DECONSTRUCTING SALES TAX FOR CONTRACTORS IN NEW YORK

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When it comes to sales tax compliance in New York, few industries have it tougher than the construction industry. Navigating the nuts and bolts of sales tax rules applicable to construction contractors can be confounding for both contractors and those who hire them. In this article we'll cover the basics of how sales tax applies to construction work in New York, and we'll also delve deeper into some of the common problems arising under that framework.

The Framework: Sales and Purchases by Contractors

Sales: The chief factor distinguishing the treatment of contractors from that of other types of vendors is that contractors are not generally treated as selling a package of tangible personal property (i.e., the lumber, nails, steel, etc., they incorporate into a structure) and the labor to install that property. Rather, contractors are deemed to be providing a single thing: a *service* to real property. The taxability of that service depends on whether the work qualifies as a "capital improvement" to the real property involved. Work on real property that fails to meet the capital improvement test is generally deemed taxable as one of two enumerated taxable services: (1) "installing tangible personal property" under Tax Law § 1105(c)(3); or (2) "maintaining, servicing or repairing real property" under Tax Law § 1105(c)(5). As we'll see later, the determination of whether a job constitutes a capital improvement as opposed to taxable installation, maintenance or repair work is where the bulk of sales tax battles are fought for contractors. And this analysis is relevant not just in determining the taxability of a contractor's sales, but also in determining the tax implications for the contractor's purchases.

Purchases: Another distinction between contractors and many other types of service providers is that contractors must generally pay sales tax up front on all of their purchases of tangible personal property, which includes not only tools and supplies, but also the building materials incorporated into a job. The "resale" exclusion does not apply to contractors; rather, contractors are considered "consumers" of not only their tools and supplies, but also the materials that are ultimately transferred to customers. A credit can be later claimed for sales tax paid

on building materials that were used on a *taxable* (i.e., non-capital improvement) job, but the general rule is that contractors cannot purchase property tax-free.

A contractor's purchases of *services* are treated differently. Specifically, if a contractor hires subcontractors to carry-out portions of the job, no sales tax should apply— regardless of whether the overall job is a capital improvement or a taxable service. First, if the contractor's job constitutes a taxable service (*i.e.*, a repair or maintenance job), the regulations permit the contractor to purchase subcontractor services tax-free—for resale to the contractor's client. Conversely, if the overall job qualifies as a nontaxable capital improvement, any subcontractors' work should also qualify as a nontaxable component of that improvement.

The Capital Improvement Test

Determining whether construction work qualifies as a capital improvement or a taxable service to real property becomes the critical inquiry in determining the sales tax implications for a construction project. Section 1101(b)(9)(i) of the Tax Law defines a capital improvement as "an addition or alteration to real property" that:

1. substantially adds to the value of or appreciably prolongs the useful life of the real property;
2. becomes part of the real property or is permanently affixed to the real property so that removal would cause damage to the property or article itself; and
3. is intended to become a permanent installation.

In contrast, per NYCRR § 527.7(a)(1), the taxable service of "maintaining, servicing, or repairing real property," is defined to include "all activities that relate to keeping real property in a condition of fitness, efficiency, readiness, or safety, or restoring it to such condition." Examples in the regulations attempt to neatly distinguish between repair work and a capital improvement. For example, the regulations state that "replacement of broken windows is a repair to real property, which is taxable," and that replacement of some shingles on a roof is a repair, while a full roof replacement is a capital improvement. But couldn't the installation of the replacement window also meet the statutory test for a capital improvement by its own terms? An unbroken window certainly adds value over a broken one; and the replacement window is presumably installed as a permanent addition. Indeed, case law confirms that if an addition meets the capital improvement test, then it's a capital improvement, and cannot simultaneously be taxable as a repair. To address this, the regulations set forth an "end result test." Under this test:

The imposition of tax on services performed on real property depends on the end result of such service. If the end result of the services is the repair or maintenance of real property, such services are taxable. If the end result of the same service is a capital improvement to the real property, such services are not taxable.

Several prominent New York cases illustrate how this plays out. In *Matter of F.W. Woolworth & Co.*, Tax Appeals Trib., Dec. 3, 1993, the N.Y. Tax Appeals Tribunal applied the "end-result test" to find that a multi-million-dollar project to inspect and either repair or replace thousands of individual terracotta tiles making up the exterior of a New York skyscraper constituted a capital improvement, even though some aspects of the work viewed in isolation (i.e., repairing cracks in place) might constitute "maintenance" or "repair" work. Our firm also successfully litigated a case in which stripping a steel highway bridge of all existing paint down to the structural steel and applying a new protective coating constituted a capital

improvement under the "end result" test—even though "repainting" of existing structures is noted in the regulations as constituting taxable maintenance and repair. Even under the "end result" inquiry, though, the work still must meet all three prongs of the capital improvement test.

Proving that an addition to real property "substantially adds to the value of or appreciably prolongs the useful life of the real property" (Prong 1), is typically the easiest hurdle to clear. Establishing the cost of the addition and its useful life, generally will suffice to meet the "value" prong. Here, there is no bright-line test, but various cases and rulings confirm that the threshold is not high. For example, in *Matter of Gem Stores, Inc.*, Tax Appeals Tribunal, Oct. 14, 1988 installation of security camera systems at variety stores valued at $5,000 to $7,000 was deemed sufficient under the first prong.

The second prong of the test—that the item be "permanently affixed" to the property (Prong 2)—focuses objectively on the means by which an item is installed (e.g., screwed in, bolted, glued, etc.). However, in practice, determinations on this element of the test often involve more subjective opinions on how much damage would occur to either the item itself or the underlying property if the improvement was removed. Two "rollercoaster" cases demonstrate this. In *Matter of Darien Lake Theme Park and Camping Resort, Inc,* Admin. Law Judge Determination, Aug. 4, 1994, the concrete *footings* of a wooden rollercoaster were deemed to meet the "permanently affixed" test, but other parts of the structure, including the track bed, could be removed without damage. By contrast, in *Matter of Amusements of WNY, Inc.*, Tax Appeals Trib., May 26, 2011, a different wooden rollercoaster was held to meet the "permanently affixed" test in its entirety. Generally, items merely screwed or bolted into place and which could be relocated essentially intact will not meet the test.

The final prong of the test—whether the item is "intend to become a permanent installation" (Prong 3)—can be the trickiest prong to prove, since it involves the *subjective* intent of the property owner. Courts have turned to the common law of "fixtures" to assist on such determinations:

"The controlling intent is not petitioner's secret or subjective intention at the time the units were acquired, but rather the intention the law will objectively deduce from all the circumstances at the time the property is annexed to the realty to see whether it may fairly be found that the purposes of the annexation was to make the unit a permanent part of the freehold."

Quite a mouthful! As a practical matter, though, issues with the "permanent intent" prong generally arise only in a few well-defined circumstances. For example, leasehold improvements made by a tenant present a special problem, because the person making what could otherwise qualify as a capital improvement to the property is only a fixed-term tenant. In fact, under the New York State Tax Department's guidance, improvements by a tenant (as opposed the property owner) are *presumed* to fail the "permanence" prong, unless a contrary intention is proven. In these circumstances the language of the lease is the determinative factor. If title to tenant improvements immediately vest in the landlord under the lease, or improvements become the property of the landlord at the termination of the lease, the improvements will generally qualify. However, a provision requiring that the premises be restored to its original condition at termination of the lease will generally preclude capital improvement treatment.

Some leases delineate between "trade fixtures" and general improvements, requiring that "trade fixtures" be removed at the end of the term. Cases and rulings assist in drawing a line here. For example, in *Matter of Supermarket Gen. Corp. Pathmark Stores,* Tax Appeals Trib., Nov. 9, 2006, the installation of a costly refrigeration units by a supermarket tenant in a commercial space were deemed "store fixtures" rather than permanent "improvements" under the supermarket's lease,

because the units were suited strictly for a supermarket tenant. Perhaps more to the point, the Tax Department ruled that animal incinerators in space leased by a pet crematory business were "trade fixtures" and not capital improvements.

Finally, it is important to note that certain "temporary facilities" at a capital improvement construction site are exempt from tax despite the fact that these facilities do not satisfy the capital improvement test directly. Temporary facilities generally include scaffolding, pedestrian walkways, hoisting equipment, forming and shoring material, among other items. Though none of these items are permanently affixed to the real property and are not intended to be permanent, the Tax Department recognizes that these facilities "are a necessary prerequisite to the construction of a capital improvement to real property, [and] are considered a part of the capital improvement." Thus charges for labor and materials related to these items are exempt from tax. But keep in mind that such temporary facility contractors can't claim the "resale" exemption when purchasing or renting scaffolding equipment/materials. Thus, their purchases of this equipment are typically subject to tax.

Work for Exempt Organizations

One common area for pitfalls in construction work involves contracts for maintaining or improving property owned by a government agency or other tax-exempt organization. A contractor's charge to a tax-exempt organization for construction work will always be nontaxable—regardless of whether the work constitutes a capital improvement or merely maintenance/repair work. When it comes to purchases necessary for the job, though, things get trickier. A common—and sometimes costly—misconception among contractors is that if the property owner is a tax-exempt organization, all purchases for the project (whether by the prime contractor or subcontractors) are tax-exempt. This is not the case.

Generally, contractors working for an exempt entity may purchase property used on the job tax-free, but *only* if that property will be incorporated into and become "an integral component part" of the entity's property (citing N.Y. Tax Law § § 1115(a)(15),(16). That exemption for purchases of materials passes through to any subcontractors working on the site (20 NYCRR § 541.3(d)(2)(ii)). Thus, a contractor repairing broken windows on a church would not need to charge tax on the otherwise taxable repair, based on the church's exempt status. Moreover, the contractor could also purchase new glass, wood, caulk, and paint, tax-free as well, since those materials will be incorporated into the building. However, the contractor does not enjoy the same exemption on equipment or supplies used on site but not incorporated into the building (i.e., brushes, drop cloths, rented cranes or machinery, scaffolding, clean-up services). Unless the construction contract designates all contractors as legal agents of the exempt entity, authorized to make purchases on its behalf, contractors do not step into the shoes of the exempt organizations in terms of the ability to make tax-exempt purchases. Establishing a principal-agent relationship for such purposes is also not as simple as adding an agency clause to the contract. Rather, certain other elements must be met, the most notable of which are that:

(1) all purchases invoices must indicate the contractor is purchasing "as agent for" the entity; and (2) purchases must be made using funds from a special account set up by the entity.

Proper Documentation of Exemptions

For contractors in particular, properly documenting all exempt sales and purchases is critical to avoiding later problems of proof in an audit. As we've seen, determinations of whether construction work constitutes a capital improvement are highly fact-intensive, and the determination may not always be clear. Contractors can avoid later disputes over the status of a project by accepting a properly and timely completed **Certificate of Capital Improvement (Form ST-124)** from their

clients. Such a certificate, accepted in good faith, relieves the contractor of any obligation to later prove its work satisfied the test. Case law makes it clear that a contractor accepting a Certificate is relieved of that duty even if it is ultimately determined that the work did not qualify as a capital improvement. This is true even though the contractor accepting the certificate may be "in a better position [than the property owner] to determine its validity." (Quote drawn from *Saf-Tee Plumbing Corp. v. Tully*, 77AD2d 1 (3d Dept. 1980). Of course, a Certificate of Capital Improvement must be accepted in "good faith" in order to be relied upon. Although there is no bright-line test here, a contractor merely repairing a burst pipe, for example, likely would not meet the "good faith" test if a Certificate were accepted for the work.

Copies of the Certificate of Capital Improvement signed by a property owner on a project may also be accepted by all subcontractors involved on the improvement allowing the prime contractor to purchase those services tax-free.

Where a contractor performs work for an exempt organization, the contractor should request a copy of the organization's Exempt Organization Purchase Certificate (Form 119.1). Governmental agencies do not need such a form to make exempt purchases, and the contractor may rely on the contract and purchase orders from that agency.

Documenting exempt purchases is also critical for contractors. As noted above, contractors generally are required to pay tax on all purchases upfront and cannot use a Resale Certificate (Form ST-120). To document purchases that are exempt, such as building materials on a job for an exempt organization or a purchase of subcontractor services for "resale" on a taxable repair or maintenance job, contractor must use a **Contractor Exempt Purchase Certificate** (Form ST-120.1), checking the appropriate box for the exemption claimed.

Keep in mind that exempt transactions are always reviewed as part of a sales and use tax audit. It's an obvious place for auditors to look to determine if a contractor is properly following the rules and to find potential liability in the event there's a mistake or just poor recordkeeping. So these transactions are going to be scrutinized. Consequently, contractors should take special care in handling nontaxable transactions and their supporting documentation.

Conclusion

Sales tax rules for any industry can be counterintuitive and confusing, and this is especially true for the construction industry. Since New York State has decided to carve out a special set of rules applicable only to the construction industry, contractors in particular have to know how these rules impact different transactions and they have to keep excellent records. Because of the large dollar amounts frequently at issue, we've seen audits turn on just a handful of contracts or exemption certificates. The old adage "an ounce of prevention is worth a pound of cure" is particularly pertinent in this area.