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August 1998

# ALCOHOL SPECIAL OCCUPATIONAL TAXES

## Administration and Compliance Issues



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**General Government Division**

B-279781

August 10, 1998

The Honorable George Radanovich  
The Honorable John Kasich  
House of Representatives

Businesses that engage in the manufacture and sale of alcohol are required to register their operating locations with the Department of the Treasury's Bureau of Alcohol, Tobacco, and Firearms (ATF) and to pay special occupational taxes (SOT). ATF is responsible for collecting the taxes and enforcing compliance with other SOT requirements. Revenue collected from the SOTs is deposited into the General Fund of the U.S. Treasury. ATF estimates that alcohol occupational taxes accounted for more than 90 percent of the \$107 million collected from alcohol, tobacco, and firearms occupational taxes in fiscal year 1997.

Several proposals have been made to eliminate or change the alcohol SOTs. In fiscal year 1991, President Bush proposed to Congress that the tax collection point be changed by repealing the SOTs on retailers and increasing the amount of SOTs paid by wholesalers and producers. Another proposal would have changed the structure from a tax on the number of business locations to a tax that would be based on the volume of business. In 1998, a bill was introduced in Congress to repeal the SOTs on retailers and wholesalers.<sup>1</sup>

This report responds to your request that we study the alcohol SOTs. Our objectives were to identify the (1) methods that ATF uses to enforce compliance with the taxes and the costs incurred in these efforts; (2) compliance rates for alcohol producers, wholesalers, and retailers; and (3) arguments that have been made for and against these occupational taxes.

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**Results in Brief**

ATF uses a variety of methods to enforce compliance with the alcohol SOTs. For example, ATF annually sends the special tax renewal registration and return and a notification letter to producers and wholesalers holding federal permits and to retailers known to ATF. Among other information preprinted on the special tax renewal registration and return, ATF lists each known operating location and the total amount of taxes due. ATF also informs the public about alcohol occupational tax requirements using a variety of media. In addition, all but five states routinely provide retailer licensing information that ATF can compare with federal records to identify

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<sup>1</sup>HR 4140.

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retailers who may not be in compliance. ATF has assessed civil and criminal penalties, as well as interest, to enforce compliance with the SOT provisions.

ATF estimated that it cost a total of \$1.9 million to administer the SOT programs for alcohol, tobacco, and firearm businesses in fiscal year 1997. ATF officials were unable to separate alcohol SOT cost from the total cost for the ATF-administered SOTS—alcohol, tobacco, and firearms. However, the officials estimated that more than 90 percent of the costs could be attributed to the alcohol occupational tax provisions.

ATF and the audit staff at the Department of the Treasury's Office of the Inspector General (IG) have estimated rates of taxpayer compliance with the alcohol SOTS. However, the two offices used different data, methods, and definitions of compliance to make their estimates. ATF's definition of compliance covered the timely filing of tax returns and the timely payment of taxes by taxpayers.<sup>2</sup> The IG's definition of compliance covered only the payment of tax when a tax liability existed. ATF's estimate covered only those taxpayers already known to ATF, while the IG attempted to estimate the rate of compliance for all potential taxpayers. ATF estimated that, as of April 3, 1998, 93 percent of the producers and 95 percent of the wholesalers with federal permits and 89 percent of the retailers known to ATF were compliant for tax year 1998. The IG estimated the average compliance rate for retailers over tax years 1993, 1994, and 1995 to be 83 percent. Limitations in their data and methods leave the accuracy of both offices' estimates uncertain. The audit work needed to quantify the potential error in these estimates was beyond the scope of our study.

Supporters of the alcohol SOTS have justified the taxes both as a general source of revenue and as providing revenues to offset the costs to the government of regulating the industry. However, the SOTS are not likely to accurately reflect the current costs of regulation because the tax rates have rarely been changed. ATF has justified the SOTS as facilitating its regulatory and law enforcement activities. The SOTS give ATF the authority to enter the premises of alcohol dealers and require that retailers keep certain records. ATF officials believe that the access and recordkeeping authority provided by the SOTS is necessary for their efforts to control the alcohol distribution system, prevent illegal sales of alcohol, and enforce other federal taxes on alcohol. ATF officials are concerned that they may lose this authority if the SOTS are repealed and that the same authority may

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<sup>2</sup>The timely filing of a return is required of alcohol dealers who owe SOTs and of dealers who do not owe SOTs because they have gone out of business. These latter must file a return to notify ATF that they are out of the business of selling alcohol and the date on which the business discontinued.

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not exist under other provisions of current law. If that were the case, ATF officials believe that additional legislation may be needed to provide ATF with the same enforcement powers.

The SOTs have been criticized in the past because of relatively high administrative costs and low compliance rates among retailers. Although SOT administrative costs have declined in recent years, the accuracy of estimates of recent SOT compliance among retailers is uncertain. An evaluation of whether costs are excessive would require that the SOTs be compared with specific alternative revenue sources in terms of their compliance rates and administrative costs, as well as other factors, such as the cost to taxpayers of complying with the taxes.

Opponents of the SOTs have criticized the taxes for being unfair. Because the SOTs are a fixed amount per location, the SOTs may take more income from those with less ability to pay the tax, and, if compliance is low, compliant taxpayers may bear an unfair share of the tax burden. To evaluate the fairness of the SOTs, one needs to know who actually pays the tax (i.e., how much of the tax is shifted from producers, wholesalers, and retailers to others in the economy in the form of higher prices); the income of those who pay the tax; and the degree of compliance with the SOTs.

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## Background

Congress enacted a version of the alcohol occupational taxes over 200 years ago. This tax was repealed in 1817 but alcohol occupational taxes were again instituted in the 1860s to generate revenue for the Civil War. The current taxes essentially remained unchanged from 1950 until Congress passed the Omnibus Budget Reconciliation Act of 1987.<sup>3</sup> With this act, Congress raised the rates to their current levels in response to the President's proposal that direct beneficiaries of the regulatory provisions pay a greater share of the cost incurred to administer the SOT program.

In July 1987, ATF assumed the responsibility for administering the alcohol SOT program from the Internal Revenue Service (IRS). There are separate occupational taxes for alcohol producers, wholesalers, and retailers. Each tax is a fixed amount per business location per year. The per location tax is \$1,000 for large producers and \$500 for small producers who grossed less than \$500,000 the previous year.<sup>4</sup> Producers include distillers,

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<sup>3</sup>Under the Trade Agreement Act of 1979 (P.L. 96-39), Congress repealed the occupational tax for persons who rectify, purify, or refine distilled spirits to increase the alcohol proof or who blend this absolute alcohol to make compound liquors, such as brandy, whiskey, gin, cordial, and rum.

<sup>4</sup>Internal Revenue Code (IRC) 5081 and 5091.

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breweries, wineries, wine-bottling houses, and bonded wine cellars and warehouses. Wholesalers are required to pay a \$500 occupational tax for each location.<sup>5</sup> Retailers are required to pay a \$250 occupational tax for each operating location.<sup>6</sup> Retailers, who make up the largest group of alcohol SOT taxpayers, cover a wide variety of businesses—for example, liquor stores, bars, restaurants, sports facilities, grocery stores, convenience stores, airlines, caterers, and hotels.

Alcohol businesses are required to obtain a special tax stamp from ATF for each operating location before commencing business. These businesses are required to obtain the special tax stamp on or before July 1 if they are to continue operating. Businesses must file a special tax renewal registration and return and pay the appropriate taxes to obtain the stamps. (App. I contains information on the annual special tax registration and return process.) The stamps must be available for inspection as proof of payment, are nontransferable, and are valid for 1 tax year. The SOT tax year begins on July 1 and ends on the following June 30.

Under provisions of the Internal Revenue Code (IRC), retailers are required to keep specific records of the distilled spirits, wine, or beer received showing the quantity, source, and date of all shipments received on their premises. Retailers are also required to keep records for each sale of 20 gallons, or more, of any alcoholic beverage sold to the same person at the same time.

Failure to comply with the alcohol SOT provisions can result in the assessment of civil and criminal penalties against the proprietors. The civil penalties are the failure-to-file penalty and the failure-to-timely-pay penalty, both of which are limited to 25 percent of the amount due. (App. II contains more information on the civil penalties and interest.) Any person who willfully fails to comply with the alcohol SOT provisions is subject to criminal penalties under section 5691 of the IRC. This section allows fines of up to \$5,000 or imprisonment for up to 2 years, or both, for each offense.

The alcohol industry is a heavily regulated industry. ATF administers a system that regulates businesses according to their function as producers, wholesalers, and retailers and requires ATF to keep track of who is operating as a producer, wholesaler, and retailer. The regulation of alcohol businesses by function is a feature of federal and state laws, which govern

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<sup>5</sup>IRC 5111.

<sup>6</sup>IRC 5121

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the production and distribution of alcohol. Producers and wholesalers are required to obtain federal permits from ATF to operate. Federal law does not require retailers to qualify for or to obtain a federal permit. Retailers are licensed by the states and some local jurisdictions.

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## Objectives, Scope, and Methodology

To identify the methods ATF uses to enforce compliance with SOT provisions, we discussed ongoing compliance programs with ATF officials. We reviewed samples of information prepared by ATF for public release and for inclusion in the annual registration and tax return packages. We met with industry representatives to get their views on the adequacy and availability of alcohol SOT information provided by ATF. We discussed the matching of federal and state data on retailers with ATF officials. We discussed the assessment of civil and criminal penalties with ATF officials and reviewed data on cases where ATF had imposed civil and criminal penalties. We discussed the value of the occupational tax provisions as an enforcement tool with officials from ATF's Diversion Branch, Revenue Division, and Office of General Counsel.

To identify the compliance rates for producers, wholesalers, and retailers, we reviewed fiscal year 1998 compliance information provided by ATF officials and discussed the completeness, limitations, and sources of this information. We reviewed compliance estimates for retailers reported by the IG in 1996 and discussed methodological and data limitations with the audit manager for the study.<sup>7</sup> To determine the costs of collecting the special occupational taxes and alcohol excise taxes, we obtained cost information from ATF officials and discussed their methods for determining the costs of collection activities.

To determine the arguments for and against continuing the alcohol SOTs, we reviewed legislative histories, our previous reports, alcohol industry publications, IG reports, and Congressional Research Service reports. We interviewed Treasury and ATF officials and industry representatives to obtain their views on the various arguments that have been made for and against the alcohol SOTs.

We did our work from February through May, 1998, in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Secretary of the Treasury and

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<sup>7</sup>Audit of Alcohol, Tobacco, and Firearms Special Occupational Tax Program, U.S. Department of the Treasury, Office of the Inspector General, OIG-97-016, Dec. 27, 1996.

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the Director of ATF or their designees. Their oral and written comments are summarized near the end of the letter.

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## ATF Uses a Combination of Efforts to Enforce SOT Compliance

ATF has implemented a combination of efforts to enforce compliance with the alcohol SOTs. These efforts include (1) sending known alcohol businesses their annual registration and stamp renewal returns, (2) matching ATF and state information on retailers, (3) publicizing occupational tax information, (4) licensing producers and wholesalers, (5) assessing civil and criminal penalties and interest, and (6) verifying SOT compliance during on-site inspections. ATF officials believe that it would not be cost-effective to commit additional resources to enforcement.

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## ATF Administers an Annual Registration and Return Process to Enforce Compliance

In May of each year, ATF sends the special tax renewal registration and return forms to alcohol producers, wholesalers, and retailers known to the Bureau. Alcohol businesses known to ATF include producers and wholesalers who have obtained federal operating permits from ATF and retailers who paid SOTs in previous years or were identified through other means by the Bureau. ATF mails the special tax renewal registration and return form to the registered address of the primary business and shows the total amount of SOT due for all operating locations listed on the form.

With the special tax registration and renewal form, ATF includes a letter to the alcohol businesses advising them to report changes in ownership and discontinued operations. ATF also at that time advises the businesses that it may assess penalties and interest if they are liable for the special tax and do not pay on a timely basis. (App. I contains additional information on the special tax stamp registration and return process.) If the taxpayer is liable for the special tax and does not pay in a timely fashion, ATF is to follow up with correspondence that advises the taxpayer of the additional interest and penalties and that further failure to comply may result in legal proceedings.

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## ATF Matches Federal and State Data on Retailers to Enforce Compliance

ATF receives lists of alcohol retailers from all but five states.<sup>8</sup> Contract staff at ATF's National Revenue Center in Cincinnati are to manually compare the names and addresses of the businesses reported by the states as licensed alcohol retailers with the names and addresses of retailers listed

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<sup>8</sup>Ten states include payment of the federal SOTs as part of their licensing procedures. ATF accepts that there is 100-percent compliance with federal SOTs among retailers licensed to sell alcoholic beverages in these states and does not match state data with the SOT master file.

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in the SOT master file—a federal database of businesses that have paid SOTs in previous years or are otherwise known to ATF.

By comparing the two sets of information, ATF can identify businesses that were listed by the states as licensed alcohol retailers but were not shown in the SOT master file as having paid the annual occupational taxes. The National Revenue Center is to send an information package to each of the nonmatched retailers. This package includes an ATF flyer, special tax information sheet, and the special tax renewal registration and return. This information explains the SOT requirements for alcohol retailers and wholesalers. The flyer informs the retailer that it is being notified because a state or local jurisdiction has issued it a license to sell alcoholic beverages. The flyer advises the retailer that it must file a tax return and pay the occupational tax and that failure to do so could result in costly penalties and interest. Retailers that had not engaged in or are not currently engaged in the sale of alcoholic beverages are instructed to report this so that the Bureau can update the retailer's account and not mail additional notices. Otherwise, ATF is to update the amounts due and continue to contact the retailer by mail for up to 3 years to get compliance. ATF does not believe that it is cost effective to routinely go beyond this correspondence to ensure compliance.

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### ATF Publicizes Occupational Tax Information to Foster Compliance

ATF officials believe that informing the public about the SOT requirements improves compliance. We reported in 1990 that many retailers said they did not comply with the SOT provisions because they were not aware of the requirements.<sup>9</sup> Alcohol industry representatives believe that there are some retailers who may be unaware of this tax obligation.

ATF uses several methods to inform the public about the SOT requirements. For the tax year 1999 filing season, ATF issued an April 3, 1998, news release to remind businesses of the July 1, 1998, deadline for the alcohol SOT. The news release was placed on the ATF's Web site ([www.atf.treas.gov](http://www.atf.treas.gov)) with an authorizing note that allows editors to print the information in organizational magazines, periodicals, and newsletters. ATF has issued a similar release annually, just prior to the filing period.

ATF has placed on the Web site copies of the special tax renewal and registration return and instructions, which can be downloaded for filing or

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<sup>9</sup>Alcohol Excise Taxes: Simplifying Rates Can Enhance Economic and Administrative Efficiency (GAO/GGD-90-123, Sept. 27, 1990).

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informational purposes. Also on the Web site is a pamphlet entitled Liquor Laws and Regulations for Retail Dealers, which provides an overview of the SOT and other alcohol requirements pertinent to retail operations.

For the 1999 tax year, which began July 1, 1998, ATF sent its SOT news release to 412 public affairs offices and general public addressees; 78 media addressees; and 248 trade associations, societies, and state addressees. The trade associations list included a variety of organizations, such as state alcohol control and licensing organizations, the National Bar Association, the National Tax and Bookkeeping Services, the American Beverage Institute, the American Hotel and Motel Association, and state and national organizations of wholesalers and retailers.

ATF has produced several different flyers for distribution at trades shows and fairs. One flyer gives a sample listing of businesses that may be subject to the alcohol occupational taxes. Another flyer advises recipients that if they sell beer, wine, or liquor, they may owe federal occupational taxes. This flyer gives the tax rates for retailers and wholesalers, explains the type of sales to which the tax applies, notes the tax due date, and gives the telephone number for the Tax Processing Center in Cincinnati and a toll-free number the taxpayer may call for additional information. ATF also provides another flyer with toll-free numbers for its National Revenue Center and the Tax Processing Center.

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### ATF Has More Control Over SOT Compliance Among Producers and Wholesalers

ATF has more control over alcohol producers' and wholesalers' compliance with the SOT requirements than over retailers' compliance because ATF issues the federal permits for these businesses to operate and the universe of producers and wholesalers is relatively small. Alcohol businesses with federal permits are required to comply with all federal laws and regulations, including SOT requirements; and ATF can revoke their permits or charge them with fraud if they fail to do so. Additionally, the universe of producers and wholesalers is small. Tax year 1998 ATF data showed that there were about 18,000 registered alcohol producers and wholesalers compared to about 372,000 known retail entities. ATF officials believe that they can ensure greater compliance among producers and wholesalers than retailers because they have more administrative control over this smaller group of alcohol businesses.

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### ATF Assesses Civil and Criminal Penalties to Enforce Compliance

ATF can assess civil penalties and interest for failure to file the annual SOT registration and return form and/or pay the taxes due. While civil penalties are limited by statute to not more than 25 percent of the taxes due, there is

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no limit on the amount of interest taxpayers may incur for unpaid SOTS. (App. II contains more information on computing civil penalties and interest.) Examination of SOT revenue data for fiscal year 1995 showed that ATF assessed and collected about \$972,000 in failure-to-file penalties, about \$164,000 in failure-to-pay penalties, and about \$410,000 in interest from alcohol, tobacco, and firearm businesses. The total penalty and interest amounts accounted for about 1.4 percent of the total SOT payments for the fiscal year. ATF was unable to separate the penalty and interest amounts collected for the three business categories but estimated that over 90 percent of the tax, penalty, and interest amounts were from the alcohol SOTS.

ATF also has authority to assess criminal penalties to enforce SOT compliance. Businesses and individuals can be fined up to \$5,000 or imprisoned up to 2 years, or both, for each willful failure to comply with the SOT requirements. ATF uses these criminal penalties to enforce compliance with wholesale and retail operating requirements. For example, current law prohibits a retailer from selling to other retailers or from operating as a wholesaler. Review of criminal data file information showed that ATF has a history of assessing the criminal penalties to combat the black market sale of alcohol.

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## ATF Uses Site Visits to Verify Compliance

Alcohol businesses are required to have current Special Tax Stamps available for ATF inspection as proof that they have paid the required SOTS for their operating locations. ATF officials informed us that field office inspectors who routinely monitor compliance with alcohol laws and regulations also verify compliance with SOT requirements during visits to alcohol businesses, primarily alcohol producers and wholesalers. ATF inspectors who discover businesses that are not in compliance with SOT provisions are to report this information to the National Revenue Center. Following up on this information, ATF staff at the Center are required to notify the business to get compliance. They are to do this through correspondence with the noncompliant business. The correspondence includes SOT requirement information and the tax return that the business needs to file. The staff are to continue corresponding with the business for 3 consecutive years in an effort to get compliance with the SOT provisions. ATF does not believe that it is cost effective to conduct site visits solely for SOT compliance.

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## SOT Compliance Rates Are Uncertain

Both ATF and the Treasury's IG estimated SOT compliance rates. The two offices used different data and methods when computing their estimates, and those data and methods leave the accuracy of both offices' estimates uncertain. The audit work needed to quantify the potential error in these estimates was beyond the scope of our study.

The two offices also used different definitions of compliance. ATF's definition covered the timely filing of the annual return and the timely payment of taxes due in response to ATF's annual renewal notification. The IG's definition covered only the payment of tax when a tax liability existed.

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## ATF's Estimated Compliance Rates

ATF estimated that, as of April 3, 1998, 93 percent of the producers with permits, 95 percent of the wholesalers with permits, and 89 percent of the retailers known to ATF filed timely returns and timely paid the taxes due for tax year 1998.<sup>10</sup> The noncompliant taxpayers were those known to ATF that did not respond to the annual notification process and were not identified by ATF as being out of business. ATF determined that about 0.03 percent of the producers, 3 percent of the wholesalers, and 4 percent of the retailers did not respond because they were out of business.

The rates of compliance for all alcohol businesses could be lower than ATF's estimated rates because the latter cover only alcohol businesses known to ATF—producers and wholesalers with federal permits and federally registered alcohol retailers that have paid SOTs in the past or have been identified by ATF. ATF officials acknowledged that they have not identified all alcohol businesses. They could not estimate the number of illegal producers and wholesalers that might be operating, without federal permits, as moonshiners and bootleggers. Registered alcohol businesses are required to certify that all operating locations have been correctly reported to ATF, but ATF does not verify that this has been done. However, the Bureau is confident that there is high compliance among producers and wholesalers because ATF issues federal permits for these alcohol businesses to operate and closely monitors their operations. In addition, alcohol producers and wholesalers account for a small number of businesses. ATF could not estimate the number of retailers not known to ATF who had not paid their occupational taxes. SOT compliance among retailers is more difficult to manage because they do not need federal

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<sup>10</sup>For the 1998 tax year that began July 1, 1997, and ended June 30, 1998, ATF sent renewal notices to alcohol businesses in May 1997 advising them to pay the taxes by July 1, 1997, to get their 1998 stamps. An ATF staff member estimated that ATF had issued at least 98 percent of the 1998 stamps by April 1998. Stamps that ATF issued later in the year to new businesses account for the remaining 2 percent or less.

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permits to operate, have a high turnover rate, and account for a large universe of business entities.

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## IG's Estimated Retailer Compliance Rate

The IG reported an estimated average compliance rate of about 83 percent for retailers over tax years 1993, 1994, and 1995.<sup>11</sup> The IG made this estimate by comparing ATF data on the total number of SOT stamps issued in each state and the District of Columbia and the total number of retail operating locations where alcohol is sold, as reported by state and the District licensing officials whom it surveyed. A total of 43 states and the District provided usable data.

Because the IG simply compared the federal government's count of all retail locations in a given state with that state's own count, rather than doing a detailed matching of specific retail locations, it could have overestimated or underestimated the rate of compliance. The IG did not verify whether the states followed its instructions for enumerating the number of retail locations. The IG requested data from each state that (1) included all locations that were in operation at any time during the SOT tax years and (2) did not include locations that had ceased operations before the start of each SOT tax year. States may or may not have been able to produce enumerations from their information systems that met these exact criteria. Given the high rate of turnover among alcohol retailers, if the state data did not cover the time periods set by the IG, then those data could overestimate or underestimate the number of locations liable for tax. The fact that five states reported fewer retail locations than the ATF data showed had tax stamps for tax years 1993, 1994, and 1995 suggests that at least some states' data did not accurately represent the occupational taxpayer population. Also, like ATF's estimate, the IG's estimate did not cover retail locations that operate without the required state or local licenses, such as illegal after-hour clubs.

The reliability of the ATF and IG estimates is difficult to assess without a more detailed examination of the methods used and data collected. To evaluate the accuracy of the state data, one would need to know what methods the states used to collect and verify their statewide data. One would also have to estimate the number of unlicensed retailers that do not appear on any records. Because such analyses were beyond the scope of our review, we cannot say how accurate ATF's and the IG's compliance rates may be.

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<sup>11</sup>OIG-97-016.

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## Arguments for the SOT

Supporters of the SOTs have justified the taxes as a general source of revenue and as providing revenues intended to offset the costs of regulating the alcohol industry. ATF officials believe that the authority provided by the SOTs to enter the premises of dealers and require them to keep certain records has facilitated ATF's efforts to enforce the laws and regulations governing the alcohol industry. ATF is concerned that the agency could lose necessary enforcement tools if the SOTs are eliminated.

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## Supporters of the SOTs Have Justified the Taxes as a Source of Revenue

Historically, supporters have justified the SOTs as a general source of revenue. Congress reinstated the SOTs in the 1860's for the purpose of raising revenue. More recently, supporters have also justified the SOTs as providing revenues intended to recoup the federal costs of regulating the alcohol industry. Congress enacted special occupational tax rates increases under the Omnibus Budget Reconciliation Act of 1987<sup>12</sup> so that the beneficiaries of ATF regulation would pay a greater share of the costs of regulation. In addition to regulatory costs, economists believe that taxes on alcohol, such as the SOTs, may be used to offset the social cost of alcohol abuse.

The SOTs have long been a source of revenue for the federal government's General Fund. After repeal in 1817, the taxes were reinstated in the 1860s to generate revenue. Under the Budget Enforcement Act of 1990 as amended,<sup>13</sup> Congress must offset the budget impact of tax legislation that would reduce revenue. Eliminating the SOTs, or changing the SOTs in ways that reduce revenue, would require that Congress identify and enact revenue increases and/or spending reductions. For example, an increase in alcohol excise taxes has been suggested to offset revenue losses from repeal of the alcohol SOTs, and an increase in SOTs paid by producers and wholesalers has been proposed to offset revenue losses from repeal of the SOT on retailers. We have not evaluated these or other tax and spending alternatives.

Supporters of the SOTs have justified the taxes as payments by the industry for the benefits that they claim the industry receives from regulation. If ATF's regulatory activities benefit the industry, SOT revenue may offset the costs of providing these benefits. ATF's regulatory activities, such as operating laboratories for testing and labeling alcoholic products, may benefit the industry if, by assuring consumers of the safety and quality of those products, the activities increase demand for alcohol products. ATF's

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<sup>12</sup>P.L. 100-203.

<sup>13</sup>P.L. 101-508.

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law enforcement activities may benefit the industry, for example, by protecting the industry from the influence of organized crime.

Economists have justified taxes on alcohol as providing revenues to recoup the social cost of alcohol abuse. Although this justification is usually made for alcohol excise taxes, both the excise taxes and the SOTs can be viewed as offsetting the costs to the government and society of alcohol abuse. People who abuse alcohol may use certain government programs, such as government-provided health-care and criminal justice services, more than nonabusers. People who abuse alcohol also impose costs on other members of society, such as the lives and property lost in alcohol-related traffic accidents.

The SOTs are not well designed to reflect the benefits received by the taxpayer, the cost to the government of providing the benefits, or the costs to society. First, the SOTs are not likely to reflect how much individual taxpayers may benefit from ATF's regulatory activities because each alcohol retailer, wholesaler, and producer (collectively known as dealers) pays the same amount of tax for each premise. To the extent that dealers benefit from ATF's activities, the benefits are likely to vary considerably across premises because profits are likely to vary considerably from one location to another. Second, the tax rates are not likely to reflect the current costs of regulation because they are rarely changed. Before 1987, the rates had not been changed since the 1950s. Although rates were increased in 1987 for the stated purpose of recouping regulatory costs, SOT revenues may have been higher or lower than regulatory costs in 1987, and the rates have not been changed since 1987 to reflect any changes in costs. Finally, the revenue from SOTs is small relative to total federal excise taxes on alcohol, and therefore, their role in offsetting the regulatory or social costs associated with alcohol is likely to be small.

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### ATF Has Justified the SOTs as Facilitating ATF's Enforcement of Laws and Regulations

The SOTs have been justified as facilitating ATF's enforcement efforts by giving the agency the authority to enter the premises of alcohol dealers and to require that the dealers keep certain records. ATF officials said that ATF uses this authority in its efforts to control the alcohol distribution system, prevent illegal sales of alcohol, and enforce all federal taxes on alcohol. ATF officials believe that the access and recordkeeping authority provided by the SOTs is necessary for ATF enforcement efforts.

The SOTs allow ATF inspectors entry into establishments that permits them to inspect for other violations. Provisions of the IRC permit ATF inspectors

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to enter premises to examine records, documents, and any alcohol stored on the premises.<sup>14</sup> Once on the premises, ATF officials say that inspectors are able to check for nonpayment of the SOTS and other violations. For example, alcohol dealers are subject to fine and/or imprisonment for refilling or reusing liquor bottles.<sup>15</sup> Inspectors can check for this violation, which prohibits dealers from refilling bottles of more expensive brands with cheaper liquor. ATF officials note that ATF has access to producers and wholesalers as part of its licensing and inspection authority. Except for the provisions of the IRC that are related to SOTS, ATF has only limited authority over retailers and no access to retailers' premises.

The SOTS give ATF the authority to require that retailers and wholesalers keep records that help ATF control the alcohol distribution system. Under provisions of the IRC related to SOTS, retailers are required to record all of their purchases of alcohol and sales of alcohol of 20 gallons or more to the same person at the same time. The records must include the name and address of those from whom they purchased or to whom they sold the alcohol.<sup>16</sup> Wholesalers are required to keep similar records for all of their purchases and sales.<sup>17</sup> These records of transactions between dealers may help ATF enforce laws and regulations throughout the distribution system. For example, ATF officials say that the requirement that retailers record individual sales of 20 gallons or more helps ATF identify retailers who are operating as wholesalers by selling to other retailers. Retailers not paying the SOTS and unknown to ATF can be identified from the sales records of wholesalers, and the records of wholesalers and retailers can be used to trace transactions between dealers to check for payment of excise taxes. According to ATF officials, the SOTS are also useful to ATF for identifying retailers who owe floor-stock taxes. The floor-stock taxes are imposed on inventories when alcohol excise tax rates are increased and are generally equal to the difference between the old and new tax rates.

ATF officials believe that the SOTS are useful in diversion cases to control distribution and enforce taxes. Diversion occurs when alcohol is sold at an illegal destination to evade federal and state excise taxes, rather than the legal destination stated on the required federal form. There are two kinds of diversion. Export diversion occurs when a dealer claims that alcohol is exported but actually sells the alcohol domestically. The dealer avoids an excise tax on this alcohol because excise taxes are not imposed on

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<sup>14</sup>IRC 5146(b).

<sup>15</sup>IRC 5301(c).

<sup>16</sup>IRC 5124(a), 5124(b); 27 CFR 194.234.

<sup>17</sup>IRC 5114 and 5555; 27 CFR 194.221, 225-226.

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exports. Domestic diversion occurs when a dealer purchases alcohol in a low tax jurisdiction and smuggles the alcohol to a jurisdiction with higher excise tax for illegal sales.

Provisions related to the SOTS can be used by ATF to combat both kinds of diversion. ATF officials say that ATF uses its access to records required by the SOTS to detect diversion by reviewing sales of unusually large volumes of alcohol and sales in certain types of containers that are easier to divert. The retailers' records may show evidence of the domestic sale of alcohol intended for export; or the absence of such records may be grounds to prosecute retailers for receiving the alcohol intended for export.

ATF has pursued both criminal and civil prosecutions of diversion cases using SOT provisions. According to ATF data, there were 23 criminal alcohol diversion cases involving SOT violations between October 1, 1996, and March 31, 1998. ATF has also pursued civil prosecutions in 86 cases of diversion involving 62 companies between December 1, 1992, and December 19, 1996. According to ATF officials, these civil cases, like the criminal cases, involve prosecutions under the SOTS.

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### **ATF Is Concerned That It May Lose Necessary Enforcement Authority if the SOTs Are Repealed**

ATF officials believe that the authority for entering retail premises and requiring retailers to keep records provided by the SOTS has been necessary for its other law enforcement activities. ATF officials said that they were concerned that this authority may be jeopardized if the SOTS are eliminated, but they were uncertain about the effect that repeal of the SOTS would have on their enforcement capabilities. ATF was uncertain whether the access and recordkeeping authority may exist under other provisions of current law. ATF was not sure whether recordkeeping could be imposed under other provisions of the IRC if the retailer does not have a special occupational tax liability. If the SOTS were repealed, ATF said it could attempt to write regulations requiring specific records be kept by retailers. According to ATF officials, the courts could rule that the recordkeeping requirement is a valid exercise of the taxing power, or they could deny the authority because the activities that the Bureau wants recorded are not closely enough related to the excise tax collection process.

If SOTS are eliminated and access and recordkeeping authority do not exist under other provisions of current law, ATF officials believe that the laws concerning regulation of the alcohol industry may have to be changed to permit the Bureau the same enforcement powers. The Federal Alcohol

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Administration Act of 1935<sup>18</sup> (FAA) regulates fair trade practices, chiefly promotional activities of dealers that affect the sales of other dealers. The act also imposes licensing requirements for wholesalers and producers, but there is no authority in this act for imposing recordkeeping requirements. If the SOTs were repealed, FAA could be expanded to impose recordkeeping requirements on retailers. ATF officials believe that the access and recordkeeping authority currently provided by the SOTs is essential for effective enforcement of alcohol laws and regulations.

We have not evaluated ATF's claim that the access and recordkeeping authority provided by the SOTs is necessary for ATF's enforcement efforts. For example, we have not determined whether, or how seriously, repeal of the SOTs would harm ATF's efforts to combat diversion. Although retailers would no longer have a SOT liability, ATF would still need to identify and prosecute retailers who participate in illegal sales. However, we have not determined how important access and recordkeeping authority is in the prosecution of such cases, and we are uncertain whether such authority would be lost if the SOTs were repealed.

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## Arguments Against the SOTs

The SOTs have been criticized for being costly to administer relative to alcohol excise taxes, having low compliance rates, and being unfair. These criticisms have led some to propose changes in the SOTs that include (1) eliminating the tax on retailers to reduce administrative costs and (2) changing the structure of the tax from a fixed amount per business location to one that is based on business volume to make tax burdens fairer. Others have proposed that the SOTs be eliminated entirely.

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## SOTs Have Been Criticized for High Administrative Costs and Low Compliance

We concluded in two separate reports that the administrative costs of the SOTs were high relative to the costs of administering the alcohol and tobacco excise taxes and that compliance among retailers may have been low.<sup>19</sup> Since these reports were issued, the costs of administering the SOTs have declined. Estimates of current compliance with the SOTs among retailers are uncertain. An evaluation of whether administrative costs are excessive would require that the SOTs be compared with specific alternatives in terms of compliance rates and administrative costs, as well as other factors such as the compliance burden of taxpayers.

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<sup>18</sup>P.L. 74-401.

<sup>19</sup>GAO/GGD-90-123. Tax Administration: Compliance and Other Issues Associated With Occupational Excise Tax (GAO/GGD-86-49, June 5, 1986).

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In our 1990 report, we concluded that SOT costs were high relative to the costs of administering the alcohol and tobacco excise taxes. In fiscal year 1989 (in 1997 dollars), ATF spent \$13 million to collect \$162.6 million of SOTs—a cost of 8 cents for every dollar collected. In the same year (also in 1997 dollars), ATF spent \$64.9 million to collect \$12.7 billion in alcohol and tobacco excise tax revenue—a cost of 0.5 cents per dollar collected. Thus, the cost per dollar collected was 16 times greater for the SOTs than for the excise taxes. We also found in our 1986 study of compliance with the SOTs in four states that only about 60 percent of the retailers had paid the SOTs. ATF stated that it believed that the compliance rate found in our study was probably representative of compliance nationwide in 1986.

According to ATF data, the costs of administering the SOTs, and the amount of revenue collected, have declined since 1989. In fiscal year 1997, ATF spent an estimated \$1.9 million to collect \$107 million of SOTs—a decline in both costs and revenue from the \$13 million spent to collect \$162.6 million in 1989. The cost per dollar collected fell from 8 cents in 1989 to 1.8 cents in 1997. ATF also spent \$55.1 million in 1997 to collect \$12.6 billion in excise tax revenue—a cost of 0.4 cents per dollar collected. The relative cost of administering the SOTs dropped from 16 times as great as the cost of the excise taxes in 1989 to 4.5 times as great in 1997.

SOT revenues have declined in inflation-adjusted terms, despite the fact that the number of active business locations has increased from 350,000 in 1987 to 426,370 in 1998. Part of the decline is due to the fact that the tax, as a fixed amount per business location, does not increase with price inflation. Also, according to ATF officials, SOT revenues in 1989 included large amounts of back taxes, penalties, and interest that ATF discovered were owed when ATF took over administration of the SOTs from IRS. SOT administrative costs declined because ATF has devoted fewer resources to administering the SOTs.<sup>20</sup> According to an ATF official, administrative costs depend largely (1) on ATF priorities that determine how many field staff are allocated to SOT enforcement, (2) on the number of contacts with taxpayers, and (3) on the number of congressional inquiries. Currently, the SOTs are not a high priority enforcement issue for ATF. Field staff have been instructed by ATF not to pursue SOT enforcement alone, but to check for SOT payment only as part of an investigation of alcohol dealers for other violations.

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<sup>20</sup>An ATF official also noted that the costs of administering the SOTs may have been unusually high in fiscal year 1989 because (1) ATF may still have had significant start-up costs from the takeover of enforcement from IRS in 1987 and (2) ATF may have been spending more to deal with changes in the SOT tax rates that became effective in January 1988.

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While administrative costs have declined, the compliance rates, especially for retailers, are uncertain. As previously discussed, some estimates indicate that compliance among retailers may have increased from the 60 percent that we reported in 1986, but these estimates have limitations that make their reliability difficult to assess. An ATF official believes that compliance rates may have increased since 1986 because, when the Bureau took over enforcement of the SOTs from IRS in 1987, it devoted more resources to enforcement than IRS had and began matching state and federal records of alcohol dealers as part of its enforcement effort.

Determining whether the administrative costs of the SOTs are excessive may be difficult because one would have to compare the costs and compliance rate for the SOTs with those of alternative revenue sources. It is important to compare both administrative costs and compliance rates because a tax may appear less costly to administer only because compliance rates (and enforcement costs) are lower. However, complete and reliable data on compliance and administrative costs for both the SOTs and alternative revenue sources may not be available. For example, ATF has estimates of the costs of collecting excise taxes but does not have estimates of compliance rates for the excise taxes.<sup>21</sup>

A complete evaluation of the SOTs relative to alternative ways of raising revenue would have to include other factors besides administrative costs and compliance rates. The evaluation would have to include an assessment of the compliance burden imposed on taxpayers by the SOTs relative to the compliance burden of alternatives that may be proposed, as well as the relative impact of the SOTs and alternatives on the efficiency and equity of the tax system. These factors affect the total cost to society of a tax in terms of the resources taxpayers use to comply with the tax, the loss of income and output that occurs when taxes interfere with economic decisionmaking, and the losses to taxpayers who perceive the tax as producing an unfair distribution of tax burdens.

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## Opponents Have Criticized the SOTs for Being Unfair

Opponents of the SOTs have criticized the taxes for being unfair. Because the taxes are a fixed amount per location, they may take more income from those with less ability to pay the tax, and, if compliance rates are low, compliant taxpayers would pay an unfair share of the tax burden. Other features of the SOTs, such as the requirement that businesses operating for only part of the year pay the full yearly rate, have also been

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<sup>21</sup>An ATF official said that compliance is likely to be high among large producers who pay most of the tax; but ATF does not have good information on compliance among small producers, such as micro-breweries.

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criticized for imposing unfair tax burdens. The fairness of the SOTS depends on factors such as who actually bears the burden of the tax (i.e., how much of the tax is shifted from alcohol dealers to others in the economy in the form of higher prices); the income of those who pay the tax; and the rate of compliance with the SOTS.

The SOTS have been criticized as inequitable because the fixed amount of tax per business location does not vary according to the taxpayers' ability to pay. There is no universally accepted measure of tax fairness. However, one commonly used criterion of fairness is that a tax burden should increase, at least proportionately, with the incomes of taxpayers. When this criterion is violated and the tax burden, as a percentage of income, is higher for low-income taxpayers, then the tax is considered to be "regressive." Whether the SOTS are regressive depends on the incidence of the taxes, i.e., who actually bears the burden of the taxes, and the amount of the SOT paid by these individuals relative to their total income.

The incidence of the SOTS depends on how much of the tax is shifted from the dealers to others in the economy through price changes, such as price increases to consumers of alcohol. The incidence of the SOTS is uncertain, but it is likely that, in the long run, at least a part of the SOTS is passed forward in higher prices to consumers.<sup>22</sup> Determining whether the taxes are regressive requires measuring the share of the tax paid by the dealers and consumers relative to their total income. Thus, in order to determine regressivity, data are required on factors such as the total income of dealers and consumers, the effect of the SOTS on alcohol prices, and consumers' expenditures on alcohol. However, whether the taxes are shifted to consumers or paid by the dealers, the size of the SOTS means that their effect on prices and incomes is likely to be very small.

The fairness of the SOTS may also be viewed from the broader perspective of the entire tax system. In this context, whether the SOTS are regressive depends on the income of those paying the tax relative to those not paying the tax. The taxes may be judged regressive if they are paid by individuals who tend to have lower incomes.

The SOTS also have been criticized as inequitable because of allegedly low rates of compliance. Another commonly used criterion of fairness is that a

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<sup>22</sup>The SOTS increase the costs of dealers, and the dealers may attempt to pass these cost increases to others in the economy in the form of higher prices. The studies of industry structure and tax incidence described in our report, District of Columbia: Taxes and Other Strategies to Reduce Alcohol Abuse (GAO/HEHS-98-140, May 19, 1998), indicate that it is likely that at least part of the tax will be passed forward to consumers as higher prices.

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tax should provide equal treatment of individuals with equal ability to pay. Noncompliance can create inequity because people with equal ability to pay and equal tax liability end up paying different amounts. Some critics of SOTS believe that the nonpayment of tax by some alcohol dealers puts the compliant dealers at a competitive disadvantage. Some industry representatives believe that compliance among retailers may be low relative to producers and wholesalers because retailers are unaware of their tax liability and because ATF has difficulty identifying retailers who have not paid the SOTS.

Critics claim that other features of the SOTS, besides the fixed amount per location and low compliance, impose unfair tax burdens. Establishments open on a seasonal basis, such as marinas and campgrounds, have shortened sales periods but still pay the annual tax. As previously described, a standard for judging the fairness of a tax requires that the tax be related to the taxpayer's ability to pay. The SOT requirement that seasonal establishments pay the annual rate may make the taxes more regressive if the shortened sales period results in less income and the seasonal dealers bear the same tax burden as year-long dealers.

Critics also claim that the SOTS are unfair because retailers who are unaware that they owe the tax can face substantial, accumulated tax, penalties, and interest if they have been in operation for several years without filing returns and paying the taxes. Generally, the IRC limits the period during which the SOTS and other taxes can be assessed to 3 years from the date the tax return was filed.<sup>23</sup> The purpose of this provision is to limit the taxpayers' compliance costs of keeping and maintaining records. However, the IRC contains exceptions to this limitation that permit assessments at any time if, for example, the taxpayer fails to file a return or files a false return with the intent to evade taxes.<sup>24</sup> This statute of limitations with its exceptions applies to taxpayers who owe income taxes and other taxes as well as those who owe the SOTS. An evaluation of the fairness and effectiveness of these general provisions, and any need to modify the provisions, is beyond the scope of this report.

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## Agency Comments

We discussed a draft of this report on July 9, 1998, with the Director, Office of Tax Analysis, and other officials from the Office of the Assistant Secretary of the Treasury for Tax Policy and with the Deputy Assistant Director, Alcohol and Tobacco, and other ATF officials. In addition, ATF

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<sup>23</sup>IRC Section 6501(a).

<sup>24</sup>IRC Section 6501(c).

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provided written comments. ATF's comments clarified its enforcement practices, its definition of compliance, and its methods for measuring compliance. ATF officials also provided additional data on the numbers of alcohol business entities that filed timely returns and timely paid the taxes due. ATF and Treasury officials made other comments to improve the clarity of our presentation. We have incorporated the comments from ATF and Treasury officials into this report where appropriate.

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As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 30 days from the date of this letter. At that time, we will send copies to the Chairmen and Ranking Minority Members of the House Committee on Ways and Means and the Senate Committee on Finance; various other congressional committees; the Secretary of the Treasury; the Director of the Bureau of Alcohol, Tobacco, and Firearms; and other interested parties. We will also make copies available to others upon request.

Major contributors to this report are listed in appendix III. Please contact me on (202) 512-9110 if you have any questions.

A handwritten signature in black ink that reads "James R. White". The signature is written in a cursive style with a large, prominent initial "J".

James R. White  
Director, Tax Policy and  
Administration Issues

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# Contents

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Letter	1
Appendix I Special Tax Stamp Registration and Return Process	24
Appendix II Computation of Civil Penalties and Interest	25
Appendix III Major Contributors to This Report	26

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## Abbreviations

ATF	Bureau of Alcohol, Tobacco, and Firearms
FAA	Federal Alcohol Administration Act
IG	Inspector General
IRC	Internal Revenue Code
IRS	Internal Revenue Service
SOT	Special Occupational Tax

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# Special Tax Stamp Registration and Return Process

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In May of each year, the Bureau of Alcohol, Tobacco, and Firearms (ATF) sends a notification package to each alcohol business known to ATF. This begins the annual process for businesses to renew the registration of their alcohol operating locations with ATF and to obtain the Special Tax Stamps. The SOT notification package contains the special tax renewal registration and return, a notification letter, and a preaddressed return envelope. ATF preprints on the SOT return the business' name, identification number, registered address, operating locations, and taxes due. ATF instructs the taxpayer to verify the preprinted information on the return, correct any errors, sign and date the taxpayer certification at the bottom of the return, and submit the payment.

The taxpayer can submit the SOT return with the appropriate payment or report that the alcohol business is no longer in operation. After the taxpayer files the SOT return and pays the taxes, ATF issues a Special Tax Stamp, ATF Form 5630.6A, as evidence of tax payment for each location. The special stamp is nontransferable and is printed with the principal business address and the physical address of the operating business location for which the stamp was issued. Alcohol businesses are required to keep these location-specific stamps available for inspection by ATF. ATF uses unique business location numbers to account for all known operating and out-of-business locations for each principal business.

If the taxpayer fails to register the alcohol business with ATF and pay the taxes due or to report that the business is no longer in operation, the Bureau considers the taxpayer to be noncompliant and sends a follow-up inquiry letter to the taxpayer. This letter informs the taxpayer of the new total amount due, which includes the occupational taxes, failure-to-file penalty, failure-to-pay penalty, and interest. The taxpayer is advised to pay the new total due within 10 days of the letter to avoid additional penalties and interest. The letter contains an explanation of the taxpayer's appeal rights and a telephone number the taxpayer may call for assistance. The taxpayer is advised that failure to respond to the letter could result in assessment proceedings against the taxpayer.

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# Computation of Civil Penalties and Interest

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ATF advises the taxpayers in the renewal notification process that they may incur (1) failure-to-file and failure-to-pay penalties and (2) interest if they are liable for the SOT and do not pay or file in a timely fashion. The failure-to-file penalty is 5 percent of the tax liability for the first month late, plus an additional 5 percent for each additional month or part of the month. The maximum failure-to-file penalty is 25 percent of the taxes due. The failure-to-pay penalty is 0.5 percent of the taxes due for the first month late and 0.5 percent for each additional month or part of a month. The total failure-to-pay penalty also cannot exceed 25 percent of the tax due. If both the failure-to-file and failure-to-pay penalties are assessed, the total amount of these combined penalties cannot exceed 25 percent of the tax due. However, if failure to file a return is due to fraud, the penalty is 15 percent, not to exceed 75 percent.

Unlike the penalty amounts, which are limited, there is no limit on the interest charges taxpayers may incur for unpaid SOTs. Interest amounts are computed beginning with the first day of delinquency, using compound interest rates. Because of the exceptions to the statute of limitations on the assessment and collection of the SOTs, in some cases, the total amount of interest due can be substantial for a taxpayer who has not filed a return for several years. SOT revenue data show that ATF has assessed and collected failure-to-file penalties, failure-to-pay penalties, and interest for the occupational taxes.

ATF can accept offers-in-compromise or installment agreements or waive penalties if the taxpayer can show that the failure to file or failure to pay is due to reasonable cause and not willful neglect or gross negligence. If a taxpayer exercised ordinary business care and prudence and still was unable to file within the required time, the failure would be due to reasonable cause. ATF may consider that a failure to pay was due to reasonable cause if the taxpayer demonstrated ordinary business care and prudence in providing funds for payment of the tax liability but still was unable to pay or would endure undue hardship if the tax were paid on the due date. ATF does not consider ignorance of the law a reasonable cause.

# Major Contributors to This Report

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General Government  
Division, Washington,  
D.C.

James Wozny, Assistant Director, Tax Policy and Administration Issues  
Helen D. Branch, Evaluator-in-Charge  
Kevin Daly, Senior Economist

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