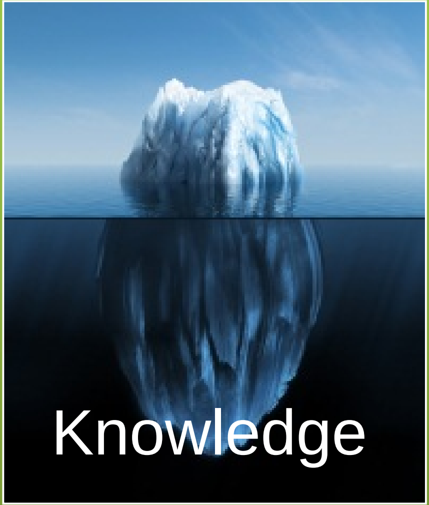

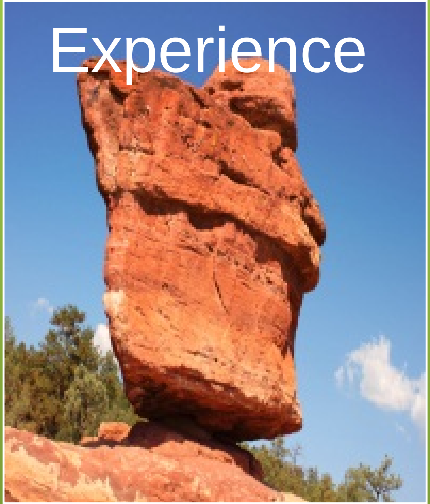

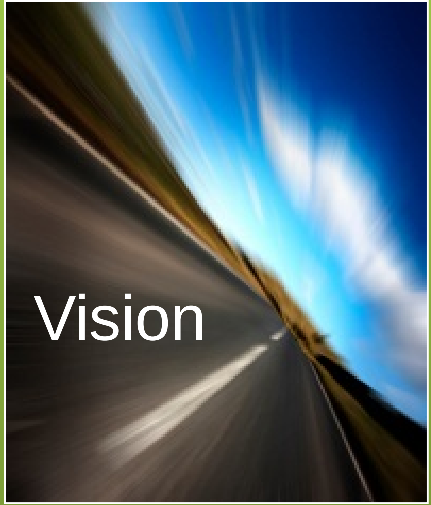

Ethanol and the Oil Spill Tax

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Phil Cleary
pcleary@christiansoncpa.com

What it is:

A tax on crude oil, including natural gasoline.

Bottom Line up Front:

An ethanol plant using natural gasoline as denaturant sourced from a fractionator is generally liable for paying the oil spill tax

What it Costs:

$.08 per barrel of crude oil, including natural gasoline

- "Barrel" means 42 United States gallons
- = $.0019 per gallon

Starting 1/1/2017:

- $.09 per barrel
- = $.00214 per gallon

Outline:

1. What's the OSLT
2. Why it's a "surprise" for ethanol producers
3. What you might owe if it turns out you're liable
4. How the issue usually comes up
5. Basic Framework for determining whether you're liable
6. Standard options for voluntary compliance
7. Next steps if you have questions

What’s the OSLT?

Tax on Refinery

26 USC 4611(a)

There is hereby imposed a tax at the rate specified in subsection (c) on-

(1) crude oil received at a United States refinery, and

(2) petroleum products entered into the United States for consumption, use, or warehousing.

What’s the OSLT?

Tax on User

26 USC 4611(b)

(1) In general. If—

(A) any domestic crude oil is used in or exported from the United States, and

(B) before such use or exportation, no tax was imposed on such crude oil under subsection (a),

then a tax at the rate specified in subsection (c) is hereby imposed on such crude oil.

What's the OSLT?

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English

OSLT is an excise tax, imposed either on:

- a <u>refinery</u> receiving the natural gasoline, or else
- the <u>user</u> of the natural gasoline, if it is never received by a refinery.

What's the OSLT?

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The Standard Application

26 USC 4612(a)(6)

In the case of any United States refinery which produces natural gasoline from natural gas, the gasoline so produced shall be treated as received at such refinery at the time so produced.

What's the OSLT?

The Fractionator's Exemption

Enron Gas Processing Co vs United States

Enron sued the government on grounds that it was exempt from the tax, and they won.

If the natural gasoline is recovered in a gas separation plant rather than at a refinery, then the tax is imposed when the gasoline is received at a refinery or when it is used without passing through a refinery.

What’s the OSLT?

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IRS Position

How the two connect

1. “We follow the Enron case as instructed in IRB 1998-11 which states that the IRS will not treat fractionation facilities as refineries for purposes of IRC 4611 tax.”
2. “Consequently, we take the position that section 4612(a)(6) doesn't apply to fractionators.”
3. “The ramification from the Enron case / IRB 1998-11 impacts downstream customers of natural gasoline, such as purchasers of natural gasoline for denaturing of ethanol.”
4. “Such a customer is liable for oil spill tax under the provisions of 4611(b).”

What's the OSLT?

Conclusion

- Normally, natural gasoline would always be received at a refinery (making the "user" never liable)
- But because of the "Enron" case, 4612(a)(6) doesn't apply to natural gasoline sourced from a fractionator.
- The Enron Case limits the definition of a refinery, thereby increasing the frequency upon which the tax is imposed to the "user."
- Interpretation of *User* = "Downstream customers of natural gasoline, such as purchasers of natural gasoline for denaturing of ethanol."

Why it's a "surprise" for ethanol producers

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Supplier Exemption

Since the natural gasoline is made from a fractionation process and never passes through a refinery, suppliers correctly believe the tax is not applicable to them.

User Liability

However, rather than there being no tax at all in that situation, the tax is imposed down to the "user" -- per 4611(b). *Something few people are aware of until the IRS makes it an issue.*

A fractionator's exemption from the tax under 4611(a) has become an ethanol plant's liability under 4611(b).

Why it's a "surprise" for ethanol producers

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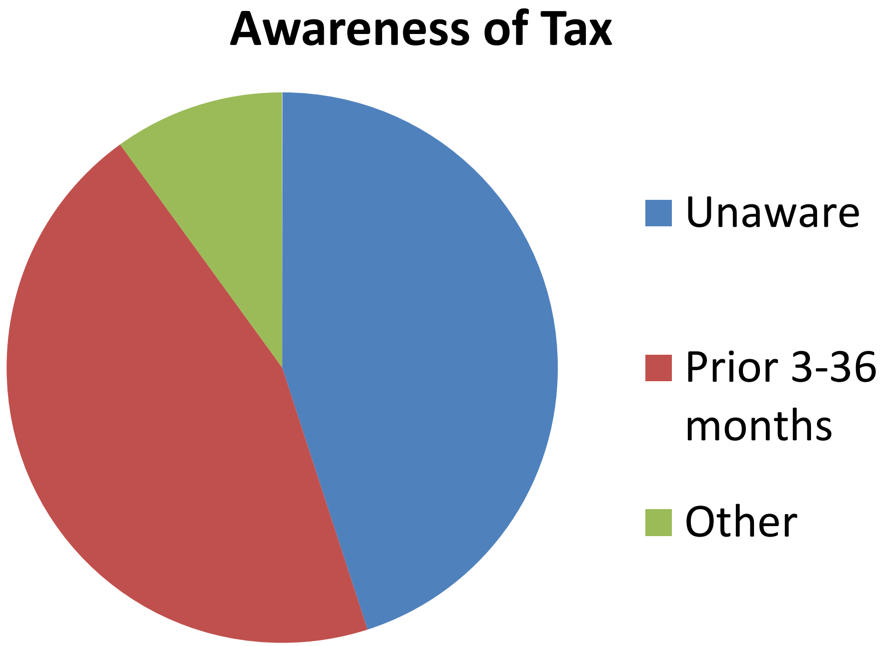

Why it’s a “surprise” for ethanol producers

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Natural gasoline produced via ‘fractionation’ is a rare example of a crude oil product that typically never goes to a “refinery” (based on the court’s interpretation in a case with Enron), but is almost always what an ethanol plant uses as a denaturant.

Why it's a "surprise" for ethanol producers

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What you might owe (annually), if you're liable

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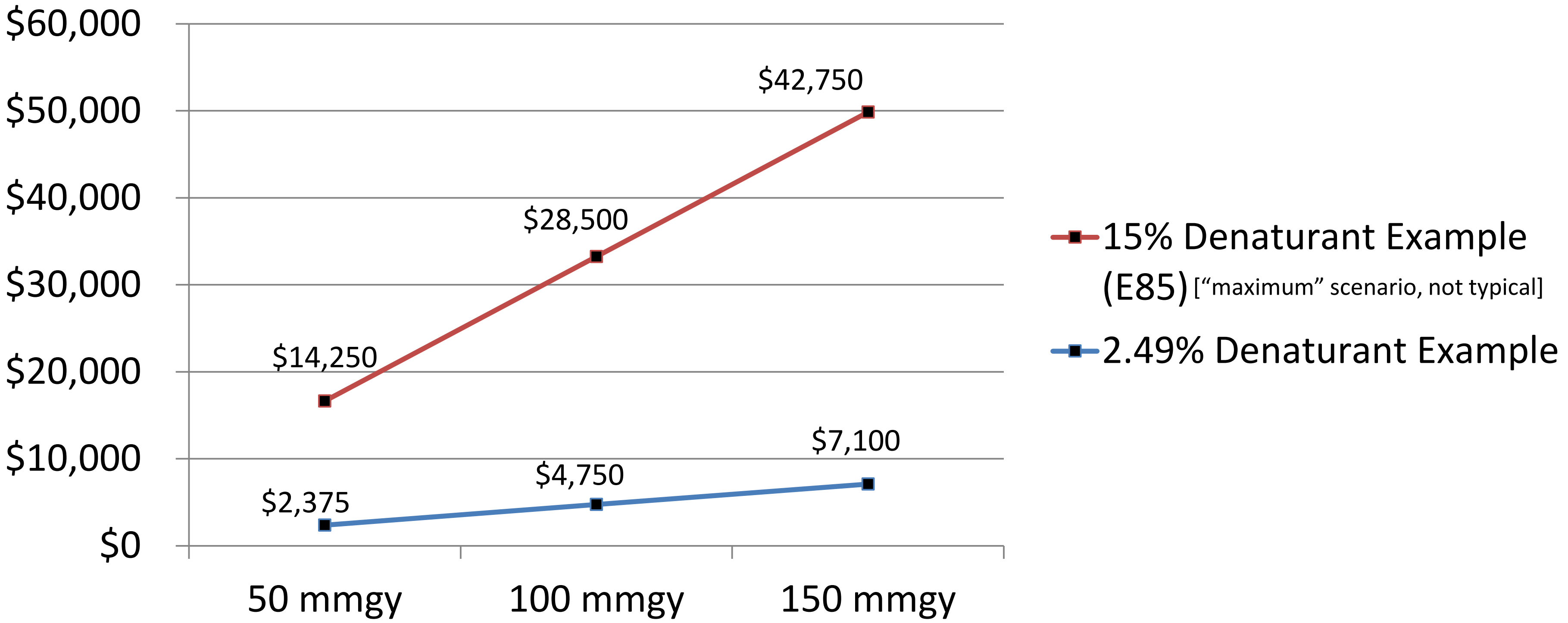

How the issue usually comes up

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The IRS generally becomes aware of the potential liability from:

- An auditor; especially when larger quantities of denaturant are being used (E85)
- During an inspection when an alcohol permit needs updating
- Having been successful over the last couple of years, their pursuit has become more aggressive

Basic Framework for determining whether you're liable

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Denaturant Type: Do you use natural gasoline?

The tax applies to all crude oil products, but natural gasoline produced via 'fractionation' is a rare example of a crude oil product that typically never goes to a "refinery."

Upstream Payment: Has someone upstream already paid the tax?

Supplier Procurement: Do they source it from a fractionator?

Chain of Custody: Has it been received at a refinery prior to your use of it?

Standard options for voluntary compliance

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Wait and See:

- If or when the IRS initiates on their own, you would go back and file amended forms for previous taxes due.
- There would be up to 50% in penalties assessed if a liability was greater than $2500 in a quarter, due to *failure to deposit,* plus any interest accrued.
- You don't know how far back they'll go.

Standard options for voluntary compliance

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Fight it:

- Many plants have mentioned wanting to fight the IRS on the application of the tax on downstream users, but felt compliance with the tax was cheaper, even in the long run, than the cost of challenging it.
- (Too small of a tax to effectively challenge it)
- The best chance for a coordinated effort was missed because it started with smaller plants and a gradual enforcement effort.

Standard options for voluntary compliance

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Fight it:

- *Option A* - Argue about who the statutes defines as *the user* of the fuel, in order to demonstrate the ethanol plant isn't "the user" of the natural gasoline.

- *Option B* - Establish custody of the natural gasoline to a <u>refinery</u> (The Enron definition of a refinery, not a fractionator) at some point before the ethanol plant used the natural gasoline, in order to demonstrate a tax shouldn't be imposed on the user at all.

- Option C - ???

Standard options for voluntary compliance

Pay it:

- <u>Pay Now</u> – Make regular payments going forward.

  Send in forms 6627 and 720 for current quarter.

  Hope the change in practice doesn't flag an audit.

- <u>Negotiate</u> – Arrange with your tax provider to provide name and EIN, and voluntarily open an excise tax audit with IRS.

  Possible Outcome: Be found subject to the tax going back 2-4 quarters, but have penalties forgiven. If it's a similar situation to many they've dealt with, where it is considered a *complex tax matter*, its probable there would be no penalties.

Disclaimer:

- General information vs. exhaustive analysis
- Not legal or financial advice

Next steps if you have further questions

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Gather the Facts and Assess your Situation

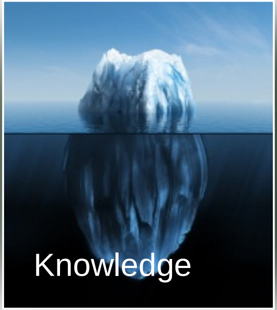
Are you liable?

Discuss with Tax Advisor

What are my options either way?

Make a plan

Ensure proper compliance and minimize potential for negative impacts to business.



Thank you!

Phil Cleary
Technical Research Analyst
Christianson & Associates, PLLP
320.235.5937
pcleary@christiansoncpa.com