison, Dwight and Merl Hackbart *The Motor Fuel Tax Evasion Issue in Kentucky (Final Report KTC-96-16)* Kentucky Transportation Center, July 1996 Table 7.
[36] See Figure 1.

annually. The next section presents several recommendations to reduce the occurring evasion of road fund revenues.

Recommendations

The recommendations provided here are provided as methods to reduce tax evasion of the road fund revenues. The Commonwealth's fiscal costs of implementing these recommendations are considered and discussed. However, the reduction of tax evasion is only one of many priorities for Kentucky. No attempt has been made to evaluate these recommendations as they affect other state priorities. Such evaluation is left to the legislature and executive policy makers to determine any potential conflict in priorities that may result from the adoption of any of the following recommendations to reduce evasion.

Vehicle Licensing Recommendations

The following recommendations are suggested as strategies that should reduce the evasion of motor vehicle licensing and registration fees and taxes.

- Redesign license plates and registration materials to enhance the visibility of unregistered vehicles.

  Enhancement of the visibility of registration can assist in enforcement of the registration laws reducing non-compliance. This could be achieved with larger year numbers on the issued registration plate stickers or could be obtained by issuance of an additional large, color-coded decal placed inside the lower corner of the rear window in the vehicle. The color code would match the coloration of the license plate sticker, thus enabling law enforcement officers a visible color-coded decal to confirm the year of registration.

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[37] Table 6 in Appendix A.

- Adopt legislation that changes the penalties associated with driving an unregistered vehicle.

  Currently, Kentucky allows for a grace period of five days for past due registration. Penalties of 3% of the tax due are assessed after five days and before 30 days past due. The maximum penalty is 10% of the taxes due and is assessed after 30 days past due. Appendix A provides a detailed discussion of this registration process. The current penalty system imposes a fee that grows in minor increments, as the registration becomes increasingly delinquent. Such a system provides little incentive for a self-compliant registration. We suggest that a $35 fine be imposed immediately after the five-day grace period. A one-time lump sum fee imposed after the grace period would provide more motivation to register and pay the taxes on time. This fee would be in addition to the current incremental system and significant enough to motivate compliance. The effectiveness of this strategy is improved when implemented in combination with the next recommendation.

- Adopt a minimal fee for unregistered vehicle citations issued by law enforcement.

  Currently, citations in Kentucky for expired registrations are "fix it" citations. These citations do not add any additional penalty to the registration and penalties due. These citations also extend the invalid registration through the court date on the citation. A minimal fee, such as $15, could be assessed upon all unregistered vehicle citations and could be earmarked for law enforcement.[38] This fee provides additional incentive for law enforcement personnel to cite unregistered vehicles encountered on the state roadways. This citation fee should be in addition to all other fines imposed on the late registration.

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[38] These earmarked revenues would provide a windfall of revenue to law enforcement given that it is estimated that in excess of 200,000 vehicles evade registration. This fee would generate less revenue as compliance increased.

- Periodic re-issuance of license plates and/or other highly visible registration materials.

  License plates are the most visible indicator to law enforcement officials that a motor vehicle has been registered. Periodically changing the color and design of the license plate facilitates enforcement in the reduction of unregistered vehicles since coloration and style are visually identifiable.

Fuel Tax Recommendations

The following recommendations are suggested as strategies that should reduce the evasion of motor fuels tax.

- Change the criminal penalty associated with motor fuel tax from a misdemeanor to a felony.

  The current criminal law in Kentucky for non-payment of motor fuel tax is a misdemeanor that carries a minimal county jail sentence or a fine, or both. Within the southern states, a change is occurring to increase the criminal penalty to that of a felony. The felony incorporates a stronger financial penalty or a state prison term, or both. This increases the social implications of evasion and produces an extremely effective deterrent, which increases compliance with the motor fuel tax laws. Furthermore, prosecution as a felony provides more time relative to misdemeanors to assemble evidence and prepare for prosecution. This is important in that many fuel tax evasion schemes are elaborate and require thorough preparation to insure conviction.

- Adopt legislation that holds corporate officers personally liable for the fuel tax submission and payment.

  Table 4 identifies Kentucky as one of only two southern region states that have not implemented laws to hold corporate officers responsible for fuel tax liability. The other state, Texas, has a felony penalty associated with motor fuel tax evasion and the point of taxation is at the rack. Kentucky has neither one of these additional safeguards. Moreover, the Revenue Cabinet has identified 8.4 million dollars in fuel tax assessments that are uncollectable from corporate entities.[39] In Kentucky, the collection of motor fuel tax confirms the collector as a trustee of the state, however individual corporate officers do not hold any personal liability. A legislative change in this liability provides additional assurance that the fuel tax revenues are appropriately collected and remitted to the state.

- Change the point of taxation from the dealer level to at the rack.

  Changing the point of taxation reduces the number of taxable parties involved in the collection and remittance of the fuels tax. This enhances the ability for auditors to conduct thorough audits and detect fraud. This change also eliminates the tax subsidy to the petroleum dealers who currently benefit from a 30-day float. State fuel tax collections by dealers can be invested until due, which generates interest income in addition to the 2.5% administration allowance.[40]

- Work with interstate cooperative organizations to coordinate enforcement of fuel tax evasion.

  A cooperative approach promotes the exchange of information among states and facilitates detection of motor fuel tax fraud. This is important in addressing evasion occurring through bootlegging. Tax rate differentials encourage interstate bootlegging leading to revenue losses in the high tax states. An even stronger deterrent would be the equalization of regional fuel tax rates. Tax rate equalization would decrease evasion as monetary incentives to bootleg fuel are reduced.

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[39] Memo from Revenue Cabinet's Miscellaneous Tax Branch to Sandy Pullen Davis, April 4, 1997.
[40] KRS 138.270

Summary

This chapter offers policy recommendations designed to reduce evasion of the road fund revenues. These recommendations are presented to address evasion of the motor fuel excise tax, vehicle registration, and the ad valorem property tax. These recommendations are summarized in Table 6. The fuel tax recommendations embody changes in legislation to reduce non-compliance and increase personal liability for the payment of collected fuel tax revenues. In general, the vehicle registration and licensing recommendations focus on enhanced visibility of compliant registration and increased penalties associated with vehicle registration. Unregistered vehicles also escape assessment of the ad valorem property tax representing a major revenue loss to the state road fund.

Table 6 Recommendations to Reduce Road Fund Evasion

Vehicle Licensing 1. Redesign license plates and registration materials to enhance the visibility of unregistered vehicles. 2. Adopt legislation that changes the penalties associated with driving an unregistered vehicle. 3. Adopt a minimal fee for unregistered vehicle citations issued by law enforcement. 4. Periodic re-issuance of license plates and/or other highly visible registration materials.
Fuel Tax 1. Change the criminal penalty associated with motor fuel tax from a misdemeanor to a felony. 2. Adopt legislation that holds corporate officers personally liable for the fuel tax submission and payment. 3. Change the point of taxation from the dealer level to at the rack. 4. Work with interstate cooperative organizations to coordinate enforcement of fuel tax evasion.

Appendix A

Kentucky Motor Vehicle Registration Process

There are two sources of road fund revenues associated with Kentucky motor vehicle registration. The first revenue is a flat fee assessed against all vehicle registrations.[41] The second revenue is based upon the property value of the vehicle that is assessed through an ad valorem taxing structure. This appendix describes the motor vehicle registration process and identifies potential improvements to enhance compliance.

Registration Payment

In the vehicle taxing structure, two choices are offered to the owner of the motor vehicle as can be seen in the chart labeled "Kentucky Motor Vehicle Registration Process." The first choice is that of payment on its due date and the vehicle registration is renewed or issued for the next year. The second choice is not to make the payment upon its due date and is a violation of Kentucky Revised Statute 186A.035. Those in violation of the motor vehicle registration law are confronted with two alternatives. One alternative is to make the registration payment late. Late payment is penalized based on the number of days past due. No penalty is assessed within the five-day grace period. A 3% penalty on the taxes due is assessed if the payment is at least six days late and no more than 30 days late. After 30 days, the penalty rises to 10% of the tax due and a 15% per year interest rate on both the assessed penalty and the tax due. The other alternative is to make no attempt at payment. All late registration penalties are incorporated with this alternative. If payment has not been made within 60 days, a notice of intent to lien is issued by the state. A lien is then placed against all vehicles that are owned by the party who has not made the registration payment.[42]

Law Enforcement

Law enforcement also plays a part in the vehicle registration process. If the registration is not paid and the vehicle is on a highway, law enforcement may stop and cite the driver of the vehicle for expired registration. This citation is a "fix it" citation that provides the recipient the opportunity to pay the registration fees or go to court over the matter. The law enforcement officer writes a court date on the citation indicating that the recipient must "fix" the registration by this date. The presiding judge may issue a warrant if the recipient does not appear in court or pay the registration due.[43] The citation does not carry with it any additional fine for placing a motor vehicle upon the highway without current registration.

Ad Valorem Tax Structure

The centralized ad valorem taxing structure is based on the vehicle value that is assessed on January 1.[44] Although the tax is incurred on January 1 for the previous year taxation, the burden of payment is the end of the birth month of the vehicle's registered owner.[45] Birth month registration is utilized to disperse the encumbrance of collection and allow the party charged with issuing the registration the opportunity to collect all state, county, city, urban-county, school, and special taxing district taxes due. In this structure, the taxation differs between the one hundred

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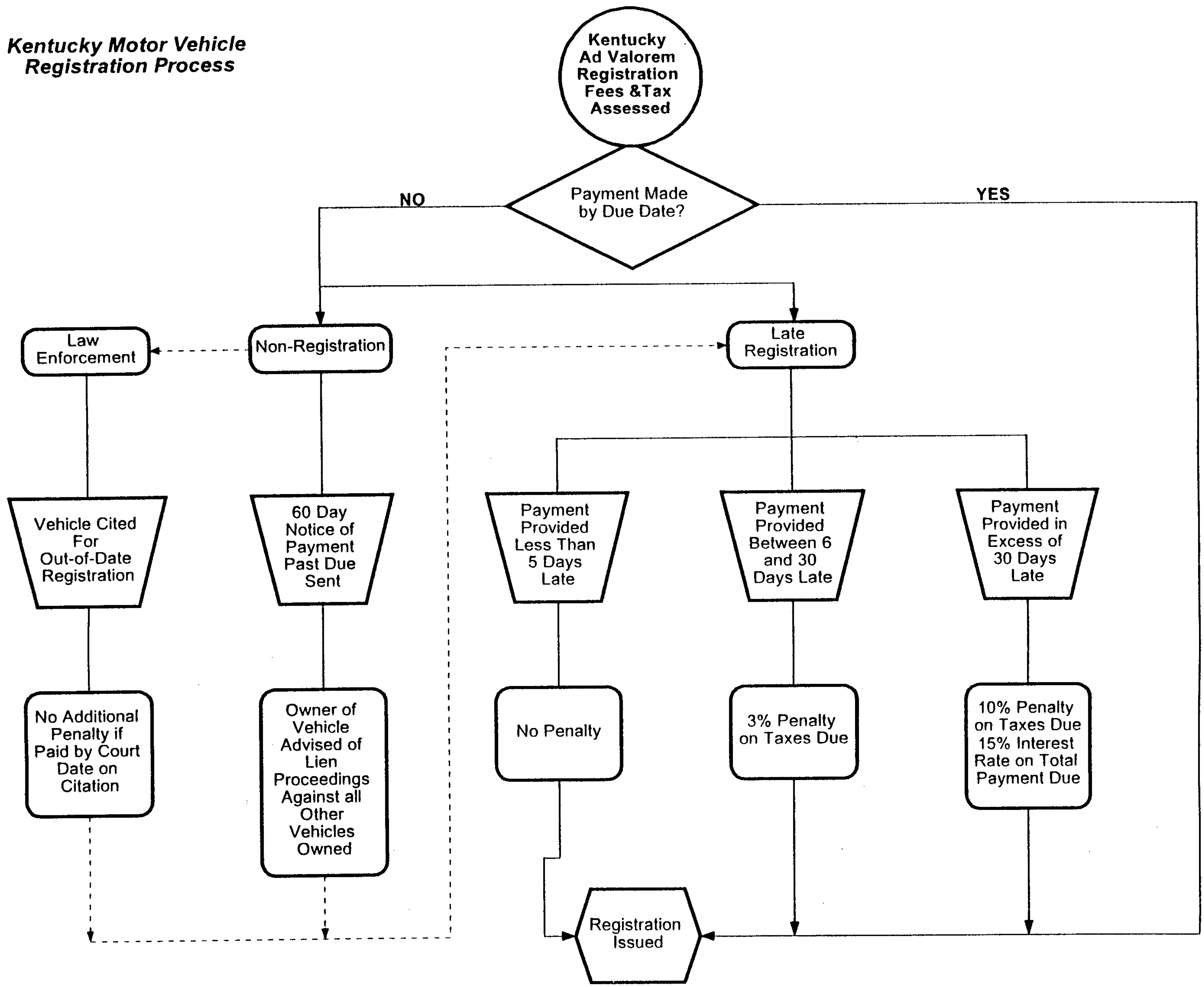
[41] KRS 186.050 The current fee is $15.
[42] KRS 134.810 (1-9)
[43] KRS 186.990 (1)
[44] KRS 132.487
[45] KRS 186A.035

and twenty counties in the state since each county/district is afforded the opportunity to assess taxation at different monetary levels.

Summary

In an attempt to reduce motor vehicle registration evasion the Commonwealth of Kentucky has implemented a standardized registration process. Incorporated in this is a penalty structure to increase compliance with motor vehicle registration. Law enforcement and the civil lien process play a pivotal role in the determent and compliance with the registration laws. Unfortunately, the citations issued by law enforcement are only "fix it" citations and do not have any monetary consequences. This also holds true for the civil lien process that makes the assumption that the vehicle owner will regard the registration of their other vehicles as a necessity.

Kentucky Motor Vehicle Registration Process



Appendix B: Evasion Estimates of Kentucky Vehicle Licensing and Registration Revenues

Estimates of the road fund revenues lost through evasion are important in assessing the costs and benefits of policy recommendations. Often times there are costs associated with the implementation of new tax policy or enforcement strategy. These costs should be compared to potential revenue increase that occurs if evasion were completely eliminated. Obviously, no anti-evasion strategy completely eliminates tax evasion. In addition, no estimate of evasion loss is completely accurate. Therefore, it is common practice to estimate evasion loss by several models and develop a range that one expects to include the actual amount of evasion. Thus, the expected efficiency of the strategy can be compared to the potential costs and benefits to determine whether an anti-evasion strategy should be implemented. Hence, the severity of evasion influences the nature and magnitude of policies implemented to reduce evasion loss.

Several econometric models are developed to estimate the number of vehicles not registered in the Commonwealth and the resulting revenue loss. Models were constructed to predict the number of automobiles and total vehicle registrations by using six different variables as predictors. Six regression equations were formed using cross-sectional data on the states for each predictor. The predictors utilized in the regressions are state statistics on the number of licensed drivers, total households, population, rural population, road miles, and aggregate personal income. These six regressions were estimated twice to predict both automobile registrations and total registrations. The six cross-sectional regressions were also estimated using data from only the southern region to derive estimates for both automobile and total vehicle registrations. The averaged results for each of the models are listed in Table 7.

Table 7

Automobile Registration	Evaded Automobile Registrations (Average of Models)	Evaded Revenues @ $172 average fee
All State Model	239,000	$41.1 million
Southern State Model	287,000	$49.4 million
Total Vehicle Registrations	Evaded Vehicle Licensing (Average of Models)	Evaded Revenues @ $120 average fee
All State Model	274,000	$32.9 million
Southern States Model	376,000	$45.1 million

These estimates suggest that the number of evaded automobile registrations in Kentucky range from 239 to 287 thousand. At an average fee/ tax collection of $172 per registration, the total loss of revenue to the road fund is between 40 to 50 million dollars. The average of the regression estimates for total vehicle registrations suggest a range from 274 to 376 thousand unregistered vehicles in the Commonwealth. Applying an average fee and tax collection of $120 per registration, the total loss of revenue to the road fund by these models is between 33 to 45 million dollars.

Any policies addressing evasion of vehicle registrations should weigh the costs of implementation against the potential increase in revenues from the collected fees. These estimates suggest that policies reducing evasion of vehicle registration could potentially increase fee and tax collection up to 49 million dollars.

Appendix C

Glossary of Acronyms

CGPA	Council of Governors' Policy Advisors
CSG	Council of State Governments
FBI	Federal Bureau of Investigations
FHT	Federal Highway Trust
FHWA	Federal Highway Administration
FR	Federal Register
FTA	Federation of Tax Administrators
FTC	Federal Trade Commission
FY	Fiscal Year
GAO	General Accounting Office
HTF	Highway Trust Fund
IRS	Internal Revenue Service
ISTEA	Intermodal Surface Transportation Efficiency Act of 1991
KY	Kentucky
OBRA	Omnibus Budget Reconciliation Act

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