

Tax and Reporting Challenges for Biofuels Distributors

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What are common BioFuels?

- Ethanol (octane 108+)
 - Typically blended with gasoline at 10% or at 85% for E-85.
 - Unlike Methanol which is a poison, Ethanol is also distilled for alcoholic beverages. Since it is taxed at a much higher rate as a beer, wine and liquor, ethanol destined for the motor fuels market are denatured with a small amount of gasoline to make it non-potable so that it cannot be diverted back into the beverage stream.

- Biodiesel (cetane usually 48+)
 - Typically blended with petroleum diesel. Low blends of 2% or more adds lubricity to fuel, blends of 20% qualify as alternative fuel.
 - a/k/a Methyl Ester. This product may also be used used to formulate certain industrial products including rust preventatives and certain metalworking fluids. Most of these applications require B-100, and therefore without the tax incentive are priced out of reach of the fuels market.

Marketplace Overview from Distributor Perspective

- Until January 2005, the number of Biodiesel producers and the number of Biodiesel distributors was relatively small.
- With Tax Incentives (both federal and state) now in place, along with an EPA mandate to transition to Ultra Low Sulfur Diesel, the number of producers and distributors is growing exponentially.
- While demand is increasing, Biodiesel is transported from production facilities to distribution terminals primarily by tank truck and rail tank cars, significantly different than petroleum fuels which move primarily via pipeline and water.
- Similar to how the distribution of ethanol began 30 years ago, there are very limited numbers of conventional petroleum terminals that have opted to offer Biodiesel for blending at the terminal rack.
- To offset this lack of availability, most distributors now keep Biodiesel at bulk plants, and typically have only one tank available.

Is Biodiesel considered Diesel? Federal and State treatment differ.

IRS Rev. Rul. 2002-76 states: Biodiesel, although suitable for use as a fuel in a diesel powered highway vehicle or diesel powered train, contains less than four percent normal paraffins and therefore is excluded liquid for purposes of the definition of diesel fuel provided in §48.4081-1(c)(2). Accordingly, Biodiesel is not taxable fuel for purposes of §48.4081-1(a)(2) until it is blended into or used as a taxable fuel product.

While many states do not formally address Biodiesel, A few states do address Biodiesel. Indiana regulations current state:

Biodiesel is a special fuel that is subject to tax or dye requirements immediately upon entry of product into the state

Import by Truck (out of state)

Removal from a Terminal

Federal Tax

- B-100 does not qualify for any Federal Tax Incentive until it is blended with Petroleum Diesel by an entity holding an “M” registration, and therefore required to file a form 720. This is consistent with the treatment of Ethanol for blending with gasoline.
- Agri-Biodiesel qualifies for a Federal Tax Incentive on 720 or 8849 of \$1.00 per gallon when blended into petroleum diesel, (dyed or undyed).
- Non-agri Biodiesel qualifies for a Federal Tax Incentive on 720 or 8849 of \$0.50 per gallon when blended into petroleum diesel (dyed or undyed).
- Since blend must reach four percent paraffins, currently a B-99.9 does not become subject to tax or dye rules for Federal Tax purposes.
- Similar to ethanol blended with gasoline, biodiesel sold as or blended into diesel for a taxable purpose must be reported to IRS on form 720.

Claiming Federal Biodiesel Tax Incentive Refund

- IRS requires the person filing for the refund to produce a CERTIFICATE FOR BIODIESEL and possibly one or more STATEMENT OF BIODIESEL RESELLER certificates. Since it is becoming more commonplace for producers to offer a B-99.9 product by blending a small amount (typically 0.1%) of petroleum diesel into the biodiesel, often times the blender of record may be the producer and not the distributor.
- Example Copies on Next Slide

Certificate Examples

CERTIFICATE FOR BIODIESEL	STATEMENT OF BIODIESEL RESELLER
<p>Certificate Identification Number: <u>02056521-10354</u></p> <p>BUYER <u>WEST CENTRAL COOPERATIVE</u> <u>406 1ST STREET</u> <u>SALESON, IA 51459</u> Employer ID# <u>419241740</u> Name, address, and employer identification number: <u>08-21-2006</u> <u>GLADWIN, MI</u> Date of sale to BUYER Location of sale to BUYER</p> <p>This certificate applies to <u>6729.8900</u> gallons of biodiesel.</p> <p>The undersigned biodiesel producer ("Producer") hereby certifies the following under penalty of perjury: Producer certifies that the biodiesel to which this certificate relates is monomethyl esters of long chain fatty acids derived from plant or animal matter that meets the requirements of the American Society of Testing and Materials D6751 and the registration requirements for fuels and fuel additives established by EPA under Title of the Clean Air Act (12 U.S.C. 7945). Producer certifies that the biodiesel to which this certificate relates is: <u>100% Agri-biodiesel (derived solely from virgin oils)</u> <u>1 Biodiesel (other than agri-biodiesel)</u></p> <p>This certificate applies to the following sale: 1. Invoice or delivery ticket number <u>02056521-10354</u> 2. Total number of gallons <u>6729.8900</u> 3. Total number of certificates issued for above invoice or delivery ticket number _____</p> <p>Producer is registered as a biodiesel producer with registration number <u>2005-2010731-MI-00</u>. Producer's registration has not been suspended or revoked by the Internal Revenue Service. Producer understands that fraudulent use of this certificate may subject producer, claimant and parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.</p> <p>Name of Producer: <u>Buyer</u> Address of Producer: <u>15000 790th Ave. Albert Lea, MN 56007</u> Printed or typed name of person signing: <u>Kelly Restorinus</u> Title of person signing: <u>Accounting Manager</u> Employer Identification Number: <u>27-0199314</u> Signature and signed date: <u>[Signature]</u> <u>8-21-2006</u></p>	<p>(To support a claim related to biodiesel or a biodiesel mixture under the Internal Revenue Code)</p> <p>The undersigned biodiesel reseller ("Reseller") hereby certifies the following under penalty of perjury:</p> <p>Reseller's name, address and employer identification number: <u>WEST CENTRAL COOPERATIVE</u> <u>426241740</u> <u>406 1ST STREET</u> <u>SALESON, IA 51459</u></p> <p>Name, address and employer identification number of Reseller's buyer: <u>AGROWAMP OIL CO. INC.</u> <u>351381253</u> <u>2500 S JUNE WAY</u> <u>DAVENP, IN 47517</u></p> <p>Date of sale to buyer: <u>08/20/2006</u> Location of sale to buyer: <u>285-ALICE GARDENWAY, MI</u></p> <p>Volume of biodiesel sold: <u>6729.88</u> Gallons</p> <p>Certificate Identification Number on Certificate for Biodiesel: <u>02056521-10354</u></p> <p>Reseller has bought the biodiesel described in the accompanying Certificate for Biodiesel and Reseller has no reason to believe that any information in the certificate is false. Reseller has been notified by the Internal Revenue Service that its right to provide a certificate and a statement has been withdrawn. Reseller understands that the fraudulent use of this statement may subject Reseller and all parties making any fraudulent use of this statement to a fine or imprisonment, or both, together with the costs of prosecution.</p> <p>File # <u>02056521-10354</u> Printed or typed name of person signing this certificate: <u>Executive VP. Soy and Nutrition Division</u> Title of person signing: <u>[Signature]</u> <u>08/20/2006</u> Signature Date signed</p>

State Tax Incentives

- Several states offer incentives that are applicable to producers. These are targeted to help states persuade plants to locate within their borders and may be defined on a per gallon of production or a grant based on the rated size of a production facility.
- Today, only a handful of states offer any type of incentive which are applicable to retail sales.
 - Indiana has a per gallon tax incentive for retail sales of E-85
 - Michigan allows an incentive on IFTA for biodiesel
 - Illinois has a sales tax credit for ethanol and biodiesel blends
 - In large part, most other states that have incentives are in the corn belt.

Bio Fuels VEETC System is Driven by Feds

- Volumetric Ethanol Excise Tax Credit (VEETC) system has been driving much of the changes in how Biofuels are tracked and taxed
 - In order for a blender to file for a tax credit on a form 720 or form 8849, the blender must be registered with the IRS with an “M” License. After the tax incentive is applied, tracking is lost.
 - While the practice of allowing B99.99 for tax incentive under VEETC does simplify the refund mechanism, it does create a system that allows undyed untaxed fuel to exist below the rack. While much of this fuel is blended into the dyed off road stream, some certainly does get blended into fuels destined for on highway use. Although common place due to logistic issues, the existence of undyed untaxed fuel below the rack does create a potential problem for State Revenue and wholesale distributors who may compete against those who exploit the opportunity.

Bio Fuels RIN System is Driven by Feds

- Soon the Renewable Identification Numbering (RIN) system will begin to impact the tracking and distribution of Biofuels Product Transfer Documents (PTD) in support of the Renewable Fuels Credit System to support federal mandates for use of renewable fuels in the fuels marketplace.
 - RIN tracking system may influence petroleum suppliers on their decision to install Biofuels tanks and blending equipment at their terminal or defer such costs and instead “buy” RIN credits from other suppliers or wholesale distributors who blend Biofuels down stream of the rack.
 - RIN may provide the tracking mechanism necessary for the IRS and State Revenue to get a handle back on the existence of untaxed and undyed fuel below th rack.

Biofuels at Terminals

- Today, ethanol is available for in line blending at limited terminals
 - Ethanol is more aggressive toward certain metals and rubber compounds than gasoline, and has an affinity for water.
 - If ethanol gets “wet”, it is no longer usable to blend with gasoline as a phase separation will occur.
 - Otherwise ethanol has limited handling challenges
- Today, very few terminals maintain biodiesel storage on site
 - Similar to ethanol, biodiesel is more aggressive toward certain metals and also has an affinity for water.
 - In addition, biodiesel has a much higher cloud point than petrodiesel, and requires insulated / heated storage tanks and lines during winter months. Thus installation costs of systems for Biodiesel are significantly higher than for ethanol.

Biofuels at Bulk Plants

- As a result of VEETC, it is now possible for a distributor to maintain E-99 ethanol, and B-99.9 biodiesel.
 - Since there are few terminals that maintain tanks for Biodiesel systems for rack blending, most of this product is currently stored at bulk plants (below the rack).
 - Most bulk plants have limited space for tanks and in order to have space for dyed and undyed petroleum diesel, most are lucky to have one tank available for biodiesel, which is undyed and untaxed.
 - While distributors are subjected to the same cold weather handling issues as terminals, as B-99.9 has a high enough flash point that it is not considered hazardous material and may be stored similar to motor oils, a distributor is in a position to possibly handle biodiesel more efficiently by blending with kerosene or storing the product indoors of a heated warehouse.

Blends of Biodiesel in market place

- In our own case, we currently blend our premium diesels, on road and off road, with 5% biodiesel as standard.
 - As loads of product are delivered into our bulk plants, we splash blend biodiesel (and dye if for off road) into the petroleum diesel before unloading, and unload a blend into our tanks.
- In addition to our standard blend, we also offer virtually any blend of biodiesel for sale to our customers. This includes customers at 10%, 20%, 30%, 50%, and 99%.
 - These are offered as clear taxable fuel, and as dyed off road fuel
 - Dye is splash blended based on two ounce per 100 gallon, with color of fuel visually inspected to be sure it is discernable.
 - Dye may be added at the time of loading, but is often added at the time of filling the customer's tank, due to unknown ullage.

How does Biodiesel get into the fuel stream?

- Most moves via truck or rail
- B-99.9 is not a hazardous material.
- In our own case, we have imported product to Indiana from Kentucky, Ohio, Minnesota, Iowa, Mississippi, Texas
 - Some of these states require us to be licensed as an exporter to obtain product tax free, while others have no restriction.

Biodiesel end user Customers

- Our customer base for biodiesel remains very strong with farmers for off road diesel, and for excavating companies who work for agricultural customers. This group is our primary users of B-5 premium diesel and is also the group that experiments most with high blends such as 50% and 99%.
- In addition, we have trucking companies that will purchase low blends of biodiesel such as B-5 to B-20 when price economics are favorable.
- We supply taxable on highway fuel in a B-5 to B-20 to fewer than 12 retail stations.
- We also supply biodiesel to local government and bid on opportunities with Federal Government.

B-99.9 or B-100?

- Currently, most suppliers who offer to sell a B-99.9, do not pass through 5 to 10 cents of the tax incentive to offset their extra costs to file back for the tax incentive and wait for their money.
- When it became possible for producers to sell a B-99.9 we had began to do so, but because of the change in cost resulting from suppliers not passing all of the incentive through, we have returned to purchasing B-100 and are filing back for our own tax incentive.
- From October 1 through March 15, in our climate, we will typically blend our biodiesel with kerosene to make a B-50 while the biodiesel is warm and miscible with petroleum diesel.
- In addition, we store a small amount (under 5000 gallons) in a heated warehouse for those instances that require more than a B-50 blend.

What do distributors want to see on tracking for taxes on BioFuels?

- Given that BioFuels are enjoying exponential growth due largely to the tax incentives offered on a federal level, the federal system is what really drives the BioFuels tax and accounting process.
- For simplicity, state and local tax rules that closely mimic federal rules make it easier for distributors, especially those in multiple states, to understand and comply with the intent of the regulations.
- Given the limited availability of Biofuels at terminals, distributors often times must maintain storage at bulk plants. So long as the feds treat the taxing and blending of biofuels with a registration system, a state licensing system that allows untaxed undyed fuels to exist below the rack, that also gets the state in a position similar to that of the feds to allow for audit is reasonable to minimize the potential for untaxed undyed fuel to be tracked.

What do distributors want to see on tracking for taxes on BioFuels?

- To protect against fraudulent use of untaxed fuel in a taxable manner, the licensing system must include registering every producing site over a given number gallons per year as a producer.
- Similar to how the rules work that allow electric cars to fall under the radar screen for taxes, or how citizens are legal to brew small quantities of alcoholic beverages for personal consumption, the IRS and states must recognize that there will be small producers who will fall through the cracks, and on such gallons no taxes will be collected. IRS and states needs to identify the threshold quantity that triggers the need for a registration / license.
 - Trying to catch all small operations that make fuel for their own consumption will only complicate the process for the bulk of biofuels.
 - These operations will not be counted under RIN tracking.

Questions?

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