Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Penalties imposed under § 6715

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ISSUES

How may the Internal Revenue Service (Service) determine the amount of dyed fuel held for a use other than a nontaxable use for purposes of assessing a penalty under § 6715(a)(2) of the Internal Revenue Code? How does the decision in Needsome Farms v. U.S., No. 97-1375-MLB, 1999 WL 1313697 (D.Kan. July 16, 1999) affect this analysis?

CONCLUSION

The Service may consider any relevant factors when calculating the amount of dyed fuel a person held for a use other than a nontaxable use (i.e., a taxable use) in assessing a penalty under § 6715(a)(2).

FACTS

The following example can be used to illustrate the issue: The Service inspects a farmer's registered pick-up truck on the highway and determines that the truck holds 30 gallons of dyed fuel. The Service then proposes a penalty of $1,000. The Service also determines that the farmer fueled the truck from the farmer's bulk storage tank that

contains 10,000 gallons of dyed fuel. While at the farm, the Service observes numerous pieces of off-highway farm equipment that are fueled from the same bulk storage tank.

LAW AND ANALYSIS

Section 6715(a)(2) imposes an assessable penalty if any dyed fuel is held for use or used by any person for a use other than a nontaxable use and such person knew, or had reason to know, that such fuel was so dyed.

Section 6715(b)(1) generally calculates the amount of the penalty as the greater of (A) $1,000, or (B) $ 10 for each gallon of the dyed fuel involved.

In the example we gave above, it is not improper for the Service to initially presume that the entire volume of fuel in the bulk storage tank is held for a taxable use. However, this presumption is rebuttable. Thus, before the penalty is actually assessed, the taxpayer is allowed to present its case to Service officials who have authority to determine the matter. See the Internal Revenue Manual Part 4.24.13.18.2 and Notice 1215 for further information on taxpayers' rights to disagree and appeal a penalty assessment.

If the taxpayer does not present any evidence of nontaxable use, or if the evidence presented is not credible or otherwise not convincing, it is not unreasonable for the Service to base its assessment on the entire 10,000 gallons of dyed fuel in the tank.

On the other hand, if the taxpayer does present credible and convincing evidence of its past usage, the Service can use this evidence to infer a pattern of future usage. Thus in the example, if the taxpayer can show that, historically, only 60% of the diesel fuel it dispenses from a bulk tank of dyed fuel is used for nontaxable purposes, it might be reasonable to assess the penalty on 40% (4,000 gallons) of the dyed fuel in the bulk storage tank even though those gallons have not yet been used. Note, however, that this result might not be appropriate if the taxpayer has established a new pattern of usage that is not consistent with its past practices.

Additionally, another way to use credible and convincing evidence of a taxpayer's past usage is to base the penalty on the use of dyed fuel that the taxpayer has actually used for a taxable purpose. For example, if the Service determines that the taxpayer bought and used 100,000 gallons of dyed fuel during the previous year and that, historically, only 60% of the diesel fuel it dispenses from its bulk tank is used for nontaxable purposes, it might be reasonable to assess the penalty on 40% of that amount (40,000 gallons) that the taxpayer actually used for a taxable use.

Note that the three possible results described in this memorandum are not necessarily the only results that are reasonable in all particular cases. Each case may have different facts and should be resolved on its own merits.

In Needsome Farms, the Service inspected a farmer's registered truck and determined the truck was using dyed fuel for other than a nontaxable use. The Service then determined that dyed fuel in the truck came from a bulk storage tank on the farmer's farm and that the tank contained 1,833 gallons of dyed fuel. The Service assessed a penalty under § 6715(a)(2) of $1,500 for the truck violation and $18,330 for the dyed fuel in the storage tank. The taxpayer argued that the fuel in the storage tank was not "involved" in the truck's violation and § 6715(b)(1)(B) calculates the penalty at $10 for each gallon of the dyed fuel "involved." The court ruled that according to the plain meaning of § 6715(a)(2), dyed fuel that is held for a taxable use is "involved." The court noted that it was undisputed that the fuel held in the farmer's storage tank was for a taxable use.

Needsome Farms does not change the analysis of our advice. In Needsome Farms, the Service determined that the entire 1,833 gallons were held for a taxable use and assessed the penalty based on that amount. The court agreed with the Service's determination, calling it "undisputed". However, if Needsome Farms presented credible and convincing evidence to the Service that only 50% of the dyed fuel was held for a taxable use, then it might have been reasonable for the Service to assess only 50% of the penalty.

Please call (202) 622-3130 if you have any further questions.