



CONSTRUCTION AND BUILDING MATERIALS EXEMPTION

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE4

TAX TYPE	Sales and use	REVENUE IMPACT	Could not determine
YEAR ENACTED	1979	NUMBER OF TAXPAYERS	965
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The exemption is generally effective at avoiding applying the sales and use tax to contractors' purchases of construction and building materials when completing projects for tax-exempt organizations. However, we found that the eligibility requirements are not clear for some projects.

WHAT DOES THIS TAX EXPENDITURE DO?

The Construction and Building Materials Sales and Use Tax Exemption [Section 39-26-708, C.R.S.] (Construction Materials Exemption) exempts contractors and subcontractors from sales and use tax on building and construction materials that are purchased and incorporated into a structure, highway, road, street, or other public work project that is owned and used by certain tax-exempt entities, such as federal, state, and local governments; not-for-profit schools; and charitable organizations.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute and the enacting legislation do not state the exemption's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption and conversations with stakeholders, our evaluation considered a potential purpose: to avoid applying sales and use taxes to contractors' purchases of construction and building materials when completing projects for tax-exempt entities. Since contractors would likely pass the cost of these taxes on, the exemption avoids indirectly taxing tax-exempt entities when they hire contractors to complete construction projects.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the exemption.
- Clarifying eligibility requirements for the exemption.



CONSTRUCTION AND BUILDING MATERIALS EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Construction and Building Materials Exemption [Section 39-26-708, C.R.S.] (Construction Materials Exemption) exempts contractors and subcontractors from sales and use tax on building and construction materials that they purchase and incorporate into a structure, highway, road, street, or public work project that is owned and used by certain tax-exempt entities. The tax-exempt entities included in this exemption are the United States government, the State of Colorado and its departments and institutions, and local governments, along with charitable organizations and nonprofit schools. The exemption was created by House Bill 79-1451 in 1979, and it has remained substantively unchanged since then.

To apply for the exemption, the contractor must submit the Contractor Application for Exemption Certificate (Form DR 0172) to the Department of Revenue with both the contractor's business information and the tax-exempt entity's sales tax exemption information. The contractor must also submit a copy of the contract agreement with the tax-exempt entity and a bid amount for the qualifying project. A contractor must apply for a separate certificate for each project it completes for a tax-exempt organization. Once the Department of Revenue approves the application, it issues an exemption certificate, which the contractor must present to the retailer at the time of sale in order to receive the exemption. Retailers report sales for which they apply the exemption on Line 4 of Schedule A of the Colorado Retail Sales Tax Return (Form DR 0100).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Construction Materials Exemption. Because contractors typically include the sales and use taxes they pay on building and construction materials in the price they charge customers, we considered the intended beneficiaries of the exemption to be tax-exempt entities, such as the United States government, the State of Colorado and its departments and institutions, local governments, charitable organizations, and nonprofit schools, since the exemption prevents them from indirectly paying sales tax on materials incorporated into their projects. To the extent that tax-exempt entities increase the size or number of eligible projects they purchase due to the cost-savings from the exemption, contractors also likely benefit.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Construction Materials Exemption do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption and conversations with stakeholders, we considered a potential purpose: to avoid applying sales and use taxes to contractors' purchases of construction and building materials when completing projects for tax-exempt entities. Since contractors would likely pass the cost of these taxes on, the exemption avoids indirectly taxing tax-exempt entities. This exemption aligns with other statutory provisions that exempt entities, such as the U.S. government, the State of Colorado, local governments, charitable organizations and nonprofit schools, from sales and use tax on tangible personal property they purchase directly, and is a common provision in states with sales and use taxes.

IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Construction Materials Exemption is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is meeting the potential purpose we considered in order to conduct this evaluation because contractors and tax-exempt organizations are aware of the exemption, and contractors use the exemption when they complete projects for tax-exempt organizations.

Statute does not provide quantifiable performance measures for this exemption. Therefore, we created and applied the following performance measure to determine the extent to which the exemption is meeting its potential purpose:

PERFORMANCE MEASURE: To what extent are contractors aware of the exemption and using it when eligible?

RESULT: Based on Department of Revenue data and conversations with contractors, we determined that contractors generally know about the exemption and use it when eligible. As shown in EXHIBIT 1, between Calendar Years 2016 and 2019, the Department of Revenue approved 19,764 applications for the Construction and Building Materials Exemption, indicating that contractors frequently use it. However, we were unable to locate data that would have indicated how many tax-exempt projects contractors undertook in each year in order to determine what percentage of eligible projects received the exemption.

**EXHIBIT 1. EXEMPTION APPLICATIONS APPROVED
BY DEPARTMENT OF REVENUE, CALENDAR YEARS
2016 THROUGH 2019**

Year	Approved Applications
2016	4,797
2017	4,785
2018	5,028
2019	5,154
Total	19,764

SOURCE: Office of the State Auditor analysis of Department of Revenue exemption application records.

Additionally, we spoke with 11 contractors and most were aware of the exemption. Further, staff at both the Colorado Department of Transportation and Colorado Parks and Wildlife stated that the tax exemption is widely used by contractors employed in state construction projects. Specifically, during Fiscal Year 2020, the Colorado Department of Transportation hired 66 contractors and Colorado Parks and Wildlife hired 303 contractors, and both agencies stated that all of their contractors applied for the exemption while working on their projects. We also spoke with 11 Colorado charitable organizations and schools, and most were aware of the exemption and have their contractors apply for the exemption.

**WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE
TAX EXPENDITURE?**

The Construction Materials Exemption likely has a significant state revenue impact because contractors use it frequently and apply it to large-scale public works projects. However, we lacked data necessary to determine the revenue impact of the exemption. Retailers report sales that qualify for the exemption on the Colorado Retail Sales Tax Return using a reporting line that aggregates several other sales tax exemptions and cannot be disaggregated for analysis; therefore, the Department of Revenue was not able to provide us with data showing the amount

taxpayers claimed for the exemption. Additionally, we were not able to locate another source of reliable data to estimate a revenue impact.

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that statutory municipalities and counties apply most of the State's sales tax exemptions, including the Construction Materials Exemption. Therefore, these local governments may experience an impact to their revenues to the extent that sales eligible for the exemption occur within their jurisdictions. However, we also lacked data necessary to estimate the eligible sales and total amount exempted in these jurisdictions. Home-rule cities established under Article XX of the Colorado Constitution that collect their own sales taxes have the authority to set their own tax policies independent from the State and are not required to exempt purchases of construction materials by contractors from their local sales tax.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the expenditure could have significant financial impacts on tax-exempt organizations that currently benefit from it, such as federal, state, and local government agencies; schools; and charitable organizations. Contractors told us that they would pass on sales and use taxes to the exempt organizations if the exemption was eliminated, which would result in a 2.9 percent increase in the amount tax-exempt organizations pay for materials on construction projects. In addition, because the exemption also applies to statutory and home rule municipalities and counties that have their sales taxes collected by the State under Section 29-2-105(1)(d)(I), C.R.S., if it were eliminated, materials purchased in those jurisdictions would also be subject to local sales taxes ranging from 0.25 to 7.5 percent, which would further increase project costs for tax exempt entities. All not-for-profit schools and charitable organizations that we spoke with stated that they have small operating margins and those that were aware of the exemption stated that without the sales tax exemption being extended to the contractors or sub-contractors they hire, they would have to decide

between smaller construction projects or cutting other services they provide. Additionally, eliminating the exemption for state projects would create administrative inefficiencies because the State would have to indirectly pay the sales tax on its own projects. Although the State would eventually get most of these sales taxes back when retailers remit the sales tax collected on the materials, retailers would be allowed to keep 4 percent – up to \$1,000 per filing period – of the sales tax collected because of the Vendor Allowance provided under Section 39-26-105(1)(d)(I), C.R.S.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the tax laws of the 44 other states (excluding Colorado) with a sales tax and identified 25 that have a similar exemption for materials purchased by contractors hired to do projects for certain tax-exempt organizations. However, not all organizations that are exempt under Colorado statute are also exempted in all states. Of the 25 states with a similar exemption, 19 allow the exemption for federal government projects, 19 for state and local government projects, 22 for public not-for-profit school projects, 19 for private not-for-profit school projects, and 16 for charitable organization projects. For example, New York does not extend the exemption to all types of nonprofit schools and Louisiana does not extend the exemption to all types of nonprofit organizations. Other states, like Alabama, do not extend the exemption to governmental road projects like Colorado does.

ARE THERE OTHER TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE AVAILABLE IN THE STATE?

As discussed, the Construction Materials Exemption is available for contractors that work on projects contracted out by certain tax-exempt entities, including federal, state, and local governments; not-for-profit schools; and charitable organizations. All of these tax-exempt entities are also exempt from sales and/or use tax when they purchase tangible

personal property directly [Section 39-26-704(1) and (4), Section 39-26-718(1)(a), and Section 39-26-713(2)(d), C.R.S.].

WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURE?

The Department of Revenue was not able to provide us with data on the amount claimed for the Construction Materials Exemption. Retailers are required to report the exempt sales on the Colorado Retail Sales Tax Return (Form DR 0100). However, they report the exemption on Line 4 of Schedule A, which is also used to report other exemptions, including sales made directly to exempt entities, and the information reported on that line cannot be disaggregated. For this reason, the Department could not provide us with tax return data on the exemption and we could not determine its revenue impact.

If the General Assembly wants to know the revenue impact of the exemption, the Department of Revenue would need to add a separate reporting line to Form DR 0100 and capture the data in GenTax, its tax reporting and information system. However, according to the Department of Revenue, this type of change would require additional resources to change the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE CONSTRUCTION MATERIALS EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we

considered a potential purpose for the exemption: to avoid passing sales and use taxes on to tax-exempt entities when they hire contractors to complete construction projects. We identified this purpose based on its operation and stakeholder input. We also developed a performance measure to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY COULD CONSIDER CLARIFYING ELIGIBILITY REQUIREMENTS FOR THE CONSTRUCTION MATERIALS EXEMPTION. Specifically, it could clarify whether it intends for the following types of projects to fall within the exemption:

- **PROJECTS THAT HAVE A PRIVATE PARTNER.** Statute does not indicate whether and under what circumstances the exemption would apply when construction materials are purchased by contractors completing projects for partnerships in which a private company that would otherwise not qualify for the exemption partners with a governmental or nonprofit organization. Further, the Department of Revenue has not issued regulations or guidance regarding this issue and its staff reported that it can be challenging to determine eligibility for the exemption under these circumstances. For example, the Department does not allow projects for certain nonprofit housing organizations that partner with private companies to qualify because they are joint owners with the private companies when the project is finished. However, because these projects may, at least partially, serve a charitable purpose, it is unclear if the General Assembly intended for the exemption to apply.
- **PROJECTS CONDUCTED UNDER "GOVERNMENTAL CAPACITY."** According to statute [Section 39-26-708(1)(a) and (2)(a), C.R.S.], materials purchased for government projects must be owned and

used by the governments “in their governmental capacities only” to be eligible for the exemption. “Governmental capacity” is not defined in statute and the Department of Revenue has not established additional regulations or guidance to define it. Department staff reported that, at times, it is difficult to determine whether certain government projects fall under an entity’s governmental capacity. For example, a contractor for a local government might submit an application for the exemption to purchase materials for a recreation center or golf course run by a municipality. It is unclear whether the General Assembly intended for these types of projects to fall under “governmental capacity,” since although governments are offering a public amenity, they typically act similarly to private proprietors for these operations, charging fees for their use and competing with private companies.

- **PROJECTS THAT ARE NOT ULTIMATELY OWNED BY CHARITABLE ORGANIZATIONS.** Some charitable organizations we spoke with reported that some of their contractors or subcontractors do not qualify for the Construction Materials Exemption because the organization is not the final intended owner of the property. For example, if a charitable organization builds a home that is sold to a low-income family, contractors and sub-contractors working on that project would not be eligible for the Construction Materials Exemption because statute [Section 39-26-708(1), C.R.S.] requires that the materials be used in a project “owned and used by” the charitable organization in the conduct of its regular charitable functions and activities. In those cases, the organization is acting in its charitable function by providing low-income housing and is exempt from sales tax when it directly purchases materials for those projects; however the Construction Materials Exemption is not extended to contractors or sub-contractors hired by the organization because the charitable organization is not the final owner of the project. Therefore, the General Assembly could consider clarifying whether it intended for the exemption to apply under these circumstances.