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Shawn R. O'Brien and May Y. Chow of Mayer Brown LLP analyze whether the tax code provisions and Treasury Regulations that allow for the alternative fuel mixture credit support the IRS's position in Revenue Ruling 2018-02 that butane and gasoline mixtures aren't eligible for the credit.

IRS Publishes Rev. Rul. 2018-02 to Address the Question of Whether Mixtures of Butane and Gasoline Are Alternative Fuel Mixtures

BY SHAWN R. O'BRIEN AND MAY Y. CHOW

On Oct. 18, 2017, we published an article titled ''Can the Alternative Fuel Mixture Credit Apply when LPG (Butane) is Mixed with Gasoline?'' in Bloomberg Tax's Daily Tax Report. We recommended that companies mixing alternative fuels, including butane, with gasoline for sale or use in their trade or business should investigate whether they are eligible for refunds of federal excise taxes paid during 2014, 2015, and 2016. After analyzing the language of the Internal Revenue Code (Code), Treasury Regulations, and existing Internal Revenue Service guidance, we concluded that taxpayers mixing butane and gasoline may be eligible for the alternative fuel mixture credit under Section 6426(e).

On Dec. 14, 2017, the IRS issued Revenue Ruling 2018-02, which states that mixtures of butane and gasoline are not alternative fuel mixtures and therefore do not qualify for the alternative fuel mixture credit under Section 6426(e). I.R.B. No. 2018-2, 277–278 (Jan. 8, 2018). This article summarizes the analysis in Rev. Rul. 2018-02, provides observations about the ruling, and discusses taxpayers' options for claiming the credit in light of the ruling.

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Revenue Ruling 2018-02

The fact pattern described in Rev. Rul. 2018-02 involves a ''Producer'' mixing gasoline with butane for sale as a fuel. Relying on IRS Publication 510, which states that butane is a form of liquefied petroleum gas (LPG), the Producer claimed the alternative fuel mixture credit under Section 6426(e) on the premise that butane is an alternative fuel, so when mixed with a taxable fuel, the butane used in the mixture is eligible for the credit. The ruling concludes that a mixture of butane and gasoline is not eligible for the alternative fuel mixture credit under Section 6426(e).

The analysis in Rev. Rul. 2018-02 appears to advance three reasons to disallow the Producer's alternative fuel mixture credit claim. First, the definitions in Section 4083 and the regulations thereunder treat butane as a taxable gasoline blendstock, rather than an alternative fuel. Second, butane is a taxable fuel when considering the definitions covered in the regulations under Section 4041, even though Section 6426 does not contain a definition of LPG. Finally, Congress never intended a mixture of butane and gasoline to qualify because mixing two taxable fuels would not yield an alternative fuel mixture.

By way of background, Treas. Reg. 48.4081-1(c)(3)(i), issued in 1996, lists butane as one of 24 enumerated products that are ''gasoline blendstocks'' for purposes of the imposition of tax under Section 4081. Enumer-

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ated products are not ''gasoline blendstocks'' if those products cannot be used in the production of finished gasoline without further processing, as provided in Treas. Reg. 48.4081-1(c)(3)(ii).

The ruling argues that a mixture of butane and gasoline is actually a mixture of two taxable fuels, which does not comply with Section 6426(e)'s requirement of a mixture of an alternative fuel with a taxable fuel, because butane is a gasoline blendstock, a taxable fuel. It cites to the definitions contained in Section 4083(a)(1), Section 4083(a)(2)(B)(i), and Treas. Reg. 48.4081-1(c)(3)(i) to support the position that butane is a ''gasoline blendstock,'' which makes butane a ''taxable fuel,'' rather than an alternative fuel. It concludes that ''[s]ince Producer used butane in the production of finished gasoline, the butane is a gasoline blendstock,'' which is a taxable fuel and not an alternative fuel. In support of this conclusion, the ruling appears to be relying on Sections 2(b) and 6(a)(1) of Notice 2006-92, which provides guidance related to claiming the alternative fuel credit and alternative fuel mixture credit under Section 6426(d) and the imposition of tax on alternative fuel and alternative fuel mixtures under Sections 4041(a)(2) and (a)(3) and 4081(b).

The ruling then discusses its position that Publication 510, which lists butane as a type of LPG in the section called ''Other Fuels (Including Alternative Fuels),'' does not support the Producer's credit claim. The term ''liquefied petroleum gas,'' which is listed in Section 6426(d)(2)(A) as an alternative fuel, is not defined anywhere in the Code or the Treasury Regulations, so the ruling turns to the regulations under Section 4041 to locate a definition for LPG. It specifically cites to Treas. Reg. 48.4041-8(f), which provides for a definition of ''special motor fuel'' and explains that the term ''special motor fuel'' includes any LPG such as propane, butane, pentane, or mixtures of those fuels, but the term ''special motor fuel'' does not include any product taxable under Section 4081. Having concluded that butane is a taxable gasoline blendstock by operation of Section 4081 under Treas. Reg. 48.4081-1(c)(3)(i), the ruling determines that butane cannot be included in the definition of LPG contained in Treas. Reg. 48.4041-8(f) addressing special motor fuel. The exclusion of butane from the term ''alternative fuel'' is therefore consistent with Publication 510, because although the publication lists butane as a type of LPG in the section called ''Other Fuels (Including Alternative Fuels),'' it specifically excludes any product (such as butane) that is taxable under Section 4081.

Finally, the ruling makes a tax policy argument that Congress did not intend to treat butane as an alternative fuel within the meaning of Section 6426(d)(2)(A), because that would mean Congress intended to allow a mixture of two taxable fuels—butane (treated as a gasoline blendstock) and gasoline—to qualify for the alternative fuel mixture credit.

Observations for Taxpayers

We have made a few observations about Rev. Rul. 2018-02 for taxpayers mixing butane with gasoline.

Our first observation is that there are several inconsistencies when reading the ruling and Section 6426. Rev. Rul. 2018-02 relies on Treas. Reg. 48.4081-1 to define butane as a gasoline blendstock. But it ignores the fact that Section 6426, the later-in-time statute, created a definition of alternative fuel for purposes of the credit, beginning in 2005. *See* Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU), Pub. Law No. 109-59 (2005); compare Section 4041(a)(2) with Section 6426. The definition of alternative fuels in Section 6426(d)(2), on its face, includes fuels that are not included in the definition of alternative fuels in Section 4041(a)(2). These definitions are noticeably different. If Congress wanted to exclude butane from the definition of LPG for purposes of the credit, it could have said so, but it did not.

Some background on the relevant Code and regulation provisions shows that the definitions are certainly different. Beginning Jan. 2, 1986, Treas. Reg. 48.4041-8 defined special motor fuel as including LPG, including butane. In 1986, Section 4041(a)(1) imposed a tax (15 cents per gallon) on diesel fuel, and Section 4041(a)(2) imposed a tax (9 cents per gallon) on special motor fuels, including LPG. At this point in time, Section 4041 did not have a provision regarding ''alternative fuels.''

Treas. Reg. 48.4081-1, which the IRS relies on in Rev. Rul. 2018-02, defines gasoline blendstocks as including butane. (Although the ruling says this definition began in 1996, a version of the regulation in T.D. 8421, 57 F.R. 32424–01, listed butane as a gasoline blendstock in 1992.) This would make butane taxable under Section 4081. Treas. Reg. 48.4081-1; Section 4083; Section 4081. According to the ruling's arguments, Treas. Reg. 48.4081-1 pulls butane out of the definition of LPG in Treas. Reg. 48.4041-8, and therefore butane cannot be an alternative fuel. But this position ignores the subsequent history of Section 4041.

Section 4041(a) retained a tax on the sale or use of special motor fuels through Sept. 30, 2006, after SAFETEA-LU was passed in 2005. *See* Pub. Law No. 109-59. Following the changes from SAFETEA-LU, Section 4041(a)(2) imposed a tax on alternative fuels, explicitly including LPG, instead of a tax on special motor fuels. SAFETEA-LU neglected to change the heading of Section 4041(a), so the heading of Section 4041(a) still reads ''Diesel and special motor fuels,'' even though there is no longer any reference to ''special motor fuels'' in the text of Section 4041(a).

At the same time, SAFETEA-LU introduced the alternative fuel credit and alternative fuel mixture credit in Section 6426(d) and (e), defining LPG again as an alternative fuel for purposes of that section.

The changes from SAFETEA-LU means that some of the regulation provisions relied upon by the ruling are outdated. The ruling points to Treas. Reg. 48.4041-8(f)(1)(i), which states that the term ''special motor fuel'' does not include fuels taxed under Section 4081. However, since 2006, there has been no tax on ''special motor fuels,'' and the text of Section 4041 no longer taxes ''special motor fuels.'' As a result, the definition of ''special motor fuel'' in the regulations is not operative with regards to including LPG in its definition. It appears that LPG is now considered an alternative fuel for purposes of Section 6426. If the IRS wanted to update Treas. Reg. 48.4041-8(f)(1)(i) to define alternative fuels, it had more than a decade to do so, but Treasury did not make such change.

The two different definitions weaken the IRS's argument that butane is not an alternative fuel for purposes of the alternative fuel mixture tax credit. Treas. Reg. 48.4041-8 and Section 4041(a)(2) (regarding special motor fuels) were in effect when Treas. Reg. 48.4081-1

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was promulgated in 1996. If the IRS wants to argue that Treas. Reg. 4081-1, promulgated after Treas. Reg. 48.4041-8, pulls butane out of the definition of LPG for purposes of taxability, then it must concede that the later-in-time statute of Section 6426 must control. The later-in-time statute creates two definitions of alternative fuel and enumerates LPG as an alternative fuel for both taxability and credits. Sections 4041(a)(2), 6426. The alternative fuel mixture credit did not exist when the IRS promulgated Treas. Reg. 48.4081-1. So if the IRS and Treasury wanted its taxability definition of LPG to control Section 6426 instead of the common industry definition of LPG that includes butane, the regulations should have been updated to address Section 6426. The credit definition in the statute suggests that any product that is commonly referred to in the industry as LPG (such as butane) is an alternative fuel for purposes of the credit.

Rev. Rul. 2018-02 repeatedly points to Treas. Reg. 48.4081-1 for its designation of butane as a gasoline blendstock, which is its reason why the alternative fuel tax credit cannot apply to mixtures of butane and gasoline. But even if butane is taxable under Section 4081, the taxability definition of LPG under the regulations (Treas. Regs. 48.4081, 48.4041) does not necessarily control the credit definition of LPG under Section 6426(d)(2).

The ruling maintains that Congress could not have wanted the alternative fuel mixture credit to apply to a blend of two taxable fuels, insisting that butane must be considered a taxable fuel. But Congress clearly created two different definitions of alternative fuel—one for imposition of tax purposes and another for credit purposes, as explained earlier. The two definitions are not coterminous. Other fuels, such as CNG and compressed gas from biomass, have been taxed not as alternative fuel but are still treated as alternative fuel for the purposes of the alternative fuel mixture credit. In a similar vein, renewable fuel, which has the same specifications as diesel, is taxed under Section 4081 but treated like a biodiesel for purposes of the biodiesel mixture credit under Section 6426. And the definition of alternative fuel for purposes of the credit, Section 6426(d)(2), does not exclude taxable fuel. The alternative fuel mixture credit does contain a reference to Section 4083 for purposes of defining taxable fuel that is to be mixed with alternative fuel. But for purposes of Section 6426(e), the clear language of the statute is that the credit definition of alternative fuel in Section 6426(d)(2)—not the taxability definition of alternative fuel—should control what is alternative fuel for the purpose of the credit. The language of the statute suggests that the alternative fuel mixture credit can apply to mixtures of butane and gasoline.

Our analysis of the relevant statutes and regulations shows that Rev. Rul. 2018-02 bears some inconsistencies with the statute. The ruling seems to conflate the two definitions of alternative fuel for the sole purpose of denying alternative fuel mixture credit claims for the activity of blending butane with gasoline.

A second observation is that Rev. Rul. 2018-02 cites to Notice 2006-92, even though Notice 2006-92 confirms that there are two different definitions of alternative fuel. Notice 2006-92 which tried to define alternative fuels for the purposes of not only the imposition of tax under Sections 4041(a)(2) and (a)(3), and 4081(b), but also the alternative fuel credit and alternative fuel mixture credit under Sections 6426(d) and (e), respectively. First, Notice 2006-92 acknowledges that the definition of alternative fuels in Section 6426(d)(2) controls. Notice 2006-92, 2(a). Section 4 of Notice 2006-92, which deals with the alternative fuel mixture credit, has nothing to add regarding the definition of alternative fuels. Then, for purposes of the taxation of alternative fuels and alternative fuel mixtures, Notice 2006-92 bifurcates alternative fuels into liquid alternative fuels and compressed natural gas. Notice 2006-92 defines liquid alternative fuels *for the purposes of the imposition of tax* as liquids that are subject to tax under Section 4041(a)(2). Notice 2006-92, 6(a). Section 6 of Notice 2006-92 is titled, ''Taxation of alternative fuels and alternative fuel mixtures,'' so it is clear that the definition of liquid alternative fuels in the Notice simply relates to the taxation of alternative fuels, not credits. But Rev. Rul. 2018-02 cites to this Notice to argue that for purposes of the credit, because butane is taxable under Section 4081, it cannot be an alternative fuel for purposes of the alternative fuel mixture credit. This argument appears inconsistent with the text of the Notice itself.

A third observation is that the ruling appears to treat all taxpayers mixing butane and gasoline the same and ignores the facts about the industry, as some blenders mix butane with finished gasoline. A gasoline blendstock is used to create finished gasoline. *See* Treas. Reg. 48.4081-1(c)(3)(ii). Butane can be used to create finished gasoline, but butane can also be mixed with already finished gasoline. *E.g.*, EPA, Butane Blending Technical Analysis (April 28, 2003), *https://www.epa.gov/sites/production/files/2015-08/documents/butane-techmemo.pdf*. In that case, the injection of butane into already finished gasoline should not be taxed as a ''gasoline blendstock,'' given how that term is defined in the relevant regulations. Treas. Reg. 48.4081-1(c)(3)(i), (ii). In this situation, the reasoning above demands even more strongly that a blender mixing butane with finished gasoline should be able to take the alternative fuel mixture credit. If the butane cannot be taxed as a gasoline blendstock, there is no reason why it is not an alternative fuel for purposes of the alternative fuel mixture credit. Taxpayers injecting butane into finished gasoline have especially strong counterarguments if the IRS relies on Rev. Rul. 2018-02 in denying their alternative fuel mixture credit.

Going Forward

The IRS issued Rev. Rul. 2018-02 after many taxpayers had claimed the alternative fuel mixture credit for mixing butane with gasoline. Taxpayers who have made claims for the alternative fuel mixture credit for mixing butane with gasoline can anticipate that the IRS will disallow their refund claims, and should investigate whether they wish to challenge the disallowance and applicability of Rev. Rul. 2018-02 in litigation. Because Revenue Rulings are not as authoritative as Treasury Regulations and statutes, courts do not need to rely on a Revenue Ruling in their decisions and can hold invalid an agency action, such as a Revenue Ruling, if it conflicts with the statute. Taxpayers with disallowed claims would likely need to litigate their refund claims in order to prevail on this issue.

Our earlier article examines the applicability of either the excessive claims penalties under Sections 6675 and 6676 or the frivolous submissions penalty under Section

6702 to claims for the alternative fuel mixture credit for blending butane with gasoline. We concluded that these penalties were unlikely to apply simply because a taxpayer took the position that the blending of butane and gasoline was eligible for the alternative fuel mixture credit.

As our discussion shows, there is tension between the ruling and the language of Section 6426. Taxpayers who believe they may be eligible for the alternative fuel mixture credit should investigate whether they should file a protective claim for the fourth quarter of 2014 (due Jan. 31, 2018) through the fourth quarter of 2016. Taxpayers making protective claims may benefit if a taxpayer succeeds in challenging Rev. Rul. 2018-02.

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