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The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate

Subject: Excise Taxes: Use of Safe Harbor Look-Back Rules

Dear Mr. Chairman:

Earlier this year a series of circumstances converged to create problems with the transfer of excise tax receipts to the Airport and Airway Trust Fund (Trust Fund). These problems involved (1) the Treasury Department's transfer to the Trust Fund of aviation excise taxes that had not yet been received as revenues, and (2) the Treasury Department's lack of authority to transfer to the Trust Fund excise taxes received after December 31, 1996. These problems resulted from the airlines' use of regulatory safe harbor look-back rules to delay deposits of aviation excise taxes until February 28, 1997. Safe harbor look-back rules provide that a taxpayer seeking assurance of meeting deposit requirements may use the amount paid two quarters previously as a benchmark.[1]

This letter responds to your concern that another situation could arise in which excise tax laws and regulations could lead to similar problems with other excise taxes. Our objective was to determine whether the regulatory safe harbor look-back rules could cause similar problems with the crediting of other excise taxes.

We reviewed the excise tax laws and regulations in effect in 1996 and 1997 and the changes in the safe harbor look-back provisions that eliminated the immediate problem with the Airport and Airway Trust Fund. We also discussed the laws, regulations, and changes with officials at the Internal Revenue Service (IRS).

We did our work in Washington, D.C., between March 1997 and July 1997 in accordance with generally accepted government auditing standards.

[1]These rules apply to all excise taxes covered in part 40 of 26 C.F.R.

## BACKGROUND

Excise taxes are selective sales taxes. Aviation excise taxes are levied on air transportation goods and activities, including domestic air passenger transportation, international air passenger departure, domestic air freight, and gasoline and jet fuels used for noncommercial aviation. Funds from federal excise taxes may be deposited in the U.S. Treasury's general fund or be mandated to fund a specific trust fund, such as the Airport and Airway Trust Fund. Taxes for the Airport and Airway Trust Fund are deposited into the general fund and then transferred into the Trust Fund.[2]

The airline industry used safe harbor look-back rules to delay payment of most of the 1996 excise taxes until 1997. After the aviation excise taxes had lapsed on January 1, 1996, the airlines were not required to collect any taxes until the subsequent reinstatement of the excise taxes for the period of August 27, 1996, through December 31, 1996. In a general information letter to the Air Transportation Association of America, dated August 30, 1996, the IRS advised the association that, under safe harbor look-back regulations, if a return had been filed for the look-back quarter reporting zero tax liability, air carriers could avoid making deposits for the fourth quarter of 1996. Instead, payment of tax would be due with the quarterly excise tax return for that period. These taxes were due by February 28, 1997.

Problems arose with respect to depositing funds into the Trust Fund. In January, 1997, the Treasury Department discovered it had mistakenly credited the Trust Fund with approximately $1.2 billion[3] which, at that time, had not been remitted by the airlines. In addition, the Treasury Department did not have authority to transfer into the Trust Fund the aviation excise taxes received after December 31, 1996. This money could not legally be transferred into the Trust Fund when it was received, because the authority provided in the Small Business Job Protection Act of 1996[4] to transfer 1996 excise taxes received from the airlines had expired.

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[2]Deposits of all excise taxes that go into trust funds (other than the excise taxes on black lung benefit trusts that fund the Black Lung Disability Fund and those on certain heavy vehicles that fund the Highway Trust Fund) are governed by part 40 of 26 C.F.R.. See enclosure II for a listing of the trust funds funded by excise taxes and established in the Internal Revenue Code (IRC).

[3]The amount deposited is based on estimates made by the Office of Tax Analysis in the Department of the Treasury.

[4]The Small Business Job Protection Act of 1996 reinstated the taxes dedicated to the Airport and Airway Trust Fund for the period from August 27, 1996, through December 31, 1996, and extended the authority of the Secretary of the Treasury to transfer aviation taxes to the Trust Fund.

When these problems were discovered, the use of the regulatory safe harbor look-back rules came under serious scrutiny by Congress and others. Subsequently, Treasury announced that it would modify the safe harbor look-back regulations to prevent the use of this safe harbor rule for a period when a tax was not in effect. Although these amended regulations have not yet been issued, the aviation excise tax legislation, which reinstated aviation excise taxes from March 7, 1997, through September 30, 1997, contains a similar provision. In addition, the aviation excise tax legislation corrected the immediate Trust Fund problem by authorizing Treasury to transfer amounts related to aviation excise taxes from the general fund to the Trust Fund, regardless of when the money is received in the Treasury.

## RESULTS

We found that regulatory safe harbor look-back rules should not cause similar problems in the future for two reasons. First, deposits of most excise taxes are covered by the modifications made this year as a part of the aviation excise tax legislation. These modifications make safe harbor look-back rules unavailable for calculating deposits of taxes that were not in effect in the look-back period. The aviation excise tax legislation covers most excise taxes that fund trust funds.[5] Second, the two excise taxes that are still subject to safe harbor look-back rules--taxes on ozone-depleting chemicals and on firearms--are not deposited in a trust fund. If taxes on either the ozone-depleting chemicals or firearms were revoked, those making deposits of the taxes could rely on the safe harbor provisions to delay deposits of taxes. However, both of these taxes are deposited in the general fund, not a trust fund; and thus any potential delayed deposit would not create trust fund problems. (See enclosure I for a summary of excise tax legislation and payment regulations.)

## AGENCY COMMENTS

We requested comments on a draft of this letter from the Acting Commissioner of Internal Revenue Service. In a letter dated August 5, 1997, IRS agreed with the conclusion of this letter. Technical comments provided by IRS were incorporated into this letter as appropriate.

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We will make copies of this letter available to others on request.

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[5]The exceptions to coverage under the modified regulations are excise taxes that fund the Black Lung Disability Trust Fund and excise taxes on the use of certain heavy vehicles that fund the Highway Trust Fund. The regulations governing their payment contain no provision for safe harbor look-back for deposits.

I trust this letter addresses your concerns with regard to the possibility of the recurrence of a similar situation involving safe harbor look-back rules as they apply to the deposit of excise taxes. Major contributors to this letter were Rachel DeMarcus, Assistant General Counsel, and Mary Phillips, Assignment Manager. If you or your staff have any questions, please contact Rachel DeMarcus, on 512-8150.

Sincerely yours,

Lynda D Willis

Lynda D. Willis
Director, Tax Policy and
Administration Issues

## REVIEW OF EXCISE TAX LEGISLATION AND REGULATIONS

### EXCISE TAXES SUBJECT TO THE ADMINISTRATIVE RULES OF 26 C.F.R. PART 40

Payment of most excise taxes is governed by part 40 of 26 C.F.R., designated "Excise Tax Procedural Regulations." Part 40 sets forth administrative provisions relating to the excise taxes imposed by chapters 31, 32, 33, 34, 36, 38, and 39 of the IRC. 26 C.F.R. § 40.0-1.

Therefore, the part 40 provisions apply to the following excise taxes:

(1) retail excise taxes imposed by chapter 31,
(2) manufacturers' excise taxes imposed by chapter 32,
(3) taxes on communications services and air transportation imposed by chapter 33,
(4) taxes on policies issued by foreign insurers imposed by chapter 34,
(5) taxes on transportation by water imposed by chapter 36,
(6) environmental taxes imposed by chapter 38, and
(7) taxes on registration-required obligations imposed by chapter 39.

Not all excise taxes imposed by these chapters are, however, subject to the part 40 rules. Section 40.0-1 also provides that part 40 does not apply to the chapter 32 tax imposed by sections 4181 (firearms tax) and the chapter 36 taxes imposed by sections 4461 (harbor maintenance tax) and 4481 (heavy vehicle use tax). The administrative provisions applicable to these taxes are discussed in the following paragraphs.

Certain other excise taxes are not governed by part 40 rules. These are the wagering excise taxes imposed by chapter 35 of the IRC, tobacco excise taxes imposed by chapter 52, and alcohol excise taxes imposed by chapter 51. In addition, chapters 42, 43, 44, 46, 47, 53, and 54 all provide for certain excise taxes that are not governed by part 40 of the regulations.

The excise tax regulations provide that the return for any of the taxes governed by part 40 must be made on Form 720, Quarterly Federal Excise Tax Return, according to the instructions applicable to the form. 26 C.F.R. § 40.6011(a)-1(a)(1). The requirement for filing a return under part 40 applies separately to each tax listed by IRS number on Form 720. An entry must be made on the line designated for the IRS number in order to file a return of the tax corresponding to that number. The entry on an IRS number line of the word "none" or "zero" or a comparable entry clearly indicating a denial of tax liability constitutes a return of that tax. The entry of the word "none" across the return or in the summary portion, provided it clearly indicates a denial of liability for all taxes, constitutes a return of all taxes listed on the return.

Any person required to file a quarterly return generally must make deposits of taxes reported on the return. 26 C.F.R. § 40.6302(c)-1. Return filers generally have an obligation to make semimonthly deposits of taxes before the due date of the return. The term "semimonthly period" means the first 15 days of a calendar month (the "first semimonthly period") or the portion of a calendar month following the 15th day of the month (the "second semimonthly period"). 26 C.F.R. § 40.0-1(c). Under § 40.6032(c)-1, taxes that are required to be deposited on the same schedule are grouped together into classes of tax and referred to collectively as "9-day rule taxes," "30-day rule taxes," "alternative method taxes," or "14-day rule taxes." Most taxes are 9-day rule taxes and must be deposited by the ninth day of the following semimonthly period. The "alternative method" applies to taxes imposed on communications services and air transportation if the amount to be deposited is based on amounts billed or tickets sold instead of on the basis of actual taxes collected. Using the alternative method, the tax calculated for a semimonthly period is considered collected during the first week of the second semimonthly period following the semimonthly period in which amounts are billed or tickets are sold. This amount must be deposited within 3 banking days after the end of the week for which the taxes are considered collected. 26 C.F.R. § 40.6302(c)-3. Section 40.6302(c)-2 (relating to taxes imposed on ozone-depleting chemicals by section 4681) provides special rules for the time to make deposits of section 4681 taxes (the "30-day rule" and "30-day rule taxes") and safe harbor rules for computing the amount of those deposits. Section 40.6302(c)-4 (relating to taxes imposed on taxable fuel by section 4081) provides rules under which qualified persons may make deposits of section 4081 taxes (the "14-day rule" and "14-day rule taxes").

Section 40.6302(c)-1(f) provides that no deposits are required for the tax imposed by section 4042 (fuels used on inland waterways), section 4161 (sport fishing equipment and bows and arrows), or IRC section 4682(h) (floor stocks tax on ozone-depleting chemicals). No deposit is required in the case of any taxes reportable on a one-time filing. For any calendar quarter, no deposit is required if the net tax liability for the quarter does not exceed $2,000. 26 C.F.R. § 40.6302(c)-1(f)(3).

In general, deposits of excise taxes must be made on the basis of one of the applicable semimonthly rules unless a safe harbor rule applies. The regulations provide two safe harbor rules for deposits of 9-day rule taxes, alternative method taxes, and 14-day rule taxes. The first safe harbor rule, set forth in § 40.6302(c)-1(c)(2), is based on look-back quarter liability. In general, a person who has made a tax return reporting a class of tax to which the safe harbor rule applies can satisfy excise tax deposit obligations for that class for a calendar quarter by depositing an amount equal to the excise tax liability for that class reported on a return for the second preceding quarter (the look-back quarter). The safe harbor look-back regulations also provide for an adjustment to the look-back quarter liability if there is a later increase in tax rates. 26 C.F.R. § 40.6302(c)-1(c)(2)(iii).

The second safe harbor rule is based on the current quarter's liability. Under this safe harbor rule, a person can satisfy excise tax deposit obligations for a class by making payments of at least 95 percent of the current liability for each semimonthly period. 26 C.F.R. § 40.6032(c)-1(c)(3).

Aviation excise taxes lapsed on January 1, 1996.[1] The taxes were subsequently reinstated for the period of August 27, 1996, through December 31, 1996. In a general information letter to the Air Transportation Association of America, dated August 30, 1996, IRS advised the air carriers that–notwithstanding that no excise taxes were required to be remitted during a look-back quarter–they could continue to use the safe harbor based on the reported excise tax liability and avoid remitting taxes collected during September, October, and November of 1996, until the air carriers filed their quarterly excise tax return for that period, on February 28, 1997.

On February 7, 1997, the Treasury Department announced that it would modify its regulations, effective for taxes imposed after February 10, 1997. The modified regulations are to provide that the safe harbor look-back will not be available for calculating deposits of taxes that were not in effect throughout the look-back quarter. Similarly, section 2(f) of the Airport and Airway Trust Fund Tax Reinstatement Act of 1997 (P.L. 105-2, February 28, 1997) provides that "nothing in the safe harbor look-back prescribed in Treasury Regulation section 40.6302(c)-1(c)(2) shall be construed to permit such safe harbor to be used with respect to any tax unless such tax was imposed throughout the look-back period." It also authorizes the Treasury Department to transfer to the Airport Trust Fund receipts attributable to aviation excise taxes, including those imposed between August 27, 1996, and December 31, 1996.

This modification to the regulations ensures that a situation similar to that which involved the air transportation excise taxes could not occur again with respect to deposits of taxes subject to the safe harbor look-back rule under § 40.6302(c)-1(c) of the regulations. As noted, the safe harbor look-back rules of § 40.6302(c)-1 apply to deposits of 9-day rule taxes, alternative method taxes, and 14-day rule taxes. Separate but similar safe harbor look-back rules are provided for deposits of ozone-depleting chemical excise taxes. 26 C.F.R. § 40.6302(c)-2(b)(2). It is possible that, if the ozone-depleting chemical excise taxes were to expire or be revoked and reinstated in a manner similar to that of the aviation excise taxes, the same issue may occur regarding the look-back quarter safe harbor. However, for this to occur, it would be necessary for the tax to be revoked for the look-back quarter and for the taxpayer to have filed a return for the look-back quarter reporting no liability. In addition, the ozone-depleting chemical excise taxes are remitted to the general fund. Therefore, no trust fund issues can occur with respect to this tax.

## EXCISE TAXES NOT SUBJECT TO THE PART 40 SAFE HARBOR RULES

Other excise taxes are subject to administrative provisions set forth in different parts of the regulations. However, with the exception of the firearms excise tax imposed by chapter 32 of the IRC, payment of these excise taxes is not subject to safe harbor look-

[1]These taxes include excise taxes on commercial air passenger and freight transportation and on fuels used in noncommercial aviation to fund the Airport Trust Fund. The three Airport Trust Fund taxes imposed on commercial air transportation are retail excise taxes.

back provisions. In addition, with the exception of the chapter 42 excise taxes imposed by sections 4951, 4952, and 4953 and the tax on use of heavy trucks imposed by section 4481, these taxes do not fund trust funds. The taxes that are not subject to the provisions of the excise tax procedural regulations (part 40) are outlined in the following paragraphs.

Section 4181 of the IRC imposes tax upon sales by manufacturers, producers, or importers of firearms. The tax applies to the sales of pistols, revolvers, ordinary rifles, and shotguns, shells and cartridges. The Director, Alcohol, Tobacco, and Firearms (ATF) has authority to administer the firearms excise tax. ATF has issued regulations under 27 C.F.R. part 53 requiring firearms and ammunition tax returns, claims and related documents previously filed with IRS to be filed with ATF. 27 C.F.R. § 53.151(a) provides that returns under chapter 32 shall be reported on ATF Form 5300.26 for a period of one calendar quarter. 27 C.F.R. § 53.159(c)(3) provides for deposits of taxes and a safe harbor rule based on look-back quarter liability.

In addition, under chapter 53, the National Firearms Act, a stamp tax is imposed on the transfer of certain firearms and destructive devices (section 5811); an occupational tax is imposed on manufacturers, importers, and dealers in certain firearms and destructive devices (section 5801); and a stamp tax is imposed on the making of certain firearms and destructive devices (section 5821).

Section 4461 of the IRC imposes a harbor maintenance tax on the use of certain ports. The harbor maintenance tax is administered and enforced by the Customs Service in a manner similar to customs duties. The importer is liable for the tax on cargo entering the United States, and the exporter is liable for the tax on cargo that is exported from the United States. In any other case, the shipper is liable for the tax. 19 C.F.R. § 24.24(e) provides rules for tax collections. For domestic vessel movements, the shipper is to pay accumulated fees on a quarterly basis and file a Harbor Maintenance Fee Quarterly Summary Report, Customs' Form 349. For export vessel movements, the exporter is generally required to pay the accumulated fees on a quarterly basis. All quarterly payments must be received no later than 31 days after the close of the quarter being paid. For import vessel movements, the fee is due when imported cargo is unloaded from a commercial vessel at certain ports. The port-use fee on unloading imported cargo is paid in accordance with the normal customs collection procedures set forth in 19 C.F.R. § 24.1 and 141.1. Section 141.1 generally provides that duties and the liability for their payment accrue on imported merchandise upon arrival of the importing vessel within a Customs port, with the intent to unlade. The port-use fee is to be paid by the importer by adding it to any normal duty, tax, or fee payable at the time of formal entry processing. 19 C.F.R. § 24.24(e)(3)(ii). Quarterly payment is also required when imported cargo is unloaded from a commercial vessel at certain ports and admitted into a foreign trade zone and where passengers board or disembark at certain ports.

Section 4481 imposes a tax on the use of certain heavy vehicles having a taxable gross weight of 55,000 pounds or more on U.S. highways. 26 C.F.R.§ 41.6151(a)-1 provides that the tax is to be paid in full at the time prescribed in § 41.6071(a)-1 for filing the return, unless the person required to file the return elects to pay the tax shown on the return in installments. Section 41.6071(a)-1 provides that highway use tax returns are due on or before the last day of the month following the month in which the first taxable use of the vehicle occurs. Section 6156 of the IRC permits a taxpayer to pay the highway vehicle excise tax in installments if the return is filed on or before the due date. The regulations provide due dates for installment payments. There are no safe harbor provisions.

Part 44 of 26 C.F.R. provides regulations on the excise tax on wagers. These taxes are reported and paid with Form 730, which is filed on a monthly basis.

Chapter 52 of the IRC imposes taxes on the manufacture or import of cigars, cigarettes, and cigarette papers and tubes. Section 5703(b) provides for the method of payment of the tax and requires that the taxes be determined at the time of the removal of the tobacco products from the factory or from internal revenue bond. Section 5703(b)(2)(A) provides that, generally, in the case of taxes on tobacco products and cigarette papers and tubes removed during any semimonthly period under bond for the deferred payment of tax, the last day for payment shall be the 14th day after the last day of the semimonthly period. 27 C.F.R. § 270.162 requires every manufacturer of tobacco products to file, for each factory, a semimonthly tax return on Form 5000.24 for each return period. Semimonthly returns are to be filed, for each return period, not later than the 14th day after the last day of the return period. 27 C.F.R. § 270.355 provides similar rules for taxes imposed on cigarette papers and tubes.

Additional excise taxes are imposed by chapters 42, 43, 44, 46, 47, and 54 of the IRC. Chapter 42 imposes taxes on private foundations and other tax exempt organizations. Chapter 43 imposes taxes in certain circumstances on qualified pension plans. Chapter 44 imposes excise taxes on qualified investment entities, which are real estate investment trusts and regulated investment companies. Chapter 46 imposes excise tax on "golden parachute" excess payments. Chapter 47 imposes excise tax on certain expenses of large group health plans. Chapter 54 imposes excise tax on a portion of the gain realized from greenmail.

## TRUST FUNDS FUNDED BY EXCISE TAXES AND ESTABLISHED IN THE IRC

| **Trust fund** | **IRC section** | **Excise tax funding sources and applicable IRC section** |
|---|---|---|
| Airport and Airway | 9502 | Excise taxes on air transportation, including domestic air passenger transportation, international air passenger departure, domestic air freight, and gasoline and jet fuels used for noncommercial aviation. Sections: 4261, 4271, 4081, 4091, and 4041(c). |
| Aquatic Resources | 9504 | Sport Fish Restoration Account: Excise taxes on sport fishing equipment and import duties on fishing tackle, excise taxes on gasoline and special motor fuels used in motorboats, and on gasoline used in small engine outdoor power equipment (nonbusiness use) (funds transferred from Highway Trust Fund).<br>Boat-Safety Account: Excise taxes on gasoline and special motor fuels used in motorboats (funds transferred from Highway Trust Fund).<br>Sections: 4041 and 4081, 4161(a), and 9503(c)(4), 9503(c)(5). |
| Black Lung Disability | 9501 | Excise taxes on coal and on black lung benefit trusts. Sections: 4121, 4951, 4952, 4953. |
| Harbor Maintenance | 9505 | Excise taxes on any port use (treated as a customs duty). Section: 4461. |
| Highway | 9503 | Excise taxes on diesel fuels and special motor fuel, retail tax on heavy trucks and trailers, tires, gasoline and diesel fuel, and use of certain vehicles. Sections: 4041, 4051, 4071, 4081, and 4481. |
| Inland Waterways | 9506 | Excise taxes on diesel and other liquid fuels used by commercial cargo vessels on specified inland or intracoastal waterways. Section: 4042. |
| National Recreational Trails | 9511 | Funds transferred from Highway Trust Fund limited by obligated amounts. Section: 9503(c)(6). |
| Vaccine Injury Compensation | 9510 | Excise tax on certain vaccines. Section: 4131. |

Note: With the exception of the excise taxes imposed on black lung benefit trusts (sections 4951, 4952, and 4953 in chapter 42 of the IRC) and the excise taxes on the use of any port (section 4461) and on certain heavy vehicles (section 4481 of chapter 36 of the IRC), all excise taxes that fund these trust funds are covered by the excise tax procedural regulations. 26 C.F.R. part 40.

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