Biofuel Mixture Credits — to Tax or Not to Tax?

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The authors address flaws in arguments often made in favor of taxing alternative fuel credits, the tax benefit rule, and how recent interpretations of the statute are interpretations of convenience and depart from the legislative history.

In recent months much has been made of IRS guidance on the income tax treatment of ethanol, biodiesel, and alternative fuel mixture excise tax credits that have at various times been available to blenders of those fuels with taxable fuels under sections 6426, 6427(e), and the income tax credit under section 34. This article will address flaws in the common arguments in favor of taxing the credits — the tax benefit rule — and how recent interpretations of the statute are interpretations of convenience and depart from the legislative history. The article also responds to the critical question whether if there is a loophole, taxpayers should be permitted to avail themselves of it.

Several years ago the IRS issued guidance on the controversial "black liquor loophole,"[1] starting a discussion that was recently reignited with the issuance of two chief counsel memoranda discussing the income tax treatment of the biodiesel mixture credit.

In early April 2014 *Tax Notes* published an article[2] arguing Congress had not intended that the alternative fuel mixture credit be available to blenders of off-road fuel — a loophole that was eventually closed by an amendment to the law — and that there is no support in the code for excluding those credits from taxable income. The article argued that both the tax benefit rule in section 61 and the accession to wealth doctrine under *Commissioner v. Glenshaw Glass*[3] provide support for including the credits in taxable income.

That article speaks directly to the issue at the heart of the debate over the mixture credits, which revolves around the question whether Congress intended for them to be included in taxable income. The IRS seems to have taken positions that provide a contradictory answer to that question. Following an audit of Kapstone Paper and Packaging's 2007, 2008, and 2009 federal income taxes, the IRS agreed that the alternative fuel tax mixture credit was not subject to federal income tax. Kapstone reported the same on its 2011 Form 10-K filing. Like most paper companies, Kapstone had no federal excise tax liability and therefore claimed the mixture credit as a payment under section 6427(e), the same position taken in ILM 201342010[4] relating to whether the section 6426(c) excise tax credits for creating a qualified biodiesel mixture and section 6427(e) excise tax payments are items of gross income under section 61. The chief counsel advice concludes that neither the section 6426(c) credits nor section 6427(e) payments are items of gross (or taxable) income. In reaching its conclusion, the IRS states:

> In our view, in the absence of a specific statutory provision or judicial doctrine requiring inclusion, federal tax credits are not gross income for purposes of determining a taxpayer's federal income tax liability.
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> Our conclusion is consistent with the intent of Congress when it enacted the biodiesel mixture credit. The American Jobs Creation Act of 2004 (Act), P. L. 108-357, added several new provisions regarding biodiesel fuels to the Code, including sections 6426(c), 6427, 40A, and 87. The Act's legislative history provides that the section 40A credit must be included in gross income but is silent regarding the section

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[1] The loophole allowed paper companies to claim the alternative fuel mixture credit for blending small amounts of diesel with black liquor, a byproduct of the paper manufacturing process that is used as a fuel by paper companies in their mills. *See* ILM 200941011.

[2] William Hoffman, "Black Liquor: The Loophole That Won't Quit," *Tax Notes*, Apr. 7, 2014, p. 18.

[3] 348 U.S. 426 (1955).

[4] The chief counsel advice was released to the public on Nov. 3, 2013, but is dated Aug. 29, 2013, and lists a release date of Oct. 18, 2013.

> 6426(c) credit and the section 6427 payment. See H.R. Conf. Rep. No. 108-755 at 306-310 (2004). We think the fact that sections 6426(c), 6427, and 40A were enacted together, yet Congress chose only to specifically provide that the credit under section 40A is includible in gross income, indicates that Congress intended to exclude from gross income the section 6426(c) credit and the section 6427 payment.

The chief counsel advice also states, ''where Congress has decided that a particular credit should itself be treated as an additional item of taxable income, it has done so expressly. In our view, in the absence of a specific statutory provision or judicial doctrine requiring inclusion, federal tax credits are not taxable income for purposes of determining a taxpayer's federal income tax liability.''

That chief counsel advice, consistent with the position taken by taxpayers claiming the alternative fuel mixture tax credit for black liquor blending, appeared to settle the issue — having opined on the alternative fuel and biodiesel mixture credits it follows that the alcohol mixture credit would be treated similarly. However, a few months later, on January 30, 2014, the matter was again discussed when the IRS issued ILM 201406001, addressing section 6426(a). Described as a clarification to ILM 201342010, the January guidance stated that credits claimed under section 6426 are simply a reduction in excise taxes due (or a reduction in excise tax expense), and therefore rather than being excluded from taxable income the mixture credits constitute a reduction in the excise tax expense that the taxpayer may claim as part of its cost of goods sold. At its core, ILM 201406001 draws a distinction between the mixture credit claimed under section 6426 and section 6427(e), giving section 6426 a different character so that the question of the credits' taxability becomes moot.

Legislative History Tells the Story

Those who think that the mixture credits are taxable base their arguments on a variety of sources. However, they rarely engage in a detailed analysis of the legislative history of the credits — an analysis that is critical to gain clarity on Congress's intent. The mixture credits were enacted as part of the American Jobs Creation Act of 2004. Before that act, incentives and credits for biofuels took the shape of excise tax exemptions for some mixtures including gasoline or special fuel,[5] and a 40-cent-per-gallon alcohol mixture and alcohol fuel income tax credit to encourage the mixing of alcohol at a greater volume.[6] The Crude Oil Windfall Profit Tax Act of 1980 included a provision stating that gross income includes the income tax credit reduced by the applicable excise tax exemption if the mixed fuel would be taxable otherwise (that eventually became section 87). In the general explanation of the Crude Oil Windfall Profit Tax Act of 1980, the Joint Committee on Taxation staff stated:

> The amount included in income reflects any reduction made to coordinate the credit with the excise tax exemption for gasohol. . . . The reason for this income inclusion is that the benefit is intended to be generally the same as the benefit of a 4-cent-per-gallon excise tax exemption for a gallon of gasohol which is comprised of 10 percent alcohol and 90 percent otherwise taxable motor fuels.

Also, section 6427(f) required the IRS to pay to a person an amount equal to the tax paid on gasoline if the gasoline is used to produce a mixture.

The Jobs Act did two things: (1) it created a new refundable excise tax mixture credit enacted as a tax credit under section 6426, an excise tax payment under section 6427(e), and a refundable income tax credit under section 34; and (2) it amended the existing section 40 income tax credit to include a credit for biodiesel (section 40A) and to conform to the new excise tax credit. Regarding the latter, the conforming amendment is in section 40(c).

Notwithstanding an interpretation by the IRS in its 2009 guidance on the black liquor credit that a taxpayer may elect a section 40 or sections 6426 and 6427 credit, the statutory language in the Jobs Act appears to clarify that Congress's intent was that the excise tax credit must be claimed first and the section 40 alcohol mixture credit is reduced by the section 6426 alcohol mixture credit and section 6427(e) payment. That would eliminate the section 40 credit and therefore the application of section 87 — which brings that credit within gross taxable income — because the entirety of the credit that exceeds a taxpayer's excise tax liability may be claimed under section 6427 (or section 34 if the time to claim under section 6427 has expired).

To understand the intent and rationale behind the creation of a refundable mixture credit, it is not enough to simply look at the final enacted statute; rather the history of the proposal must be reviewed in its entirety. The first iteration of the tax credit came in the House Ways and Means Committee

[5]At least 10 percent alcohol or, for gasoline or special fuel sold for use in producing a mixture, at least 10 percent which is alcohol.

[6]*See* section 40.

version of the legislation,[7] which contained a proposal to amend section 6427(f) to allow an alcohol mixture credit to be taken against a taxpayer's excise tax liability, with any excess to be paid to the taxpayer. The original language reads:

SEC. 251. REDUCED RATES OF TAX ON GASOHOL REPLACED WITH EXCISE TAX CREDIT; REPEAL OF OTHER ALCOHOL-BASED FUEL INCENTIVES; ETC.

> (a) EXCISE TAX CREDIT FOR ALCOHOL FUEL MIXTURES.—
>
> > (1) IN GENERAL.— Subsection (f) of section 6427 is amended to read as follows: ''(f) ALCOHOL FUEL MIXTURES.—
> >
> > (1) IN GENERAL.—The amount of credit which would (but for section 40(c)) be determined under section 40(a)(1) for any period —
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> > > (A) shall, with respect to taxable events occurring during such period, be treated —
> > >
> > > > (i) as a payment of the taxpayer's liability for tax imposed by section 4081, and
> > > >
> > > > (ii) as received at the time of the taxable event, and
> > >
> > > (B) to the extent such amount of credit exceeds such liability for such period, shall (except as provided in subsection (k)) be paid subject to sub-section (i)(3) by the Secretary without interest.''

That proposed section was limited to alcohol mixtures and, as a replacement for the reduced rates of excise tax, appeared to be intended primarily to benefit the gasohol blends that had been eligible for reduced excise tax rates before that statute. In the Senate, the focus of the legislation was on assisting the fledgling biodiesel industry by providing a cash incentive to start-up biodiesel companies — which had no excise tax liability — in the form of a refundable credit. To further that goal they amended the House legislation to split the section 6427(f) credit over two code sections: the alcohol and biodiesel mixture excise tax credit in section 6427(e) and the section 4081 offset in section 6426. The section 40 conforming amendment remained in the Senate version of the legislation, which also added a biodiesel mixture income tax credit in section 40A. The Senate also amended section 87 to treat the section 40A credit as taxable. No language was included addressing the taxability of sections 6426 and 6427(e).

By enacting those credits to the benefit of companies with minimal or no excise tax liability, especially those in need of cash to support their industry, without adding any provision specifically including the credit in taxable income, it appears that Congress intended that the credit be fully refundable with no income tax consequence. The impact of the statute, particularly compared with existing income tax credit, was captured in a July 2005 Congressional Research Service report.[8] In explaining the operation and effect of the new credit versus the previous reduced excise tax rate, the report states in pertinent part:

> The American Jobs Creation Act of 2004 (P.L. 108-357) restructured the basic tax subsidies for alcohol fuels: 1) the blender's income tax credits were eliminated and 2) the blender's excise tax exemption was replaced by an ''instant'' excise tax credit of the same amount — 5.1¢/gallon of a 90:10 mixture, which is also equivalent to 51¢ per gallon of ethanol in the mixture. These tax reforms went into effect on January 1, 2005. As before, the excise tax credit is claimed against the 18.4¢ per gallon excise tax on gasoline, so that the actual excise tax paid and remitted to the Treasury is 13.3¢ — the tax is reduced by 5.1¢/gallon just as with the exemption. *When income tax effects are considered, however, the new excise tax credit has a greater economic or subsidy value than the exemption before it because income tax deductions are taken at 18.4¢ rather than 13.3¢. In other words, by labeling the tax reduction as an excise tax credit rather than an excise tax exemption, the tax law treats the blenders as paying the full excise tax of 18.4¢/gallon rather than 13.3¢ per gallon*. At a 25 percent marginal income tax rate, the additional 5.1¢ deduction is valued at 1.7¢/gallon of a blend or 17¢/gallon of ethanol, which means that the total after-tax subsidy for alcohol fuel mixtures is effectively 68¢/gallon of ethanol rather than the nominal rate of 51¢. [Emphasis added.]

CRS reports offer a unique insight into the intent and purpose of Congress in enacting particular laws or taking up particular policy initiatives. That report assumes that a taxpayer's income tax deductions for excise taxes are not reduced by the taxpayer's blending credits claimed under section 6426 —

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[7]H.R. 4520.

[8]Salvatore Lazarri, ''Alcohol Fuels Tax Incentives,'' CRS report RL32979 (July 6, 2005).

in other words, the new excise tax credit is not taxable, a position reiterated in ILM 201342010, when the IRS noted that the position that the credit is not taxable is consistent with the intent of Congress and the legislative history of the enacting statute.

Statutes Don't Always Say What We Want Them to Say

Those who think that the mixture credits should be included as taxable income argue that it could not have been congressional intent to exclude the credits, largely because the amount of tax at issue is simply too large for Congress to have willingly intended to exclude it. However, that position mostly ignores legislative history and instead interprets the law in a manner that is convenient to the furtherance of the argument.

For example, the distinction drawn between sections 6426 and 6427 in ILM 201406001 is a distinction of convenience. The IRS acknowledged that "case law has not addressed the federal tax treatment of refundable excise tax credits, and the Service and the Treasury Department have not issued published guidance addressing the treatment of such credits," but "the Service believes that the better approach for federal income tax purposes is to treat so much of the credit that is applied against the excise tax liability as a reduction in excise taxes." The same chief counsel advice also argued that Congress would not have intended an outcome whereby income taxes would be reduced by the amount of the section 6426 credits — an assertion by the IRS that is not supported by any legislative or judicial history, and which appears to contradict its earlier guidance in ILM 201342010.

Opponents have sought to rely on Rev. Rul. 67-2,[9] assuming that would be the IRS's position on the mixture credits. That ruling deals with tax on refunds of excise tax paid to farmers for off-road use of gasoline. The credits addressed are items of taxable income, as they were set up to be a "refund of the gasoline tax paid with respect to gasoline used on the farm for farming purposes." Since farmers deduct the gasoline tax expense, the benefit received from that refund should be included in taxable income. In ILM 201342010 the IRS distinguished that ruling, saying that unlike the case of farmers seeking refunds of a previously paid tax, the biodiesel mixture credit was not structured as a "previously deducted expense"; it is therefore not a reduction in excise tax liability. It may be noted that while the IRS is correct in its conclusion on the character of the biofuel credit, it may have incorrectly distinguished Rev. Rul. 67-2. Upon closer analysis, Rev. Rul. 67-2 may itself reach an incorrect conclusion, meaning the farmers who received the refundable tax credit for gasoline used on a farm for farming purposes would have the same valid argument as the biofuel blenders. The farmers are taking advantage of an incentive provided by Congress that results in a refund of tax equal to the tax paid on the fuel by the farmers' suppliers. Farmers typically do not pay fuel tax to the IRS and do not receive a refund of any tax paid. They are merely receiving an incentive for using tax paid fuel in an exempt manner. The tax on the fuel was paid to the IRS by the person who removed the fuel from the bulk distribution system. A farmer who purchases fuel is merely reimbursing the seller for tax paid by the person who removed the fuel. That is not dissimilar from the biofuel tax credit as conceived by Congress, whereby blenders can receive an incentive for blending biofuel that is not a refund of a previously paid tax. What may have influenced the conclusion in Rev. Rul. 67-2 is the amount of the incentive. For farmers, the incentive equals the tax paid; by contrast, for biofuel blenders the biofuel credit is greater than the applicable tax rate (if any) on the blend created.

More examples of convenient statutory interpretation are found in the Senate Finance Committee description of various provisions in the Expiring Provisions Improvement Reform and Efficiency (EXPIRE) Act of 2014:

> The biodiesel fuel mixture credit must first be taken against tax liability for taxable fuels. To the extent the biodiesel fuel mixture credit exceeds such tax liability, the excess may be received as a payment. Thus, *if the person has no section 4081 liability, the credit is refundable*. [Emphasis added.]

The italicized language suggests (1) that the credit is refundable only to the extent it exceeds section 4081 excise tax liability, and (2) when taken against section 4081 liability, it has a different character altogether (it is neither a refundable nor a nonrefundable credit; therefore, it must be something else). The choice of language used by the Finance Committee is not only inconsistent with the legislative history, but appears to be an attempt to bolster the position of the IRS in ILM 201406001 without taking steps to amend the statute, and possibly be forced to acknowledge that under current law the mixture credits are not items of gross taxable income. If the statute were amended to either limit the credit to entities with section 4081 liability or be specifically included in taxable income, the position taken in ILM 201406001 and by those in favor of including the credit as taxable income would stand on shaky ground. If the statute

[9] 1967 C.B. 13.

were amended to specifically state that the mixture credits are to be included in gross taxable income, it would be a tacit admission that until the effective date the credits were excluded from gross taxable income. Finally, if it were amended to limit the credit to entities with section 4081 liability, the very entities that were intended to benefit from the credit — start-up biodiesel blenders with no section 4081 liability — would be unable to avail themselves of the credit and the question of the taxability of the credit remains unanswered.

The *Tax Notes* article[10] noted earlier included statements from an attorney in the IRS Office of Chief Counsel who claimed that, regarding the black liquor loophole, the IRS was in the process of drafting guidance that would have stated that the credits were taxable income when lobbyists for the paper industry persuaded Treasury officials and IRS executives to shelve the draft ruling and change its position. While there may be some truth to the assertion that the IRS can be easily swayed to take a particular position, any effort to rely on unpublished draft guidance that purports to further a preferred interpretation of the statute lacks authoritative weight.

What About the Tax Benefit Rule?

Another oft-raised argument is that the tax benefit rule in section 111 should apply. However, section 111 is not applicable because the mixture credits are not a refund of a prior tax paid. According to the conference report accompanying the legislation that enacted that section, the current iteration of the tax benefit rule states that "an increase in tax with respect to credits will only arise where an amount was paid or incurred, and there is a subsequent price adjustment, or similar adjustment with respect to that amount." In all other instances in which a taxpayer receives a credit, that amount is not includable in taxable income. The JCT report provides further guidance on the interpretation and intent of the section, stating:

> If a credit was allowable for a taxable year with respect to certain property and, in a subsequent taxable year, there is a downward adjustment of the price of the property (or other amount on which the credit was based), the tax liability of the taxpayer for the year of recovery is increased by the amount of the credit attributable to the adjustment.

The mixture credit does not result in a subsequent downward price adjustment for the mixtures to which the credit relates, therefore under section 111 the credits are not taxable.

[10]Hoffman, *supra* note 2.

An alternative argument is that section 61 should apply, but that argument fails to acknowledge what the IRS already has: Congress excluded those credits from section 61 when it enacted section 87 and did not include sections 6426, 6427, and 34 within its scope. Section 87 was enacted along with the section 40 alcohol income tax credits in the Crude Oil Windfall Profit Tax Act of 1980. It specifically provides for the section 40 (and upon amendment in 2005, section 40A) credit to be included in taxable income. That illustrates how Congress can expand the scope of section 61 (or taxable income) through other code sections. Moreover, it is highly significant that having exercised that legislative power, Congress never sought to do the same for sections 6426, 6427, and 34. While Congress and the courts can explicitly expand the scope of income captured under section 61, in ILM 201342010 the IRS appears to acknowledge that it does not have the discretion to expand the scope of section 61 through administrative rulings or regulations:

> Where Congress has decided that a particular credit should itself be treated as an additional item of gross income, it has done so expressly. In our view, in the absence of a specific statutory provision or judicial doctrine requiring inclusion, federal tax credits are not gross income for purposes of determining a taxpayer's federal income tax liability.

The IRS has gone further in taxpayer correspondence relating to alcohol mixture credits, agreeing that the tax benefit rule in section 111 does not apply because the mixture credits are not a refund of a prior tax paid and credits under sections 6427(e) and 34 need not be included in income under either section 61 or section 87. Having chosen to give credits under section 6426 a different character, the IRS does not reach the question of taxing those credits in the aforementioned correspondence.

Can a Taxpayer Take Advantage of a Loophole?

Legislative history strongly supports the proposition that the mixture credits were not intended to be included in taxable income. However, that position is unpopular in many quarters, largely because of the sums of money involved. Opponents often describe the position, espoused by the IRS in the black liquor cases and ILM 201342010, as an unintended loophole and argue that taxpayers should not be permitted to benefit. That argument is fundamentally flawed, since statutes frequently result in unintended consequences. Just because those unintended consequences result in significant benefits to the taxpayer does not mean the statutes should be reinterpreted as is convenient to the government and to the detriment of the taxpayer.

The IRS has consistently agreed that a taxpayer should be permitted to claim a benefit allowed by statute if and until the statute is amended by Congress. There are many examples of so-called loopholes that benefit taxpayers, but two in the excise tax arena are particularly apt.

The ''splash and dash loophole'' arose because the Jobs Act did not place any nexus restrictions on the mixture credit. In 2008, legislation to amend the statute acknowledged that the loophole was an unintended consequence.[11] However, Congress did not suggest that the statute be amended retroactively beyond the date the amending legislation was introduced, nor was it suggested that because the activity did not further government policy that taxpayers should not be allowed to benefit from the loophole before the effective date of the amending legislation. Indeed, the IRS continued to pay claims based on that activity throughout the period that legislation was under consideration, with only claims that occurred after May 4, 2008 (the effective date of the amending legislation), having to be repaid.

Second is the oft discussed and highly controversial black liquor loophole. The original intent of the alternative fuel mixture credit was to encourage the use of liquid biomass to produce motor vehicle fuel. In 2008 Congress expanded the scope of the credit to include off-road uses of alternative fuel. Confirmed by the IRS in ILM 200941011, that expansion of the credit allowed paper producers to claim the credit for blending black liquor — a byproduct of the paper production process — with small amounts of diesel and burning the mixture in their boilers during the paper production process. As with the splash and dash loophole, the law was eventually amended to exclude black liquor from its scope.

To the extent the language of the statute supports the assertion that the credits are not taxable — a position accepted at least in part by the IRS — it follows that whether it was intended or not, taxpayers should not be barred from taking advantage of that language simply because some groups believe it is unfair or incorrect.

The Final Analysis

While it may not be popular within the hallways of the IRS and among some scholars, the legislative history supports the position that the mixture credits are not taxable. Whether Congress actually intended that result remains up for debate, but it does not change the result. Unless or until the law is amended, taxpayers shouldn't be punished for simply interpreting and benefiting from the law as written.

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[11]JCT, ''General Explanation of Tax Legislation Enacted in the 110th Congress'' (Mar. 2009).