

The Nuts and Bolts of New York's Sales Tax Rules for Contractors

by Timothy P. Noonan, Lance E. Rothenberg, and Joshua K. Lawrence



Timothy P. Noonan



Lance E. Rothenberg



Joshua K. Lawrence

Noonan's Notes is a column by Timothy P. Noonan, a partner in the Buffalo and New York offices of Hodgson Russ LLP. This month's column is coauthored by Lance E. Rothenberg, a senior associate in the New York office, and Joshua K. Lawrence, a senior associate in the Buffalo office.

In this article, the authors write about New York's sales and use tax rules that apply to contractors in the construction industry and their customers.

No matter who you talk to, people often complain about contractors: The project is over budget; the project is delayed; the jobsite is hazardous; the contractor stopped taking calls; there's dust everywhere. Sound familiar? We think we know why, but the problem may not be entirely the contractor's fault. Part of the problem, at least, is the myriad and complex sales and use tax (sales tax) rules that contractors and their customers must grapple with behind the scenes. Trying to keep abreast of the tax man is surely getting in the way of contractors focusing on their work.

As a general matter, New York's sales tax rules are not all that easy to follow from a compliance perspective, no matter what the industry. The sales tax rules applicable to the construction industry, though, are particularly confusing, counterintuitive, and dense. There are special rules affecting the taxation of capital improvements; repairs; maintenance; purchases of construction materials; purchases for resale; leasehold improvements; and new construction, among others. It turns out, that the right tool to get the job done may well be a CPA or an attorney. Our punch list is long. We'll explain.

I. The Foundation

To explain the nuances, we first need to briefly review some of the basics. Under New York's rules, sales of goods

and sales of services are treated differently. The sales tax applies broadly to the sale of tangible personal property.¹ When you buy a hammer, you generally pay sales tax. In contrast, the sales tax applies only narrowly to the sale of services; typically, a particular service is taxable only if the statute specifically says so.² That's why neither engineering nor architectural services are subject to tax, but interior decorating services are.³

Construction services fall under many special rules. To begin, there are two taxable services that are particularly noteworthy. First, the statute imposes tax on the service of "installing, maintaining, servicing or repairing tangible personal property."⁴ For example, the charge for piano tuning is taxable,⁵ and so is the charge for installing a washer/dryer to existing wiring and plumbing.⁶ Second, the statute similarly imposes sales tax on the service of "maintaining, servicing or repairing real property."⁷ For example, the charge for repairing a broken window is taxable,⁸ as is the charge for some landscaping services, such as regular lawn mowing.⁹

Essentially, installation, repair, or maintenance services either to tangible personal property or to real property are generally taxable. But here's where it starts to get interesting. If the construction services performed rise to the level of a "capital improvement," as distinct from merely an installation, repair, or maintenance service, that service is not taxable.¹⁰ For example, the charge for removing a portion of a masonry wall for the purpose of installing a door and window is not taxable, even though the two statutes that were just mentioned might otherwise seem to impose tax.¹¹ Consequently, distinguishing whether a particular project qualifies as a capital improvement or as just an installation or repair is quite significant. And that is merely the beginning.

¹N.Y. Tax Law section 1105(a).

²N.Y. Tax Law section 1105(c).

³N.Y. Tax Law section 1105(c)(7).

⁴N.Y. Tax Law section 1105(c)(3).

⁵20 NYCRR section 527.5(a)(3).

⁶20 NYCRR section 527.5(a)(2).

⁷N.Y. Tax Law section 1105(c)(5).

⁸20 NYCRR section 527.7(b)(1).

⁹20 NYCRR section 527.7(b)(3).

¹⁰N.Y. Tax Law section 1105(c)(3)(iii) and (c)(5).

¹¹20 NYCRR section 541.2(g)(1).

II. Some Notes on Capital Improvements

New York employs a three-prong test to define a capital improvement. A capital improvement is any addition or alteration to real property that (1) substantially adds to the value of the real property or appreciably prolongs the useful life of the property; (2) becomes part of the real property or is permanently affixed to the real property so that removal would cause material damage to the property or article itself; and (3) is intended to become a permanent installation.¹² Each prong must be met to satisfy the test. That can lead to some distinctions that may initially seem odd. Installing carpet in a brand new building is a tax-free capital improvement, but installing brand new carpet in your old apartment is a taxable installation of tangible personal property.¹³ Given those distinctions, misunderstanding the rules and improperly accounting for transactions will leave you with the feeling of having just stripped a screw.

If installing a hot-water heater is a tax-free capital improvement, but replacing a thermostat on a hot-water heater is a taxable repair,¹⁴ how are contractors and customers to know the difference? As a preliminary matter, step back and consider whether the construction work is intended to permanently alter or improve real property. Carefully consider each of the three prongs of the capital improvement test.

Then contrast those prongs with work that merely maintains, services, or repairs real property, which the regulations tell us are “terms which are used to cover all activities that relate to keeping real or personal property in a condition of fitness, efficiency, readiness or safety, or restoring it to such condition.”¹⁵ For example, charges for regular trash removal or rodent control are taxable maintenance services.¹⁶ In contrast, when a contractor purchases trash or debris removal services in connection with the performance of a capital improvement (such as knocking down that masonry wall to build that door and window), those charges are not taxable.¹⁷

Most importantly, New York employs the “end result” test to aid in making those determinations. The regulations tell us that the imposition of tax on services performed on real property “depends on the end result of such service.”¹⁸ If the end result of the service is the repair or maintenance of real property, the service is taxable. If the end result of the same service is a capital improvement to real property, the service is tax free. To assist with those types of determinations, New York has issued guidance that lists many types of

construction activities and classifies them either as capital improvements or as taxable installation, repairs, or maintenance work.¹⁹ While instructive, not every situation is covered. Further, even New York acknowledges that the method of installation may affect taxability, so determinations require a case-by-case review.²⁰

In *L & L Painting*, New York’s Tax Appeals Tribunal examined the taxability of some construction services performed to a drawbridge connecting Brooklyn and Queens.²¹ That case helpfully highlights the difficulty in distinguishing between a capital improvement and a repair or maintenance service. In brief, the work performed included the removal of old paint and coatings, installation of a temporary containment system to contain pollutants and debris, and application of a special protective zinc-and-epoxy-based coating to the bridge and its piers. The tax department argued that the work amounted to painting and that under its regulations,²² painting is nothing more than a taxable repair and maintenance service. In contrast, the taxpayer pointed to the statutory three-prong definition of a capital improvement, as well as the end result test, and argued that the work amounted to a capital improvement. Disregarding the department’s painting regulations, the Tax Appeals Tribunal reasoned that when the facts satisfy the statutory definition for a capital improvement, the work is entitled to capital-improvement treatment.²³

In practice, though, auditors tend not to apply the end result test to the entire project. For larger projects, auditors seem to request and review the contractor’s breakdown of work in order to find aspects that may not qualify as a capital improvement on their own.

III. Certificate of Capital Improvement

The good news is that these often complex and far-reaching determinations — which heavily affect taxability (and audit exposure) — are supposed to be made by the customer. That’s right. The customer, not the contractor, makes the call.²⁴ When construction services are being provided, the customer is asked, through the issuance of a Form ST-124, “Certificate of Capital Improvement,” to

¹⁹New York State Department of Taxation and Finance, Publication 862, *Sales and Use Tax Classifications of Capital Improvements and Repairs to Real Property* (Apr. 2001).

²⁰TB-ST-104, *supra* note 12.

²¹*L & L Painting Co. Inc.*, Nos. 822266, 822227 (Tax Appeals Tribunal) (June 2, 2011).

²²20 NYCRR section 527.7; 20 NYCRR section 541.2.

²³*Id.* (“The capital improvement provision in Tax Law section 1105[c][5] is not to be viewed as an exception as to which the taxpayer bears the burden of proof, but rather is to be construed under the rule that [a] statute which levies a tax is to be construed most strongly against the government and in favor of the citizen”).

²⁴20 NYCRR section 541.5(b)(4)(i) (“When a properly completed certificate of capital improvement has been furnished to the contractor, the burden of proving the job or transaction is not taxable and the liability for the tax rests solely upon the customer”).

¹²N.Y. Tax Law section 1101(b)(9); 20 NYCRR 527.7(a)(3); 20 NYCRR 541.2(g); New York State Department of Taxation and Finance, “Capital Improvements,” TB-ST-104 (July 27, 2012).

¹³20 NYCRR section 527.7(a)(3)(ii)(a).

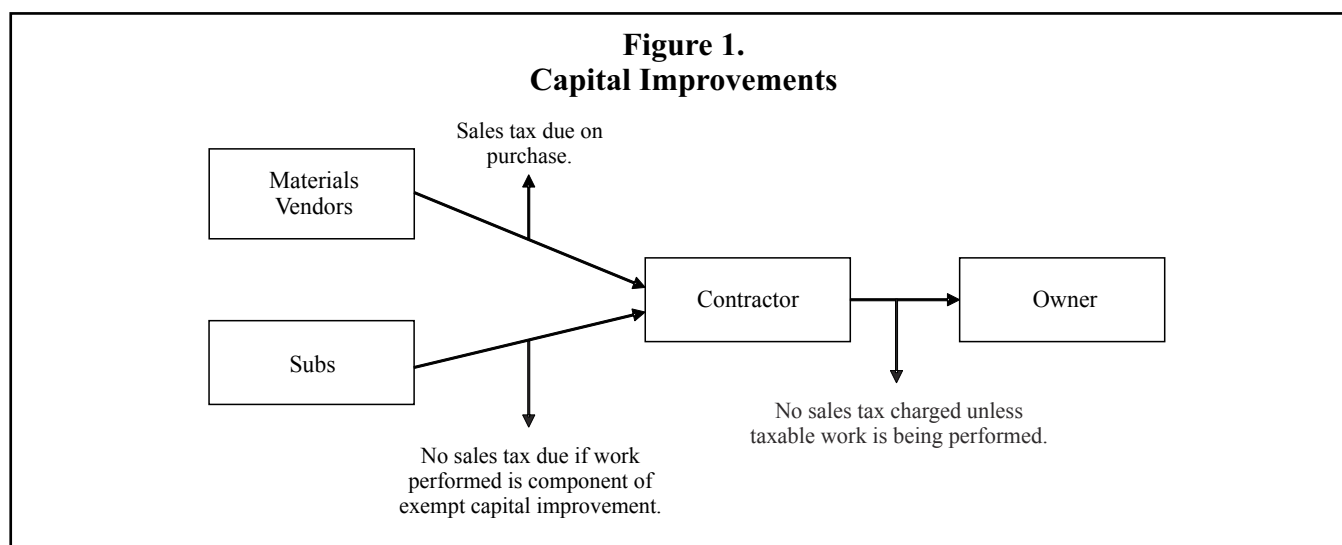
¹⁴TB-ST-104, *supra* note 12.

¹⁵20 NYCRR section 541.2(l).

¹⁶20 NYCRR section 541.5(d)(2).

¹⁷20 NYCRR section 541.7(b).

¹⁸20 NYCRR section 527.7(b)(4).



certify whether the work performed “will result in a capital improvement to the real property.”²⁵ The contractor must likewise certify that he has entered into a contract to perform the work described in the certificate and that the certificate has been accepted in good faith.²⁶

Whether a customer has the requisite knowledge of construction work and a sufficient understanding of these complex sales tax rules to properly make those determinations remains an open question to us. However, these rules are designed to benefit the contractor by relieving him of liability. And case law establishes that a Certificate of Capital Improvement is no less valid merely because the contractor may be in a better position than the customer to assess whether the work meets the test.²⁷ While sales are generally presumed to be taxable, when a vendor accepts an exemption certificate in good faith, he is generally relieved of his collection liability.²⁸ A certificate is accepted in good faith when a contractor has no actual knowledge that the certificate is false or is fraudulently presented and the contractor exercises reasonable ordinary due care.²⁹ We can imagine various situations, though, when that standard is not always so easy to apply.³⁰

²⁵New York State Department of Taxation and Finance, “New York State and Local Sales and Use Tax: Certificate of Capital Improvement,” Form ST-124 (Feb. 2012).

²⁶*Id.*

²⁷See *Saf-Tee Plumbing Corp. v. Tully*, 77 A.D.2d 1, 3-4 (3d Dep’t, 1980).

²⁸20 NYCRR section 532.4(a), (b).

²⁹20 NYCRR section 532.4(b)(2)(i); *supra* note 25.

³⁰For instance, these issues can be exacerbated when dealing with leasehold improvements. Tenant alterations are generally presumed temporary. As such, what might be a capital improvement if done at the direction of a building owner could nonetheless be treated as a taxable installation when done at the direction of a tenant.

IV. Contractor Purchases

So far, we have spent a lot of time talking about the differences between a tax-free capital improvement and a taxable installation, maintenance, or repair service. As discussed, distinguishing between the two classifications can be tricky. But the importance of properly characterizing a transaction cannot be overemphasized. That determination affects the taxability of both ends of the transaction. It governs the taxability of the contractor’s charges to its customer for the construction service. It also dictates the taxability of the contractor’s purchases and subcontracts necessary to perform the construction service.

A. Capital Improvement Jobs

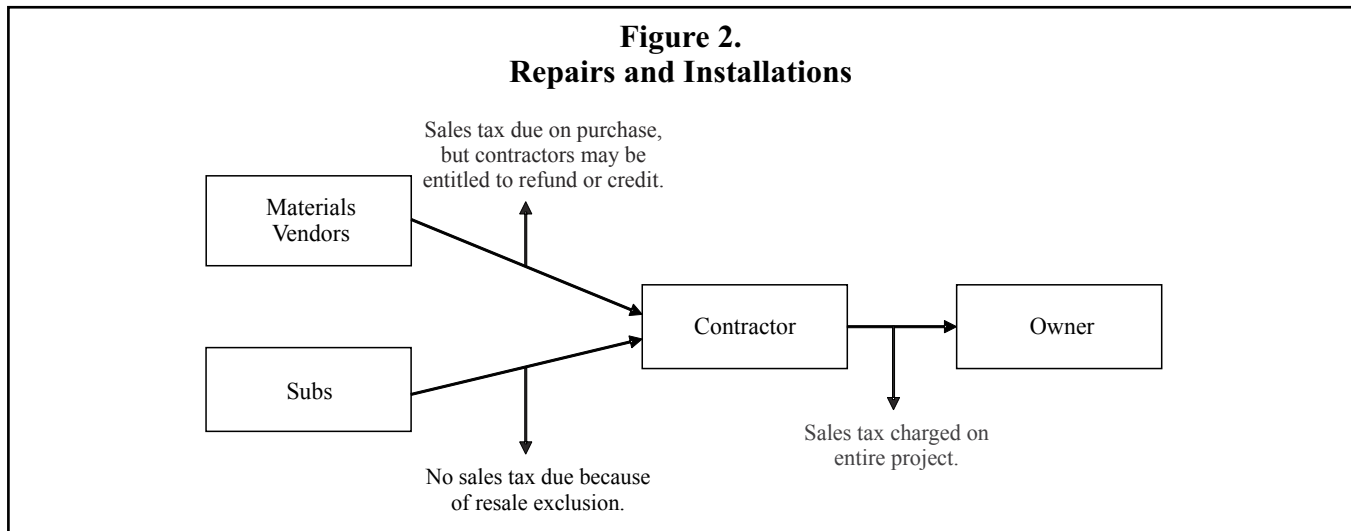
Let’s first consider projects that qualify as capital improvements. See Figure 1 for an illustration. No sales tax is due from the customer on the contractor’s fee (whether for labor or materials or both) for completing the capital improvement.³¹ Contractors should, of course, obtain a Certificate of Capital Improvement from the customer. What about the tax treatment of the contractors’ purchases? Contractors who are performing a capital improvement must pay tax on the cost of their materials.³² But no tax is due on labor charges of subcontractors, provided the subcontractors are performing a component of the capital improvement project.³³ Subcontractors, though, must pay tax on their purchases.

³¹20 NYCRR section 541.5(b)(2).

³²20 NYCRR section 541.5(b)(1).

³³See, e.g., New York State Department of Taxation and Finance, “Taxability of Drilling Test Wells and Associated Services,” TSB-M-10(4)(S) (Mar. 15, 2010) (when subcontracted drilling services are performed as a constituent part of a capital improvement to real property, charges are not subject to tax); New York State Department of Taxation and Finance, “Sales Tax Treatment of Certain Temporary Facilities Provided at Construction Sites,” TSB-M-14(15)S (Oct. 23,

(Footnote continued on next page.)



From a policy perspective, contractors are treated as the ultimate consumers of the tangible personal property that they purchase to build the capital improvement.³⁴ As such, contractors' purchase or rental of materials and supplies in connection with a capital improvement cannot be made for resale. In fact, contractors are prohibited from using typical sale-for-resale exemption certificates.³⁵ Therefore, contractor purchases are subject to tax, while the contractors' fee for the capital improvement service is not. Taxes on the contractors' purchases are generally passed on to the customers in the form of a higher overall fee, but they cannot be itemized as sales tax payable by the customers.

B. Repair or Installation Jobs

Now let's consider projects that qualify as taxable installation, repair, or maintenance services. See Figure 2 for an illustration. Sales tax is due from customers on the contractors' full invoice amount for the taxable labor and materials.³⁶ What about the tax treatment of the contractors' purchases now? Those, too, are subject to tax, but with a caveat: Purchases of any tangible personal property by contractors for use or consumption in a taxable installation, repair, or maintenance service are subject to tax.³⁷ Unlike with capital improvements, though, contractors who pro-

vide a taxable service may be entitled to a refund or credit of tax paid regarding any materials that are incorporated into real property and are later transferred to the purchasers in conjunction with the taxable service.³⁸

Let's focus on that for a moment. Repainting a building generally is not a capital improvement. As such, the customer will pay tax on the contractor's fee for the painting service. Likewise, the contractor will pay tax on the purchase of materials, tools, and supplies necessary to get the job done (for example, paint, spackle, brushes, and drop cloths). The contractor will be entitled to a refund or credit for tax paid on the cost of those materials that are incorporated into the building, such as the paint and spackle.³⁹ The contractor would not get a credit or refund, though, for the brush or drop cloths, which are consumed rather than transferred to the customer.

Further, when dealing with a taxable installation, maintenance, or repair service, contractors can purchase subcontractor services tax free under a resale exclusion. That is, the subcontractor services will be treated as if they have been purchased for resale to the customer.⁴⁰

V. Exempt Organizations

A customer's own tax-exempt status may also relieve the contractor from collecting tax on an otherwise taxable repair or maintenance project in New York. For instance, some categories of organizations enjoy tax-exempt status on their direct purchases of labor and materials from contractors, regardless of whether the work constitutes a capital improvement or a taxable installation, maintenance, or repair. But whether the contractor's purchases relating to work for an

2014) (subcontracts to provide temporary facilities at construction sites, which are a necessary prerequisite to the construction of a capital improvement to real property, are considered part of the capital improvement).

³⁴20 NYCRR section 527.7(b)(5).

³⁵20 NYCRR section 532.4(d)(5) ("Contractors who are purchasing tangible personal property for use in performing capital improvement work or repairs on real property are not permitted to use a resale certificate").

³⁶20 NYCRR section 541.5(d)(1)(i) (tangible personal property) and (d)(2) (real property).

³⁷20 NYCRR section 541.5(d)(3).

³⁸*Id.*

³⁹*Id.*

⁴⁰20 NYCRR section 541.5(d)(1)(iii).

exempt organization are subject to tax is a trickier issue, and mistakes in this area are common among contractors and subcontractors working in New York, sometimes resulting in substantial sales tax liabilities.

Here's how that works: Generally, contractors working for an exempt organization may purchase supplies and materials tax free only when the items will be incorporated into real property owned by the EO. One common misconception among contractors and subcontractors is that the property owner's tax-exempt status automatically carries over to the prime contractor, so that all purchases of materials and labor by the prime contractor become tax exempt. That kind of blanket exemption can exist, but only in specific cases when the EO and the prime contractor have entered into a written agreement in which the prime contractor is designated to act as a legal agent of the EO regarding purchases.⁴¹ Otherwise, a contractor should not assume that all its purchases are exempt just because it is doing work for an EO.

As with capital improvement projects, a contractor working for an EO should accept and retain proper documentation on the exempt nature of its work. The contractor should accept Form ST-119.1, "Exempt Organization Exempt Purchase Certificate," from its customer to certify its exempt status. For an exempt governmental organization, copies of the contract and government purchase orders will suffice to document the exempt nature of the transactions. And to make exempt purchases in connection with a project for an EO, the contractor should provide its vendor or subcontractor with a completed Form ST-120.1, "Contractor Exempt Purchase Certificate."

VI. Other Nuts and Bolts Stuff

A. Temporary Facilities at Construction Sites

The installation of temporary facilities at a construction site that are necessary prerequisites to the completion of a capital improvement are considered a component of the improvement and are thus exempt from tax (even though they are ultimately removed).⁴² This includes items such as scaffolding, protective pedestrian walkways, and fixed hoist-

⁴¹For a principal/agent relationship to be recognized, the following conditions (in addition to the existence of a written agency agreement) must be met: (1) All invoices to the contractor must be billed to specify the contractor is purchasing "as agent for" the EO; (2) the EO itself or the contractor on its behalf must pay for the purchases through a special fund set up by the organization for this purpose; and (3) the contractor must provide its vendors and subcontractors with certification of the EO's status, along with a statement signed by an officer of the organization confirming the contractor's status as agent. For more information, see New York State Department of Taxation and Finance, "Purchases by New York Governmental Entities Through Properly Appointed Agents," TSB-M-05(6)S (June 8, 2005).

⁴²20 NYCRR section 541.8.

ing equipment, and the exemption is applicable regardless of whether the charge is expressed as a lump sum or itemized as labor and materials.⁴³

B. Dealing With IDAs

Construction work on projects adopted by an industrial development agency (IDA) presents another source of confusion for contractors. The key thing to know is that although the IDA is technically a sales-tax-exempt entity, a contractor must be appointed as an agent of the project operator in order to make any tax-free purchases. Qualifying contractors must use Form ST-123, "IDA Agent or Project Operator Exempt Purchase Certificate," to make those purchases.

C. Direct Payment Permits?

Don't bother! Direct payment permits really have no application in the contractor context. Here's an explanation from Tax Bulletin ST-163:

- a direct payment permit may *only* be used by the business to which it has been issued and when the business is unable to determine at the time of a purchase how otherwise taxable property or services will be used; and
- a direct payment permit *cannot* be used to defer payment of the sales tax on purchases, substitute for a resale or other exemption certificate, or transfer the permit holder's privileges to someone else.⁴⁴

For example, say a business has a direct payment permit, and it hires a contractor to construct an addition to its showroom. The contractor may not use the business's direct payment permit to defer the contractor's payment of tax on its purchases for the construction of the addition.⁴⁵

VII. Conclusion

As with dealing with contractors, navigating these various sale tax rules can be headache-inducing. Whether a contractor is obligated to charge and pay sales tax depends on the nature of the work performed. Installation, maintenance, and repair services are taxable. Capital improvements are not. Figuring out which regime you fall under is critical. We've covered many of the important rules, but there are several others that significantly affect the construction industry. (For example, there's a whole series of rules on scaffolding.)⁴⁶ Mistakes can be costly. You would not get very far using a wood drill bit to bore into a brick wall. Knowing how to navigate the sales tax rules affecting the construction industry is no different. Having the right tools is necessary for complying properly and, for the unlucky, mounting a sturdy audit defense. ☆

⁴³See TSB-M-14(15)S, *supra* note 33.

⁴⁴New York State Department of Taxation and Finance, "Direct Payment Permits," TB-ST-163 (June 24, 2013).

⁴⁵*Id.*

⁴⁶See TSB-M-14(15)S, *supra* note 33.