

DRAFT EXECUTIVE SUMMARY

UPDATE ON PRACTICES IN CONSTRUCTION USE TAX

Prepared for the City of Boulder, Colorado

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EXECUTIVE SUMMARY

A. Background

In August of this year, the City of Boulder mailed over 300 letters to contractors and homeowners regarding reconciliation of construction use tax on completed building projects. Homeowners, builders, contractors and others responded by informing the city they were unaware of the need to reconcile the actual completed project cost with the estimated value and had concerns over the language within the city's tax code. Many voiced concern regarding the potential financial impacts and expressed anger and/or frustration with the letter that caught them by surprise.

Because of these concerns, the city suspended follow-up on the voluntary compliance letters in September and instituted a 60-day re-examination process. The firm of Anita White Consulting (hereby referred to as "Consultants") was selected as a third-party reviewer of the current construction use tax practices.

B. Project Scope

This review of the City of Boulder's construction use tax policies, practices, and procedures has focused on the following tasks of:

- Conducting stakeholder interviews to:
 - (a) Identify and analyze the concerns of builders, contractors, homeowners, and other stakeholders regarding the City's recent reassessment of construction use tax; and
 - (b) Collect the opinions of stakeholders regarding future improvements in use tax policies, practices, and processes.
- Comparing City of Boulder's policies, practices, and processes with those identified in the Boulder Revised Code (BRC) and with those of other Colorado jurisdictions; and
- Comparing the City of Boulder's practices with best municipal financial practices and customer service practices.

C. Report Structure

The final report contains a detailed review of both the historic context and stakeholder concerns. Additionally, the City of Boulder's current construction use tax policies, practices, and processes were analyzed and compared against the following:

- City's municipal code and information on the City's website;
- Municipal best management practices related to revenue management and customer services; and
- Those of other Colorado jurisdictions.

D. Major Themes of Stakeholder Meetings

During the period of October 28 through November 20, the Consultants held four meetings with stakeholders. The first meeting involved the stakeholder liaison group that counsels the Public Works and Community Planning and Sustainability Departments, specifically the staff in the "Planning and Development Services" fund and service area, on building and land use issues. The three subsequent meetings were open to the public. The majority of attendees at the public meetings were those who received the August 25, 2009 "voluntary compliance" letter. However, the meetings also were attended by several contractors who had not received letters, at least one non-contractor, a few homeowners who had served as their own contractor, architects and others who had received letters.

The major themes voiced by the stakeholders are summarized below:

1. Avoid surprises, especially around unpredictable costs
2. What is valuation?
3. Taxes may have been overpaid (i.e. over-estimates, no credit for sales taxes paid by subcontractors)
4. Is placing the General Contractor in the role of collector of taxes appropriate?
5. Construction use tax is significantly different from sales tax
6. There was no formal communication with contractors and builders between the April 2009 audit letters and the August 2009 voluntary compliance letters
7. Potential errors in the Construction Tax Assessments and Reconciliation Form may have led to some misunderstandings
8. How will the City handle those situations where a contractor/builder has made payments because of the April audits or August voluntary compliance letters?
9. The City's Planning and Development Services staff and Finance Department appear to have different views of the issue
10. The City's Tax Code is difficult to read and does not appear consistent
11. There is a strong desire by the stakeholders for the City to acknowledge and apologize for the manner in which this matter was handled and concern it has caused.

E. Summary of Findings

1. The City's approaches to construction use tax reconciliation and audit does not vary significantly from that of other Colorado jurisdictions.
2. The City's determination to audit construction use tax is an appropriate response to carrying out the usual responsibilities expected under best practices identified for municipal finance departments.

3. The Boulder Revised Code (BRC) is complex and not well understood by the builders and contractors, particularly because they usually focus on the Building Code and not on the Tax Code, which is where the construction use tax is addressed in detail.
4. The City of Boulder has not consistently enforced some elements in the BRC related to the construction use tax, such as the requirement for a final reconciliation at the completion of a construction project. Few construction projects were audited each year and the commonly audited projects were large and, generally, impacted only the City's largest builders and contractors.
5. The City of Boulder's previous practices, of not requiring the reconciliations from all projects on completion, and of rarely auditing projects for the construction use tax, led stakeholders to believe that their original construction use tax estimates was all that they owed (except for the occasional large-scale audited project, where taxes were sometimes overpaid/underpaid).
6. When the August letters went to builders, contractors, homeowners, architects, and others regarding the need to prepare the reconciliations, the letter recipients were unprepared for the potential workload and financial impacts.
7. The City's Planning and Development Services staff, who are the first contact for the calculation of the construction use tax, were not fully aware of the potential impacts of the decision to enforce the reconciliation approach and may not have provided enough information regarding the re-emphasized approach on reconciliation and audit.
8. When stakeholders addressed their questions to Planning and Development staff, those stakeholders may not have been informed by the Planning and Development staff about the reconciliation process.
9. Although the Finance Department's staff were exercising due diligence, the re-emphasized approach did not account for the impact to stakeholders.
10. The policies and procedures that the City had in place were not necessarily changed, but were actually being followed. However, since this resulted in a change in practice (and potentially in fiscal impacts to those who had paid construction use taxes), the approach to dealing with the change in practice, was not well conceived.
11. The City generally has a very inclusive process, allowing a lot of stakeholder input. This change in practice seemed a divergence from that usual inclusive process.
12. At a time of economic distress, the potential for significant tax payments on already completed projects led to a difficult situation for the involved stakeholders and City staff.
13. Some of the recommendations for making the process more understandable to the stakeholders in the future will be difficult to implement because of the City's current computer systems.

F. Recommendations

Based on the analysis completed, and the findings delineated above, the Consultants believe that the City of Boulder's policies, practices, and processes are not significantly different from those of other jurisdictions. It is a sound and appropriate practice for the City's Finance Department to audit all revenue sources, and the City must retain its auditing obligations.

However, it is also clear that the City's approach to the construction use tax reconciliation was not handled as well as it could have been. The Consultants believe the stakeholder's concerns can be appropriately addressed utilizing a few basic changes in approach. As a result of the information obtained through this review, the Consultants recommend the following changes in practice and process:

1. Involve Stakeholders

- 1a. Involve stakeholders in a discussion of the problems that led to the apparent undercollection of the use tax and solicit suggestions on ways to avoid such undercollection in the future.
- 1b. Work with the stakeholders to redesign the reconciliation form to ensure that it addresses the issues they have identified, including whether sales taxes are already being paid in the City of Boulder by subcontractors.
- 1c. Work with interested stakeholders to determine whether the 50% estimate for materials is true for all projects, or is more appropriate for high-end residential remodels and commercial projects.

2. Assessments and Valuation

- 2a. Ensure that the assessments being considered have correctly calculated the potential underpayment by reviewing the actual methods for determining potential underpayments, discussing the ways in which these calculations have considered such things as the use tax rates that should be used, county use taxes, etc.
- 2b. Consider an approach like that of Westminster for dividing residential projects into three levels, based upon the assumption that custom residential work utilizes a higher percentage of construction costs than the normal or low-end residential work.
- 2c. Consider how those projects that do not require building permits will be assessed a use tax and ensure that the City's sales tax training addresses these issues as thoroughly as possible.
- 2d. Consider the use of a temporary certificate of occupancy, which becomes final only upon the acceptance of a final reconciliation of the use tax paid.
- 2e. Consider using the contractor's valuation for tenant finishes, for which the valuation table may not work well.
- 2f. Consider changing the terms used to discuss the valuation approach for construction use tax to recognize the fact that the preliminary payment is a deposit which is expected to be reconciled (assuming this is the approach which the City ultimately selects).

3. Clarify Reconciliation Process and Responsibility for Payment of Tax

- 3a. Make the accounting and documentation requirement clear to all who will be paying use taxes so that they know how long to retain documentation such as receipts.
- 3b. Consider the ramifications of changing the references in Tax Regulation 13 and the Code to acknowledge that property owners are ultimately responsible for the use taxes, even if the contractors collect them.
- 3c. Require that the responsible party complete the reconciliation no later than 180 days after the completion of a project.

4. Appeal Process

- 4a. Ensure that, for example, when sending out documents like the recent reassessments, that the involved stakeholders understand their appeal processes. The recent reassessments sounded as though there would be no possible way of addressing the apparent underpayment other than paying now or waiting for an audit and perhaps paying additional interest and penalties.

5. Staff Training

- 5a. Ensure that the employees of the City's Finance Department and Planning and Development Services within the Public Works and Community Planning and Sustainability Departments understand their roles in this process and know how to explain the use tax and its implementation to their customers.
- 5b. Once the City's approach has been determined, ensure that training provided to all staff is consistent and appropriate for the kinds of questions they will be asked.

6. Clarity of Information and Process

- 6a. Update the Boulder Revised Code and the City's websites to accurately display all changes.
- 6b. Evaluate current computer systems to determine how to implement chosen recommendations.