



Program Evaluation and Audit

**Central Corridor Light Rail
Transit**

Construction Contracts Sales Tax Documentation

January 13, 2012

INTRODUCTION

Background

Minnesota State Statute 297A.71 exempts the Central Corridor Light Rail Transit project (CCLRT) from paying Minnesota state sales tax for “construction materials and supplies used or consumed in, and equipment incorporated into, the construction or improvement of” the line. Given that the standard Minnesota state sales tax rate is 6.875%, the sales tax exemption can amount to real savings for the CCLRT project. The original budget for the largest CCLRT construction contract, for example, Civil East, includes a \$6,000,000 allowance for sales taxes paid, out of a total bid of \$205,111,234.

The sales tax is not refunded at the point of sale, however. The statute requires that it be paid up front, and then applied for under a separate refund process. The two “advanced” construction contracts—Advanced Utility Relocation (AUR) and Advanced Traffic Improvements (ATI)—were bid with sales taxes included in their unit-price line items, but the larger construction contracts—Civil East, and Civil West, Operations and Maintenance Facility (OMF), and Systems—contain a separate line item for “sales tax allowance.” With each pay request, the contractor submits its receipts for materials and supplies purchased, and the Council reviews the documentation and reimburses the contractor under this line item.

At any rate, it is the Council that bears the longer term burden of applying for the sales tax refund. The contractor must be reimbursed for the taxes it paid with each pay request, but the Council can only apply for the refund twice a year. In effect, the Council carries the cost of the tax for at least six months (or longer, depending on the timeliness of the refund request), and then must wait for the state’s Department of Revenue to process the request and deliver the refund. What could be a relatively simple operation—refunding or exempting the tax at the point of sale—is instead a complicated bureaucratic task, one with many points of contact.

Although work on the advanced CCLRT construction contracts is largely complete, the larger construction contracts are active, submitting pay requests on a monthly basis. An audit of the accuracy and efficiency of the process of reimbursing and applying for a refund of sales taxes therefore seems timely, especially if the process can be improved. Is the Council receiving a refund for all of the sales tax due to it?

Purpose

- To ensure that internal controls have been developed and maintained.
- To determine that CCLRT construction contractors are following contract terms for the reimbursement of sales tax payments.
- To identify overpayments, if any, to contractors for the reimbursement of sales taxes.
- To find greater efficiencies, if any, in the payment of sales tax reimbursements and the filing for sales tax refunds.
- To develop a framework for continuous monitoring and reconciliation of contractor sales tax payments and reimbursements with Council reimbursements.

Scope

The scope of the audit is the three sales tax refund applications from Metro Transit's Finance Department to the state Department of Revenue that include CCLRT transactions to date: August 2009, June 2010, and December 2010.

Methodology

The criteria for exempting CCLRT transactions from state taxes are specified in Minnesota State Statute 297A.71. It says:

Materials and supplies used or consumed in, and equipment incorporated into, the construction or improvement of the Central Corridor light rail transit line and associated facilities including, but not limited to, stations, park-and-ride facilities, and maintenance facilities, are exempt. The tax must be imposed and collected as if the rate under section 297A.62, subdivision 1, applied and then refunded in the manner provided in section 297A.75.

The *process* for applying for the refund, suggested here, is spelled out for CCLRT in two places. The construction contracts describe what the contractor does to claim reimbursement from the Council for sales taxes paid, and Central Corridor Project Office (CCPO) Procedure 630-03, *Claim for Progress Payment*, describes what the Council does to apply for the refund. (This process is modeled on Metro Transit's standard procedure, and indeed CCLRT transactions are simply included in the larger application for refund that Transit Finance makes twice a year.)

Although the scope of this audit is the three applications that include CCLRT transactions, only the December 2010 application included enough CCLRT transactions—715—to substantially audit. For this audit, we examined each of these 715 transactions. We wanted to determine:

- If the contractors' submissions for reimbursement to the Council are following contract terms, and if the amount submitted matches the amount listed on the receipts.
- If the contractors' submissions for reimbursement to the Council are completely and accurately reflected in the Council's application for refund to the state.

After examining what the Council submitted to the state, Audit examined what the state returned to the Council, in terms of items disallowed. How does the information about the disallowances work its way back to the field personnel charged with reviewing the initial submission from the contractor?

Beyond this examination of individual line items, Audit interviewed project principals to evaluate the sales tax reimbursement process itself. Is it as efficient as it can be, while still in accordance with contract terms? Is the Financial Analyst responsible for submitting the documentation to the state duplicating work that could be completed by the contractor, or by CCPO?

Assurances

This audit was conducted in accordance with the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing* and the U. S. Government Accountability Office's *Government Auditing Standards*.

OBSERVATIONS

The first step in applying for a refund from state sales taxes, according to CCPO procedure 630-03, *Claim for Progress Payment*, is for the contractor to submit documentation of the taxes it has paid to the Council Authorized Representative, or CAR. The CAR gives the pay request to the Office Engineer (a designee of the CAR), who—according to the procedure—“reviews the ... documentation to certify that ... the amount billed to the Sales Tax Allowance is a valid charge to the Project,” and communicates that review back to the CAR, who either signs approval or notifies the contractor of invalid charges. From there, the CAR passes the pay request to the CCPO Rail Budget Analyst, who reviews the documentation to ensure it contains everything needed for the refund, and the Budget Analyst passes it to the Financial Analyst within Metro Transit’s Finance Department, who actually prepares the documentation to be submitted as part of the Met Council’s refund application to the state, twice a year.

Certifying that an amount billed is a valid charge to the project could mean several things. Most simple, it could mean checking that an amount submitted by a contractor (listed on the Excel log of receipts that the contractor submits with each pay request) is accompanied by a valid receipt. It could also mean striking items from the sales tax log that the project should not be paying for at all. Examples of these *invalid* charges are administrative or office costs that would normally factor into the contractor’s overhead, or the sales tax on the purchase of a piece of capital equipment that is not used or consumed in construction, but which the contractor keeps for future projects. According to the contract, taxes paid to other states are also invalid charges, and should not be reimbursed.

Most substantial, reviewing a pay request for valid charges could mean verifying that an item submitted by a contractor is eligible for the sales tax refund from the state. In past applications, for example, the state has not refunded the sales taxes on office equipment, or on the rental of construction equipment.

Audit confirmed that the Office Engineers on CCLRT construction contracts are performing the first kind of review: checking that the amounts submitted by the contractors for reimbursement are accompanied by a receipt. In practice, the responsibility for reviewing the pay request for invalid or ineligible charges has fallen to the final point of contact in this process, the Financial Analyst in Metro Transit. She not only reenters the sales tax data from the pay requests into Department of Revenue Form ST11-PUR, the form required by the state to apply for the refund (reviewing invalid and ineligible charges as she does so), she also searches Accounts Payable for CCLRT transactions that fall outside the regular pay requests. She separates the amount of state tax--the amount due for refund--from local and city taxes. (The Metropolitan Council is exempt from paying local and city taxes.) In short, she makes sure the refund application matches the documentation provided on the receipts.

The Financial Analyst is also the Council's main point of contact with the state Department of Revenue. She gets feedback from their budget analysts about which items are refundable to the Council, and which items are disallowed for refund. After the review of the Council's December 2010 request for refund, the Financial Analyst communicated this information to CCPO's Project Controls Manager. Because CCLRT transactions have been substantially included in only one refund application so far, however, the information from the state about what is and is not refundable is not absolutely settled. We were told that the state's review process can be subjective, depending on the judgment of the reviewer.

The sales tax refund application examined by Audit was accurate and thorough.

As discussed, Audit examined the CCLRT items on the Metro Transit's December 2010 sales tax refund application. We matched each of the 715 individual CCLRT items on that application to the receipts presented by three major CCLRT construction contractors in their pay requests, and verified that the sales tax submitted by the Financial Analyst for refund corresponded with the tax reported on the receipts.

When we could not find a receipt in the construction pay requests that had been submitted for refund, the Financial Analyst directed us to other project-related invoices that contained the expense. When we found a receipt in the construction pay requests that was not submitted for refund, we agreed with the Financial Analyst's explanation for leaving the expense off of the refund application. Office supplies are an example of the latter expense. Because they are not items used or consumed in the construction of the line and had been disallowed earlier by the Department of Revenue, the Financial Analyst did not include them in the application.

Audit found one instance where the cost of the item submitted for refund was misreported on the sales tax application, but the sales tax paid was submitted accurately.

One item that could have been submitted for reimbursement was not, because it was not listed in the contractor's sales tax log.

As she fills out the sales tax application with items from the contractor's pay request, the Financial Analyst matches the items that the contractor lists for reimbursement in the sales tax log to the documentation of that item—the receipt--provided by the contractor. The 715 items in the December 2010 application were compiled from several logs and 28 different pay requests. Audit surveyed those pay requests as a whole—not just the items listed in the log—and found only one item that could have been reimbursable but was not included in the application. The Financial Analyst explained that she does not actively search for reimbursable items not listed in the log. Even so, we found one particularly large “un-logged” expense that *was* submitted for refund, because the Analyst happened across it and was able to gather the necessary information to submit it from the receipt.

Contractors are not being asked to submit sales tax documentation in a consistent format.

The specifications for the AUR contract did not require the contractor to submit sales tax documentation. That omission was addressed in AUR Change Order 18 (which required the contractor to provide “all sales tax documentation ... on a monthly basis”), and in subsequent contracts, which include this clause in their specifications:

CONTRACTOR shall submit the following documentation with its Application for Payment in order to be eligible for the tax refund: Receipts showing sales tax paid. . . . and an Excel log of the receipts which shall include date sales tax paid, paid by, paid to, rate paid, receipt number, item description, and other descriptive information as directed by the CAR.

The ATI, CE, and CW contractors have been submitting the receipts showing sales tax paid and a hard copy of the Excel log of the receipts with their monthly pay requests. They have not been submitting the Excel log itself. Moreover, the three contractors submit their logs in a slightly different format, and not all the logs contain all the required information.

Information from the state about disallowed items takes considerable time to work its way back to Metro Transit’s Finance Department.

Metro Transit’s Finance Department submitted the December 2010 application for refund to the state’s Department of Revenue (DOR) on December 22, 2010. The first communication from the DOR about that application was received on February 10, 2011. After several more exchanges, the refund was received from the state on April 26, 2011.

Metro Transit’s Finance Department missed the deadline for appealing the state’s decision on the December 2010 application.

Data received by Audit from the Financial Analyst indicated that the Council paid \$274,369.99 to CCLRT construction contractors (and others) in sales tax reimbursement, over the 28 invoices reviewed from the December 2010 submission. Of this total, the Financial Analyst submitted \$266,009.16 to the Department of Revenue for refund, after she removed some duplicate invoices and items that she knew from previous applications the state would not refund. From that application, the state disallowed \$23,229.90. Transit Finance missed the 60-day deadline for formally appealing that decision. In a series of exchanges with the DOR auditor before the refund was issued, however, the Financial Analyst was able to answer the auditor’s questions about many items that may have been disallowed, and those items were refunded.

There was confusion among project principals about the sales tax review process, and whether the contractor should be reimbursed for ineligible items.

As we reviewed the sales tax reimbursement process, Audit uncovered some confusion between CCPO and Metro Transit's Finance Department about what items the contractor should submit for reimbursement. CCPO believed that the contractor should submit *all* the items it paid sales taxes on, and that it should be reimbursed for all of those items, minus the invalid ones. Transit Finance believed that the contractor should submit only *eligible* items for refund, because if CCPO reimbursed the ineligible items, it would be paying out more to the contractor than it received in refund from the state. The confusion exposes an ambiguity in the larger contracts over this point. It is clear that the contractors were told, in the pre-bid meetings and in the contract's "Instructions to Bidders," that they would be reimbursed for all sales taxes paid under a separate Sales Tax Allowance line item. That is, they were told to separate sales taxes from the other line items under which they are paid, to facilitate CCPO's process of applying for the refund.

CONCLUSIONS

1. *The review of sales tax documentation in CCPO field offices needs improvement.*

As previously noted, Audit noted that the Financial Analyst's review of the sales tax documentation submitted to her by CCPO was accurate and substantially complete. At the beginning of the review process, Office Engineers have been checking that the charges listed in the sales tax log are accompanied by a receipt, but they have not regularly been rejecting invalid charges from the sales tax reimbursement request. If the Council reimburses the sales tax on invalid charges, it is paying out more money than it will receive from the state in refund.

2. *Because contractors are not being asked to submit sales tax documentation in a consistent format, the process of reviewing that documentation and submitting it to the state is less efficient than it could be.*

The inconsistency among contractors and the lack of complete information make Metro Transit's Financial Analyst's job in submitting the refund application to the Department of Revenue more difficult. Without the electronic Excel log, she must reenter the data herself, in the exact format required by the state. Reentering the data increases the possibility of errors (although we have already noted that we found only one, insignificant error). It also greatly increases the clerical effort-- and time--needed to apply for the refund.

The specifications add that "Submittal of incomplete documentation of sales taxes paid will result in rejection of the sales tax refund request by the COUNCIL." As quoted above, they also say that the CAR and the Council can ask for more information than the specifications list, if deemed necessary.

3. *The time it takes for information from the state about disallowed items to work its way back to Metro Transit's Finance Department contributes to the inefficiency of the refund process.*

CCPO and Metro Transit's Finance Department have no control over the time it takes the state's Department of Revenue to review a refund application. The December 2010 application took approximately four months to resolve. This lag time contributes to the difficulty in getting information about disallowed items from Transit Finance back to CCPO and the personnel in the field.

4. *The confusion among project principals about the sales tax review process was caused by the contract specifications, which describe the statutory exemption.*

The larger CCLRT construction contracts--Civil East, Civil West, OMF, and Systems--contain a description of the Minnesota State Statute that exempts the Central Corridor project from paying sales taxes on “construction materials and supplies used or consumed in, and equipment incorporated into, the construction or improvement of” the line, and that requires the contractor to submit “receipts for costs of each of the **exempt** items and state taxes paid.” They add that the contractor will be reimbursed for “**eligible** sales taxes paid” (emphasis added). This contract language could be interpreted to mean that the contractor should submit sales tax documentation for only exempt or refundable items, not for all items purchased, and that it would be reimbursed only for those refundable items. The unique approach to sales tax documentation taken by these contracts—that is, separating sales taxes paid on construction materials from the materials themselves—also caused confusion among those bidding on the contract. CCPO clarified the sales tax issue in its answers to contractors’ questions about the Civil East and Civil West bid documents, and these questions and answers were included in the contract documents issued for construction.

RECOMMENDATIONS

Program Evaluation and Audit recommendations are categorized according to the level of risk they pose for the Council. The categories are:

- **Essential** – Steps must be taken to avoid the emergence of critical risks to the Council or to add great value to the Council and its programs. Essential recommendations are tracked through the Audit Database and status is reported twice annually to the Council’s Audit Committee.
- **Significant** – Adds value to programs or initiatives of the Council, but is not necessary to avoid major control risks or other critical risk exposures. Significant recommendations are also tracked with status reports to the Council’s Audit Committee.
- **Considerations** – Recommendation would be beneficial, but may be subject to being set aside in favor of higher priority activities for the Council, or may require collaboration with another program area or division. Considerations are not tracked or reported. Their implementation is solely at the hands of management.
- **Verbal Recommendation** – An issue was found that bears mentioning, but is not sufficient to constitute a control risk or other repercussions to warrant inclusion in the written report. Verbal recommendations are documented in the file, but are not tracked or reported regularly.

1. CCPO should recover from CCLRT construction contractors the sales taxes that were reimbursed to them on invalid charges, and reject invalid charges from future pay requests (Essential).

Based on its review of the contract, and discussions with Metro Transit’s Finance Department, CCPO Project Controls, and project managers, the following categories of items are invalid charges to the project:

- Taxes paid to another state
- Food, water, disposable items, perishable items
- Telephone charges
- Equipment that becomes the property of the contractor

These items are not valid for the Minnesota Sales Tax exemption in the contract (i.e., taxes paid to another state) or are items that the contractor would pay for as a normal cost of doing business (i.e., items not specifically related to CCLRT construction).

CCPO Office Engineers have not regularly been rejecting invalid charges from the sales tax reimbursement request. Audit determined that, in the December 2010 application, the contractors were reimbursed for \$3,648.56 in invalid sales tax charges. CCPO should work with Metro Transit’s Finance Department to recover this money from the contractors.

In addition, the CAR and his/her designees should reject invalid charges from future pay requests. (These field personnel are the most appropriate personnel to reject them, because they are CCPO's first reviewers of the pay requests.) The CAR and Project Controls should ensure that these invalid items are not being charged to the project through other line items.

Management Response: *Agreed. CCPO Project Controls will coordinate with the Council Authorized Representative(s) to obtain a credit on the invalid charges and will reject invalid charges in the future that are not in association with construction of the CCLRT Project. This will happen within the next two construction pay application cycles. Training for construction staff has been scheduled for 2/13/12 that will cover this recommendation.*

2. CCPO project managers should align the practice of sales tax reimbursement with the contract specifications (Essential).

At CCPO, the practice to this point has been to reimburse all sales taxes to the contractor. The specifications for the larger construction contracts, however, allow only taxes on eligible charges—items “used or consumed” in the construction of the line--to be reimbursed. One way to resolve this conflict would be to inform the contractors (after the appeals process has run its course) that, in the future, only eligible sales tax charges will be reimbursed. Another way to resolve it would be to amend the contract to clarify that the project will reimburse all sales taxes paid to the contractor, regardless of their eligibility for refund under the statute. Whatever solution is found, the present conflict between CCPO practice and the contract specifications should be resolved to ensure that CCPO and the contractors have the same understanding and expectations of the sales tax reimbursement process and requirements.

Management Response: *Agreed. The CCPO Deputy Project Director will coordinate a review of the various options with the Program Director and Project Director as well as other expertise within the Council (Procurements, Office of General Counsel). This will commence immediately with a goal to completion by the end of Q1 2012.*

3. When there is a question about whether an item will be refunded by the state, Metro Transit's Finance Department should err on the side of submitting it (Significant).

As of this writing, Metro Transit's Finance Department has submitted three applications for sales tax refund to the state, and has prepared a fourth application. It has a better idea of what items the state tends to declare ineligible in its review, but one reviewer may accept some items as used or consumed in the construction of the line that another reviewer rejects. Given that variability, unless the Financial Analyst is absolutely sure that an item is ineligible, it should be submitted. Again, this is the only way to maximize the amount refunded.

Management Response: *Agreed. Metro Transit Finance has already begun to implement this practice in the refund application submitted to the State in December 2011.*

- 4. CCPO Project Controls should require CCLRT construction contractors to submit sales tax documentation in the format of Department of Revenue Form ST11-PUR. In addition, all contractors should be required to submit such documentation in electronic (Excel file) as well as hard copy format (Significant).**

Submitting sales tax documentation in a consistent format, the format dictated by the state, would save time and effort, and more easily allows comparisons across contractors. Submitting the documentation in electronic format would save Metro Transit's Financial Analyst from having to reenter the information presently contained in the hard copy sales tax log and the individual receipts. The contract specifications allow CCPO to ask for the sales tax documentation in the format it deems necessary. Requiring contractors to submit the electronic Excel log in addition to the hard copy log would cost them and the project nothing, and requiring them to submit the information in a different format is a slight adjustment to an already established process.

Management Response: *Agreed. CCPO Project Controls has implemented the requirements for contractors to submit electronic files and will continue to work with Metro Transit Finance to fully implement the recommendation that contractors submit sales tax documentation in the format of the DOR's Form ST11-PUR, with a goal of completion by the end of Q1 2012.*