

Recommendation 32: Exempt DoD from paying the Federal Retail Excise Tax.

Problem

The Federal Retail Excise Tax (FRET) distorts DoD vehicle-buying decisions, increases administrative costs, and conflicts with current contract-pricing policy and governmentwide regulations limiting pass-through charges.

Background

Section 4051 of the Internal Revenue Code of 1986 imposes a 12 percent tax, referred to as the Federal Retail Excise Tax (FRET), on the sale of certain medium and heavy trucks, trailers, semitrailers, and parts or accessories attached to such vehicles at time of sale.¹ FRET is imposed on the sale or refurbishment (improvements to a vehicle that total more than 75 percent of the cost of a new vehicle) of truck body types and chassis (hereafter covered vehicle) with a gross vehicle weight or maximum total weight of more than 33,000 pounds that transit the U.S. highway system.²

Vehicle buyers pay FRET as part of the purchase price, which transfers the tax burden to the vehicle Original Equipment Manufacturer (OEM) to pay to the IRS. The tax, which originated in 1917, has increased over time. At its current 12 percent, FRET is the highest percentage of all Federal *ad valorem* taxes (a tax charged as a percentage of the value).³ FRET was first implemented to offset costs of World War I and is currently used to help fund the Highway Trust Fund (HTF)—a fund managed by the Department of Transportation to support surface transportation and mass transit construction and maintenance projects.⁴

HTF, which provides funding to maintain federal highways, generates income on a user-pay basis through two primary sources—fuel taxes and truck-related taxes.⁵ In user-pay systems, costs to pay for and maintain a resource are allocated to those that use the resource. Gasoline and diesel taxes make up 90 percent of the total revenue for the fund.⁶ FRET constitutes slightly less than 5 percent of the total amount of HTF.⁷

Procedurally, the vehicle OEM—the taxpayer of record at the time a covered vehicle is sold to a third party—is required to pay the tax to the Internal Revenue Service (IRS). When DoD contracts to buy covered vehicles, DoD policy requires that all contracts with vehicle OEMs contain a contract line item

¹ Imposition of tax on heavy trucks and trailers sold at retail, 26 U.S.C. § 4501.

² Internal Revenue Service, Publication 510 (01/2016), Excise Taxes, June 2016, accessed February 8, 2018, <https://www.irs.gov/publications/p510#idm140588875529376>.

³ Heavy Truck, Tractor, and Trailer Retail Federal Excise Tax Repeal Act of 2017, H.R. 2946 – 115th Congress (2017-2018), accessed June 2, 2018, <https://www.congress.gov/bill/115th-congress/house-bill/2946>.

⁴ Edward G. Keating, Chad Pino, and Sara H. Bana, *Understanding and Assessing the Costs of the Federal Retail Excise Tax on the Department of Defense* (Washington, DC: RAND Corporation, 2016), accessed June 2, 2018, https://www.rand.org/content/dam/rand/pubs/research_reports/RR1600/RR1635/RAND_RR1635.pdf.

⁵ John Lewis, “Understanding the Highway Trust Fund,” United States House of Representatives, accessed November 28, 2016, <https://johnlewis.house.gov/legislative-work/issues/transportation/understanding-highway-trust-fund>.

⁶ Tax Policy Center, Key Elements of the U.S. Tax System, “What are the major federal excise taxes, and how much money do they raise?,” accessed February 7, 2018, <http://www.taxpolicycenter.org/briefing-book/what-are-major-federal-excise-taxes-and-how-much-money-do-they-raise>.

⁷ *Ibid.*

in the amount of FRET to reimburse the OEM for the subsequent tax payment by the OEM to the IRS.⁸ DoD is paying the required tax; however, it is doing so by passing the payment burden through to the OEM.

Covered vehicles sold for use outside the United States are not subject to the tax unless they are repatriated.⁹ The policy articulated in IRS Publication 510 also excludes sales to state or local governments, sales to the United Nations for official use, as well as a few other categories, clearly carving out certain categories of vehicle sales covered by FRET.¹⁰

Previous attempts to amend the FRET collection process through legislation have not gained traction as a priority for any of the executive agencies affected by FRET for various governance and policy-making reasons not directly related to DoD. DoD has long had concerns regarding its role in FRET collection and the associated pass-through process which, in other regulatory contexts where the government pays a contractor for charges or fees for which the contractor has no performance obligations, are limited or prohibited.¹¹ As part of the DoD effort to examine FRET's effects on acquisition and budget priorities, Congress directed DoD to study the FRET process in 2013 with a mandate to do the following:

(1) Assess the benefits and drawbacks of the current process of using contractors as pass-through taxpayers; and

(2) Identify alternatives to the current process to improve efficiency, such as waiving the tax on vehicles acquired by the Department of Defense, or using interagency transfer authorities to aggregate tax payment.¹²

The RAND Corporation, along with the Office of the Undersecretary for Acquisition, Technology, and Logistics, Manufacturing and Industrial Base Policy provided the required assessment in 2016.¹³ The Section 809 Panel used the RAND study to inform its findings and recommendations, along with a Naval Postgraduate School thesis on FRET authored by Harry Hallock, former Army senior acquisition executive, titled, *A DoD Conundrum: The Handling of Federal Retail Excise Tax on the Army's Medium and Heavy Truck Fleet*.¹⁴

⁸ Edward G. Keating, Chad Pino, and Sara H. Bana, *Understanding and Assessing the Costs of the Federal Retail Excise Tax on the Department of Defense* (Washington, DC: RAND Corporation, 2016), accessed June 2, 2018, https://www.rand.org/content/dam/rand/pubs/research_reports/RR1600/RR1635/RAND_RR1635.pdf.

⁹ Internal Revenue Service, Publication 510 (01/2016), Excise Taxes, June 2016, accessed February 8, 2018, <https://www.irs.gov/publications/p510#idm140588875529376>.

¹⁰ Ibid

¹¹ See Limitation on Pass-through Charges, FAR 52.215-23.

¹² 2013 NDAA, Report of the Committee on Armed Services House of Representatives on H.R. 4310, 189, accessed June 2, 2018, <https://www.congress.gov/112/crpt/hrpt479/CRPT-112hrpt479.pdf>.

¹³ Edward G. Keating, Chad Pino, and Sara H. Bana, *Understanding and Assessing the Costs of the Federal Retail Excise Tax on the Department of Defense* (Washington, DC: RAND Corporation, 2016), accessed June 2, 2018, https://www.rand.org/content/dam/rand/pubs/research_reports/RR1600/RR1635/RAND_RR1635.pdf.

¹⁴ Harry Hallock, *A DoD Conundrum: The Handling of Federal Retail Excise Tax on the Army's Medium and Heavy Truck Fleet* (Monterey, CA: Naval Postgraduate School, June 2001), accessed November 18, 2017, <http://www.dtic.mil/dtic/tr/fulltext/u2/a396521.pdf>.

Discussion

The Section 809 Panel focused its attention on the increased costs to DoD and vehicle OEM's that result from managing FRET policy, including the contracting and administrative burden required to facilitate the contract pass-through costs and the potential for FRET effects to distort DoD vehicle decisions.

The FRET process creates a loop in which annual appropriations provided by Congress are used by DoD to contractually obligate funds to pay OEMs for the FRET charge. The OEMs then return that money to the U.S. Department of Treasury via revenue taxes, and the Treasury Department reallocates those FRET funds to HTF. OEMs account for their increased internal compliance costs through their indirect rate structures, and they make their FRET payments through their tax disbursements to the IRS.

For contractual purposes, FRET creates added process steps and increases costs for DoD and OEMs that supply vehicles covered by FRET. Each contract for a covered vehicle not otherwise exempt from the tax must contain a line item for FRET to reimburse the OEM to facilitate the payment of the tax back to the Treasury. Generally, such amounts are processed by OEMs through their indirect cost pools and require investment in systems and personnel to perform contract reporting and compliance tasks to manage and administer FRET payments each year. Those contract costs or fees are passed through to the government by vehicle OEMs in the form of increased overhead or indirect rates.¹⁵

In other transactional circumstances involving federal contracting, such facilitation payments would be considered pass-through charges and are narrowly regulated to avoid paying a contractor fees for which there is no corresponding performance obligation. Where applicable, FAR 52.215-23, Limitations on Pass-Through Charges, currently limits pass-through charges (fees and costs) to minimize paying contractors for administrative efforts not associated with a performance obligation, usually in cases for which the contractor adds no or negligible value to a subcontractor's performance. FRET is not a non-value-added pass-through charge as envisioned by the FAR clause, which is concerned more with limiting prime contractor profit on subcontractor efforts. Instead, it is a percentage-based fee, tied to the value of a covered vehicle, to facilitate a tax payment. In the case of FRET, OEMs are not prohibited from including the cost of administering FRET in their indirect accounts, and thus FRET is an added cost paid by DoD to the OEM to do nothing other than facilitate tax payments to HTF.

As Hallock lays out, the transfer of the tax from one federal government account to another is largely a zero-sum game for the taxpayer, but has the unintended consequence of increasing the cost of covered vehicles for DoD and working capital costs for the OEM.¹⁶ The OEM must pay FRET before being reimbursed for it. The delay between outlay to the Treasury and reimbursement for FRET from DoD requires the OEM to cover the value of FRET in a manner similar to an interest free loan, further

¹⁵ Edward G. Keating, Chad Pino, and Sara H. Bana, *Understanding and Assessing the Costs of the Federal Retail Excise Tax on the Department of Defense* (Washington, DC: RAND Corporation, 2016), accessed June 2, 2018, https://www.rand.org/content/dam/rand/pubs/research_reports/RR1600/RR1635/RAND_RR1635.pdf.

¹⁶ Harry Hallock, *A DoD Conundrum: The Handling of Federal Retail Excise Tax on the Army's Medium and Heavy Truck Fleet* (Monterey, CA: Naval Postgraduate School, June 2001), accessed November 18, 2017, <http://www.dtic.mil/dtic/tr/fulltext/u2/a396521.pdf>.

increasing costs to DoD.¹⁷ These increased capital requirements for the vehicle OEM, which RAND estimates to be about \$595,000 per \$100 million in annual FRET payments, increase indirect costs associated with administrative and compliance tasks with no additional value, and they are ultimately passed on to DoD.¹⁸

Identifying those vehicles that are subject to FRET can also be difficult, due in part to the location reporting requirements and the additional challenge of excluding weight that does not contribute to the highway function of the vehicle.¹⁹ This provision means any additional feature that does not contribute to the highway function, such as a high-pressure water pump or weapon, would be removed from the taxable weight and value. RAND points out, however, that the “determination of which equipment on a vehicle should not be subject to the FRET is an area of uncertainty and contention.”²⁰

Additionally, the exemption for vehicles to be used outside of the continental United States (OCONUS), requires that each service must notify the OEM prior to delivery if the vehicle is to be used OCONUS. This additional step increases the requirements to administratively track where each vehicle will be used.²¹

Most of the vehicles with DoD as the end-user are also primarily driven on military installations, rather than interstate highways. Hallock estimated that a typical Army covered vehicle spends only 35 percent of its lifespan on federal highways, equating to only 25,000 miles over a vehicle’s 20-year lifespan, dramatically less than the approximately 300,000 for commercial operators.²² A DoD usage rate of 35 percent that reflects less than 10 percent of the rate at which commercial vehicle operators use the public roads over 20 years is inconsistent with a user-pay system.

Beyond increased agency and contract costs and limited highway use unaddressed in the FRET rules, FRET drives DoD decision-making in other ways. DoD acquisition personnel are potentially incentivized to avoid FRET to preserve precious appropriated mission funds from being squandered as pass-through fees. The decision process could potentially lead to delays in acquiring new FRET-eligible vehicles at certain points of the fiscal year because of the need to conserve funds for other emerging, urgent, mission-related purposes.²³ The prospect of paying FRET could also drive program managers to spread out purchases over time or opt for a smaller fleet to conserve resources in any given fiscal year.²⁴

Alternatively, affected programs may choose a FRET-free vehicle at a lighter weight rather than acquiring a more appropriate, but heavier, vehicle for the mission. FRET might also drive decision-

¹⁷ Edward G. Keating, Chad Pino, and Sara H. Bana, *Understanding and Assessing the Costs of the Federal Retail Excise Tax on the Department of Defense* (Washington, DC: RAND Corporation, 2016), accessed June 2, 2018, https://www.rand.org/content/dam/rand/pubs/research_reports/RR1600/RR1635/RAND_RR1635.pdf.

¹⁸ Ibid.

¹⁹ Ibid.

²⁰ Ibid.

²¹ Ibid.

²² Harry Hallock, *A DoD Conundrum: The Handling of Federal Retail Excise Tax on the Army’s Medium and Heavy Truck Fleet* (Monterey, CA: Naval Postgraduate School, June 2001), accessed November 18, 2017, <http://www.dtic.mil/dtic/tr/fulltext/u2/a396521.pdf>.

²³ USD(AT&L) Manufacturing and Industrial Base Policy, email to Section 809 Panel, June 16, 2017.

²⁴ Edward G. Keating, Chad Pino, and Sara H. Bana, *Understanding and Assessing the Costs of the Federal Retail Excise Tax on the Department of Defense* (Washington, DC: RAND Corporation, 2016), accessed June 2, 2018, https://www.rand.org/content/dam/rand/pubs/research_reports/RR1600/RR1635/RAND_RR1635.pdf.

makers towards repairing a damaged vehicle rather than buying a new one, as long as the repair costs are less than 75 percent of a newer, FRET covered vehicle.²⁵ Acquiring the wrong set of mission vehicles due to FRET concerns could ultimately lead to having to buy more vehicles to offset a fleet of misconfigured vehicle weights not suited to the mission.

Making assumptions based on cost breakouts from FY 2015 to FY 2017, DoD estimates that through FY 2026 DoD will pay \$197 million in FRET on Medium Tactical Vehicles and Heavy Tactical Vehicles.²⁶ Although DoD has never accounted for more than 1 percent of the overall HTF contributions, RAND estimates there are some years, especially during market fluctuations when industry is unable or unwilling to upgrade trucks, when DoD purchases from OEMs make up a greater proportion of the applicable truck sales and refurbishments than in other years.²⁷ For example, RAND estimated that in 2008, at the height of the Global Financial Crisis, DoD provided about 25 percent of the truck-related funds for the total HTF through this pass-through process.²⁸

Such a high percentage is disproportionate to the use of public highways by DoD vehicles, and contrary to a user-pay approach of HTF funding. The greatest burden falls on the Army as the primary purchaser of covered vehicles.²⁹ The Marine Corps is the second largest purchaser of covered vehicles.³⁰

There are a few alternatives to payment of FRET that may address some of these challenges. For example a direct payment of applicable taxes for each vehicle from DoD to the HTF or a lump sum payment that would provide a portion of the budget.³¹ With respect to other highway tax exemptions, the federal government is exempt from the federal highway vehicle-use tax imposed by section 4481 of the Internal Revenue Code of 1986 and applied to vehicles weighing more than 55,000 pounds.³² DoD is also exempt from the excise tax on tires³³ and certain classes of fuel use, including off-highway use of gasoline and road diesel fuels.³⁴ In line with these kinds of exemptions Congress should exempt DoD from payment of FRET.

Conclusions

The Secretary of the Treasury has authority to authorize FRET exemption under Section 4293 of the Internal Revenue Code of 1986, but has yet to do so. Section 4051 is the FRET.

²⁵ Ibid.

²⁶ USD(AT&L) Manufacturing and Industrial Base Policy, email to Section 809 Panel, June 16, 2017.

²⁷ Edward G. Keating, Chad Pino, and Sara H. Bana, *Understanding and Assessing the Costs of the Federal Retail Excise Tax on the Department of Defense* (Washington, DC: RAND Corporation, 2016), accessed June 2, 2018, https://www.rand.org/content/dam/rand/pubs/research_reports/RR1600/RR1635/RAND_RR1635.pdf.

²⁸ Ibid.

²⁹ Ibid.

³⁰ USD(AT&L) Manufacturing and Industrial Base Policy, email to Section 809 Panel, June 16, 2017.

³¹ Edward G. Keating, Chad Pino, and Sara H. Bana, *Understanding and Assessing the Costs of the Federal Retail Excise Tax on the Department of Defense* (Washington, DC: RAND Corporation, 2016), accessed June 2, 2018, https://www.rand.org/content/dam/rand/pubs/research_reports/RR1600/RR1635/RAND_RR1635.pdf.

³² Federal, State, Local and Foreign Taxes, DoD Financial Management Regulation, Volume 10, Chapter 6 (2009), accessed June 19, 2018, https://comptroller.defense.gov/Portals/45/documents/fmr/archive/10arch/10_06_Sep09.pdf.

³³ Internal Revenue Service, Publication 510 (01/2016), Excise Taxes, June 2016, accessed February 8, 2018, <https://www.irs.gov/publications/p510#idm14058887529376>.

³⁴ Federal, State, Local and Foreign Taxes, DoD Financial Management Regulation, Volume 10, Chapter 6 (2009), accessed June 19, 2018, https://comptroller.defense.gov/Portals/45/documents/fmr/archive/10arch/10_06_Sep09.pdf.

§4293. Exemption for United States and possessions

The Secretary of the Treasury may authorize exemption from the taxes imposed by section 4041, section 4051, chapter 32 (other than the taxes imposed by sections 4064 and 4121) and subchapter B of chapter 33, as to any particular article, or service or class of articles or services, to be purchased for the exclusive use of the United States, if he determines that the imposition of such taxes with respect to such articles or services, or class of articles or services will cause substantial burden or expense which can be avoided by granting tax exemption and that full benefit of such exemption, if granted, will accrue to the United States.³⁵

FRET is a non-value-added contract pass-through and cost burden to DoD and vehicle OEMs. It artificially limits decision-makers' consideration of appropriate mission-related vehicle types; it distorts the marketplace for covered vehicles; and it results in an unnecessary work-around to accomplish non-DoD tax-related policy. Congress should enact an exemption from FRET for DoD.

Implementation

Legislative Branch

- Amend Section 4051(a) of the Internal Revenue Code of 1986, adding a paragraph indicating that the tax imposed by paragraph (1) will not apply to items purchased for the exclusive use of the Department of Defense, or if Congress is interested in furthering the reach of the amendment, the United States, effective on the date of enactment.

Executive Branch

- There are no Executive Branch changes required for this recommendation.

Implications for Other Agencies

- IRS will need to adjust required instructions and forms.
- HTF will need to address the loss of revenue.

³⁵ Exemption for United States and Possessions, 26 U.S.C. § 4293.

RECOMMENDED REPORT LANGUAGE

Sec. XXX. Exemption for Department of Defense from Federal Retail Excise Tax.

This section would amend section 4051(a) of the Internal Revenue Code of 1986 to exempt the Department of Defense from application of the Federal Retail Excise Tax (FRET) if the purchased vehicle is for the exclusive use of the Department.

The committee is aware that the greatest burden for collecting FRET is on the Army as the primary purchaser of covered vehicles. The Marine Corps is the second largest user of covered vehicles. This section would address the Department's role in the collection of the FRET and the associated pass through costs.

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DRAFT — FRET EXCLUSION

[NOTE: The draft legislative text below is followed by a “Sections Affected” display, showing the text of the provision of law affected by the draft legislative text.]

1 **SEC. ____ . EXEMPTION FOR [DEPARTMENT OF DEFENSE]/[FEDERAL**
2 **GOVERNMENT] FROM FEDERAL RETAIL EXCISE TAX.**

3 (a) IN GENERAL.—Section 4051(a) of the Internal Revenue Code of 1986 is amended by
4 adding at the end the following new paragraph:

5 “(6) The tax imposed by paragraph (1) shall not apply to any article to be
6 purchased for the exclusive use of the [Department of Defense]/[United States].”.

7 (b) EFFECTIVE DATE.—Paragraph (6) of section 4051(a) of the Internal Revenue Code of
8 1986, as added by subsection (a), shall apply to any retail sale after the date of the enactment of
9 this Act.

§4051. Imposition of tax on heavy trucks and trailers sold at retail

(a) IMPOSITION OF TAX.—

(1) IN GENERAL.—There is hereby imposed on the first retail sale of the following articles (including in each case parts or accessories sold on or in connection therewith or with the sale thereof) a tax of 12 percent of the amount for which the article is so sold:

- (A) Automobile truck chassis.
- (B) Automobile truck bodies.
- (C) Truck trailer and semitrailer chassis.
- (D) Truck trailer and semitrailer bodies.
- (E) Tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.

(2) EXCLUSION FOR TRUCKS WEIGHING 33,000 POUNDS OR LESS.—The tax imposed by paragraph (1) shall not apply to automobile truck chassis and automobile truck bodies, suitable for use with a vehicle which has a gross vehicle weight of 33,000 pounds or less (as determined under regulations prescribed by the Secretary).

(3) EXCLUSION FOR TRAILERS WEIGHING 26,000 POUNDS OR LESS.—The tax imposed by paragraph (1) shall not apply to truck trailer and semitrailer chassis and bodies, suitable for use with a trailer or semitrailer which has a gross vehicle weight of

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26,000 pounds or less (as determined under regulations prescribed by the Secretary).

(4) EXCLUSION FOR TRACTORS WEIGHING 19,500 POUNDS OR LESS.—The tax imposed by paragraph (1) shall not apply to tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer if—

(A) such tractor has a gross vehicle weight of 19,500 pounds or less (as determined by the Secretary), and

(B) such tractor, in combination with a trailer or semitrailer, has a gross combined weight of 33,000 pounds or less (as determined by the Secretary).

(5) SALE OF TRUCKS, ETC., TREATED AS SALE OF CHASSIS AND BODY.—For purposes of this subsection, a sale of an automobile truck or truck trailer or semitrailer shall be considered to be a sale of a chassis and of a body described in paragraph (1).

(6) The tax imposed by paragraph (1) shall not apply to any article to be purchased for the exclusive use of the [Department of Defense]/[United States].

(b) SEPARATE PURCHASE OF TRUCK OR TRAILER AND PARTS AND ACCESSORIES THEREFOR.—Under regulations prescribed by the Secretary—

(1) IN GENERAL.—If—

(A) the owner, lessee, or operator of any vehicle which contains an article taxable under subsection (a) installs (or causes to be installed) any part or accessory on such vehicle, and

(B) such installation is not later than the date 6 months after the date such vehicle (as it contains such article) was first placed in service, then there is hereby imposed on such installation a tax equal to 12 percent of the price of such part or accessory and its installation.

(2) EXCEPTIONS.—Paragraph (1) shall not apply if—

(A) the part or accessory installed is a replacement part or accessory, or

(B) the aggregate price of the parts and accessories (and their installation) described in paragraph (1) with respect to any vehicle does not exceed \$1,000 (or such other amount or amounts as the Secretary may by regulations prescribe).

(3) INSTALLERS SECONDARILY LIABLE FOR TAX.—The owners of the trade or business installing the parts or accessories shall be secondarily liable for the tax imposed by paragraph (1).

(c) TERMINATION.—On and after October 1, 2022, the taxes imposed by this section shall not apply.

(d) CREDIT AGAINST TAX FOR TIRE TAX.—If—

(1) tires are sold on or in connection with the sale of any article, and

(2) tax is imposed by this subchapter on the sale of such tires,

there shall be allowed as a credit against the tax imposed by this subchapter an amount equal to the tax (if any) imposed by section 4071 on such tires.