



A GUIDE TO THE NEW TAX LAW: CHANGES IN TAX INCENTIVES FOR ETHANOL AND BIODIESEL

Introduction

On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (P.L. 108-357).

This law significantly changes the way taxes are collected on gasohol and other ethanol blends. By providing a new excise tax credit system for all ethanol blends and biodiesel, this law provides greater flexibility and new market opportunities for the use of E-10, E85, and biodiesel. Effective January 1, 2005, the American Jobs Creation Act provides a refundable excise tax credit for blends of ethanol and gasoline, extends the ethanol tax incentive to 2010, deposits all taxes paid on gasohol and other ethanol blends into the Highway Trust Fund, and allows farmer cooperatives to claim the small ethanol producer tax credit. The law also establishes new tax credits for biodiesel blends until December 31, 2006.

The Internal Revenue Service (IRS) of the Department of Treasury is responsible for implementing the fuel tax provisions contained in the American Jobs Creation Act of 2004. On December 16, 2004, the IRS issued Notice 2005-4, "*Fuel Tax Guidance; Request for Public Comments*" providing interim guidance on the new IRS Code Sections created or modified by the Act. On January 10, 2005, the Internal Revenue Service published [IRS Internal Revenue Bulletin 2005-02, "Excise Taxes"](#), containing the Notice. However, while the new fuel tax provisions affecting ethanol and biodiesel became effective January 1, 2005, IRS regulations implementing the law and revised IRS Forms pertaining to the new excise tax and registration provisions have not yet been issued.

This Brief is designed to assist ethanol producers, blenders, refiners, and farmers by providing an overview of the new tax credits established under the American Jobs Creation Act. Additional information will be provided as IRS finalizes new tax Forms and issues new rules governing ethanol and biodiesel tax credits.

NOTE: Ethanol marketers and blenders should consult their tax advisor to determine the impact of the new fuel tax changes on their specific company or business operation. Since IRS has not issued revised Forms for claiming the ethanol and biodiesel tax credits, or issued rules implementing the new tax changes, the information contained in this document is preliminary, and may be altered by subsequent IRS rulemakings and guidance.

What are the Major Changes in the Federal Tax Incentive for Ethanol?

Beginning January 1, 2005, the American Jobs Creation Act of 2004 established a new system for federal taxation of ethanol blends. The major changes are as follows:

- Modifies the excise tax for gasohol blends containing 10%, 7.7%, and 5.7% ethanol by providing a \$0.51 cents per gallon excise tax credit for each gallon of ethanol blended with gasoline rather than providing a reduced tax rate. The new excise tax credit system is called the “Volumetric Ethanol Excise Tax Credit” (VEETC).
- Extends the \$0.51 cents per gallon tax credit for ethanol through December 31, 2010.
- Requires blenders to pay the full rate of tax (18.4 cents per gallon) on each gallon of a gasoline-ethanol mixture, but provides a \$0.51 cents per gallon tax credit or refund for each gallon of ethanol used in the mixture.
- Allows blenders having excise tax liability to apply the excise tax credit against the tax imposed on the gasoline-ethanol mixture. For blenders having limited or no motor fuel excise tax liability, a refund may be claimed. IRS is required to provide refunds within 45 days, or if a claim is filed electronically, the refund must be paid within 20 days, or interest will accrue.
- Deposits all gasohol excise taxes into the Highway Trust Fund, and pays for the credit out of the General Fund.

What is the Rate of the Ethanol Tax Credit?

Effective January 1, 2005, the rate of the ethanol tax credit or payment is \$0.51 per gallon for ethanol with a proof of 190 or greater. On January 1, 2005, the ethanol tax incentive was phased down from \$0.52 cents per gallon to \$0.51 cents per gallon ethanol for qualifying mixtures. The phase-down is the result of a requirement in the Transportation Equity Act for the 21st Century (TEA 21) enacted by Congress in 1998, and is not related to passage of the new tax law.

How Does the Ethanol Excise Tax Credit Work?

The new law allows a credit against the excise tax imposed on the sale of gasoline, diesel, or kerosene. The credit is allowed to the person that blends the alcohol and gasoline mixture for sale or use in their trade or business.

Under the new excise tax credit system, gasoline refiners and marketers are required to pay the full rate of tax (18.4 cents per gallon) on the total gasoline-ethanol mixture (including the ethanol portion), but are able to claim a \$0.51 per gallon tax credit or refund for each gallon of ethanol used in the mixture. The credit is paid on the amount of alcohol added to the fuel mixture. Gasohol blended at the terminal will be taxed at 18.4 cents per gallon on the total mixture. Gasohol blended below the rack will be taxed at the full rate of 18.4 cents per gallon as well. Persons producing taxable fuel are required to report excise taxes on Form 720, “*Quarterly Federal Excise Tax Return*”. The blender may claim the tax credit as either a credit against the excise tax imposed on the sale of gasoline, or a refund (payment) from the IRS. Under the Code’s coordination rules, a claim may be taken only once with respect to any particular gallon of alcohol or biodiesel.

Who is Eligible for the Credit?

Any person that produces an “alcohol fuel mixture” for sale or use in the producer’s trade or business is eligible to claim the excise tax credit. For purposes of the credit, an “alcohol fuel mixture” is defined as a mixture of alcohol and taxable fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel or (2) is used as a fuel by the taxpayer producing the mixture. A mixture that includes ETBE or other ethers produced from alcohol produced by any person at a refinery prior to a taxable event is treated as sold at the time of its removal from the refinery (and only at such time) to other persons for use as fuel.

How Do Blenders Claim the Ethanol Excise Tax Credit?

Blenders of ethanol and gasoline may claim the excise tax credit on [Form 720, "Quarterly Federal Excise Tax Return"](#) in accordance with the instructions for that Form. Schedule C, “Claims”, included in Form 720, may be used if one is reporting liability in Part I or II of the Form.

The credit is treated as a payment of the taxpayer’s tax liability received at the time of the taxable event. A credit may be taken against the blenders excise tax liability equal to the number of gallons of ethanol blended with gasoline. In lieu of the reduced excise tax rates (which applied prior to January 1, 2005), the alcohol mixture credit may be applied against one’s excise tax liability. For gasoline ethanol blenders who remit excise taxes semimonthly, a credit may be taken against the blenders excise tax liability equal to the number of gallons of ethanol blended with gasoline.

Form 720, “Quarterly Federal Excise Tax Return” is required to be filed 30 days after the end of each quarter. For the first quarter of 2005, Form 720 would be required to be filed by April 30, 2005. At the present time, the IRS has not yet revised Form 720 to reflect the changes required by the JOBS Act. IRS plans to issue a revised Form 720 by Spring of 2005.

To the extent that the alcohol fuel mixture credit exceeds one’s tax liability (under Section 4081), or if the person has no Section 4081 liability, ethanol blenders may file for a refund equal to the credit. The refund may be claimed on [Form 8849, "Claim for Refund of Excise Taxes"](#), in accordance with instructions for this Form.

The new tax law requires IRS to pay non-electronic claims within 45 days. If such a claim is not paid within the required time frame, the law requires IRS to pay the claim with interest. IRS is in the process of developing an electronic claim system. For electronic claims, IRS is required to pay the claim within 20 days, or the claim must be paid with interest.

Who Needs to Register With the IRS?

The Internal Revenue Service requires that any producer or importer of ethanol or biodiesel must be registered with the IRS by July 1, 2005. IRS also requires that any person that produces blended taxable fuel must be registered with the IRS **prior to blending** such taxable fuel.

Parties may apply for registration on [Form 637, "Application for Registration \(For Certain Excise Tax Activities\)"](#) in accordance with the instructions for that Form. Form 637 is being revised to reflect new registration requirements added by the American Jobs Creation Act of 2004. It is anticipated that revised Form 637 may be available in late January 2005. It is likely that entities that are both alcohol producers and blenders will need to register for each "activity" on the revised Form.

Producers & Importers of Ethanol & Biodiesel

Under the American Jobs Creation Act of 2004, a new registration requirement has been established for all ethanol producers and importers. Under the law, every person producing or importing alcohol (other than alcohol with a proof of less than 190) or biodiesel must be registered by the IRS by July 1, 2005. Penalties will be imposed for failure to register as required.

IRS will be modifying Form 637 to establish a new category for producers and importers of ethanol and biodiesel. Since registration is not required until July 1, 2005, producers (who are not blending) may wait until the new Form is issued before registering.

In order to be registered by the IRS as an alcohol or biodiesel producer, the IRS will need to determine that the applicant is (1) engaged as a producer or importer of alcohol or biodiesel, or is likely to become a producer or importer within a reasonable time after being registered; and (2) is satisfied with the filing, deposit, payment, reporting, and claim history for all federal taxes of the applicant and any related person.

Blenders of Ethanol & Biodiesel

IRS requires that any person producing blended taxable fuel must be registered by the Internal Revenue Service prior to blending. Under the new tax law, any ethanol blender or E85 blender who is not yet registered, and seeks to blend alcohol and gasoline and claim the excise tax credit for the amount of ethanol used must **be registered with the IRS prior to blending**. Application for registration is made on Form 637, "*Application for Registration (For Certain Excise Tax Activities)*". Part II of Form 637 requires applicants to enter an "Activity Letter" for each activity being applied for. Persons applying to blend gasoline and ethanol (or biodiesel) should mark the letter "M", which is a "blender of taxable fuel outside the bulk transfer/terminal system".

Gasoline marketers who blended ethanol inside the terminal prior to January 1, 2005, (and other taxable fuel) and are currently operating as a "registered blender" under Activity Letter "M", will not need to change their registration at this time. Marketers registered under Activity Letter "T" (buyer of gasoline for blending into gasohol outside the bulk transfer/terminal system) will have

until July 1, 2005 to change their registration to activity “M”, a blender of taxable fuel outside the bulk transfer/terminal system.

What General Requirements are Imposed on the Alcohol?

In order to qualify for the excise tax credit, the alcohol may not be produced from petroleum, natural gas, or coal (including peat). For purposes of claiming the 51 cents per gallon credit, the alcohol is required to have a proof of at least 190 (determined without regard to any added denaturants).

Does Imported or CBI Ethanol Qualify for the Tax Credit?

Yes. Both imported ethanol and ethanol produced or imported from a CBI beneficiary country qualify for the ethanol tax credit. No restrictions are imposed on the use of imported ethanol.

While neither the Transportation Equity Act for the 21st Century, nor the new American Jobs Creation Act restricts the use of imported or CBI ethanol from qualifying for the credit, ethanol imported from a non-CBI beneficiary country is subject to U.S. Customs duties at the time of importation.

Is Ethanol In Storage During 2004 Eligible for the Tax Credit?

Yes. Ethanol held in storage tanks prior to January 1, 2005 is eligible to receive a tax credit under the new tax law. There are no restrictions imposed on storage of ethanol. The ethanol is only considered “taxable fuel” at the time it is blended with gasoline.

Does the new Legislation Affect State Tax Exemptions or Credits?

No. The establishment of a new Federal excise tax credit for ethanol in lieu of a reduced rate of excise tax does not affect state tax exemptions for ethanol or biodiesel. The current excise tax credit provisions affect only Federal taxes on alcohol or biodiesel mixtures, not state tax incentives.

Why did Congress Modify the Structure of the Ethanol Tax Incentive?

Under the new tax law, the entire amount of fuel taxes imposed on ethanol blends will be deposited into the Highway Trust Fund. The credit will be paid from the General Fund, thus eliminating any impact that gasohol might have on the Highway Trust Fund. This change will significantly benefit state transportation programs and highway projects, by ensuring that Federal highway aid allocated to states from the Highway Trust Fund is not reduced by increased use of ethanol-blended fuels.

In addition, the new system of taxing all gasoline-ethanol blends at the full rate of 18.4 cents per gallon is designed to prevent “fuel fraud” by eliminating the practice of purchasing reduced rate gasoline at the terminal for blending with ethanol and failing to subsequently blend that gasoline with ethanol.

What Are the Tax Credits for Biodiesel?

The American Jobs Creation Act of 2004 provides a new excise tax credit for biodiesel mixtures. For agri-biodiesel, the credit or payment amount is \$1.00 per gallon; for biodiesel other than agri-biodiesel, the credit or payment amount is \$0.50 per gallon. A credit is available for each gallon of biodiesel used by the taxpayer in producing a qualified biodiesel mixture for sale or use in a trade or business. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing the mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing the mixture. The biodiesel excise tax credits are in effect until December 31, 2006.

A new income tax credit is also provided for biodiesel used as a fuel. Under Section 40A of the Code, a new nonrefundable income tax credit for biodiesel used as fuel is included in the general business credit. For agri-biodiesel, the credit or payment amount is \$1.00 per gallon; for biodiesel other than agri-biodiesel, the credit or payment amount is \$0.50 per gallon.

In the case of biodiesel not in a mixture (100% biodiesel or B100), the credit is allowable to the person selling the biodiesel in a qualifying retail sale or, if the biodiesel has not been sold in a qualifying retail sale, to the person using the biodiesel as a fuel in a trade or business. A sale is a qualifying retail sale if it is at retail and the biodiesel is placed in the fuel tank of the purchaser’s vehicle at the time of the sale. In the case of biodiesel in a mixture, the credit is allowable to the producer of a mixture that is sold or used in the producer’s trade or business. This credit is claimed on Form 8864, “*Biodiesel Fuels Credit*”, in accordance with the instructions for that Form.

Under the Code’s coordination rules, a claim may be taken only once with respect to any particular gallon of alcohol or biodiesel.

How Does One Claim the Biodiesel Excise Tax Credit?

An excise tax of 24.4 cents per gallon is imposed on the sale of diesel fuel. Blenders of biodiesel may claim a credit for each gallon of biodiesel used in the mixture. The credit may be claimed on [Form 720, "Quarterly Federal Excise Tax Return"](#) in accordance with the instructions for that Form.

The credit is only allowed if a certification is obtained from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel or agri-biodiesel in the product. IRS Notice 2005-04 and [IRS Internal Revenue Bulletin 2005-02, "Excise Taxes"](#) provides preliminary guidance on these certification requirements.

The excise tax credit is treated as a payment of the taxpayer's tax liability received at the time of the taxable event. A credit may be taken against the blenders excise tax liability equal to the number of gallons of biodiesel blended with diesel fuel. For biodiesel blenders who pay excise taxes semimonthly, a credit may be taken against the blenders excise tax liability equal to the number of gallons of biodiesel blended with diesel fuel. Form 720, "Quarterly Federal Excise Tax Return" is required to be filed 30 days after the end of each quarter. For the first quarter of 2005, Form 720 would be required to be filed by April 30, 2005.

To the extent that the biodiesel mixture credit exceeds a person's § 4081 liability for any particular quarter, an income tax credit or a payment is allowable to the producer of the mixture. This credit or payment is claimed on Form 720, "*Quarterly Federal Excise Tax Return*"; Form 4136, "*Credit for Federal Tax Paid on Fuels*"; or Form 8849, "*Claim for Refund of Excise Taxes*"; in accordance with the instructions for those Forms.

What Modifications Were Made to the Small Ethanol Producer Credit?

Present law provides a separate 10-cents-per-gallon credit for small ethanol producers, defined generally as persons whose production does not exceed 15 million gallons per year and whose production capacity does not exceed 30 million gallons per year. The small producer credit is part of the alcohol fuels tax credit under section 40 of the Code.

The American Jobs Creation Act of 2004 modified the small ethanol producer credit. The new law allows cooperatives to elect to pass the small ethanol producer credit through to their patrons. Specifically, the credit is to be apportioned among patrons eligible to share in patronage dividends on the basis of the quantity or value of business done with or for such patrons for the taxable year. The election must be made on a timely filed return for the taxable year, and once made, is irrevocable for such taxable year.

The amount of the credit not apportioned to patrons is included in the organization's credit for the taxable year of the organization. The amount of the credit apportioned to patrons is to be included in the patron's credit for the first taxable year of each patron ending on or after the last day of the payment period for the taxable year of the organization, or, if earlier, for the taxable year of each patron ending on or after the date on which the patron receives notice from the cooperative of the apportionment. If the amount of the credit shown on the cooperative's return for a taxable year is in excess of the actual amount of the credit for that year, an amount equal to the excess of the reduction in the credit over the amount not apportioned to patrons for the taxable year is treated as an increase in the cooperative's tax. The increase is not treated as tax imposed for purposes of determining the amount of any tax credit or for purposes of the alternative minimum tax.

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