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CONSTRUCTION LAW

Sales Taxes On Construction Projects



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Tax laws are complicated and confusing, and tax laws for construction projects in New York are no exception. As a result, contractors often pay and charge sales tax where such taxes are not imposed and property owners end up paying more for the project than is necessary. It is therefore critical that the owner and contractor have a thorough understanding of the rules governing sales tax on construction projects in order to ensure that the owner is not overpaying for the work.

The general rule is that the sale of supplies and material and the labor performed on construction projects are taxable.¹ Thus, absent an exception, a contractor pays sales tax on the purchase of material from a supplier, and subsequently charges sales tax on the material and labor sold to the customer (this is on top of the tax paid by the contractor to the supplier that is incorporated into the cost of the material charged by the contractor to the customer). Although these charges add appreciably to the cost of construction, there are exceptions to the general rule that allow the owner to avoid sales tax for certain charges. The most pervasive of these exceptions is one that applies to projects deemed capital improvements.

Capital Improvement Projects

In New York, charges on a project considered a “capital improvement” are exempt

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from sales tax. Determining whether a project is properly classified as a capital improvement requires a three-part test that considers the “end result” of the improvement.² A capital improvement can be an addition or alteration to real property, and must (a) substantially add to the value of the real property or appreciably prolong the useful life of the real property, (b) become part of the real property or be permanently affixed to the real property, and (c) be intended to become a permanent installation.³

To illustrate, examples of capital improve-

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ment projects include new construction, additions to existing structures, installation of central air conditioning systems, complete replacement of hot water boilers, planting shrubs or trees, complete replacement of sidewalks, painting of new buildings and complete replacement of roofing materials. On capital improvement projects such as these, the contractor must pay tax on the material purchased from the supplier, but the owner is not required to pay sales tax on the material used or the labor performed by the contractor.

In addition, although temporary services and installation required for construction projects such as heating, electric, plumbing and protective walkways do not fit neatly

into the three-part test as capital improvements, the regulations exempt such items from sales tax when they are a “necessary prerequisite” to the construction of the capital improvement project.⁴ At the beginning of this year, material and labor necessary to provide scaffolding on capital improvement projects became exempt from sales tax, and it is expected that the list of services deemed a “necessary prerequisite” and therefore eligible for tax exemption will expand in the future.⁵

Conversely, repair and maintenance activities which are performed to keep property in a condition of fitness, efficiency, readiness or safety are not considered capital improvements and are subject to tax.⁶ With such activities, the contractor must pay sales tax to the supplier for material, and is required to charge sales tax to the owner for both the material and the labor. However, the line between what is a capital improvement and what is a repair and maintenance activity can often be blurred. By way of example, original installation of wiring or circuit breakers is considered a capital improvement and not subject to sales tax; however, the repair of outlets or replacement of switches are considered repairs, maintenance or installation and therefore subject to the tax. Similarly, application of window film in connection with complete window replacement is considered a capital improvement; applying window film to an existing window is subject to sales tax.

As noted above, capital improvement projects do not exempt the payment of sales tax to the supplier. A contractor performing a capital improvement project will pay sales

tax to the supplier for material and supplies but will not collect sales tax from the customer. An owner that purchases materials and supplies directly from a supplier will pay sales tax to the supplier but will not pay tax to the contractor for the labor on a capital improvement project.

The rules are less clear when the work is to be performed for a tenant of the property. As a general rule, work for a tenant is presumed to be temporary and not considered a capital improvement.⁷ However, this can be overcome if the tenant can demonstrate that the improvement is intended to be permanent. A lease provision that transfers title of the improvement to the property owner could support a finding that the improvement is intended to be permanent. Conversely, a lease provision that requires the tenant to return the leased premises to its original condition at the expiration of the term would indicate that the improvements are temporary and therefore not classified as a capital improvement exempt from sales tax. A tenant seeking to perform work in the demised space should therefore consider whether arrangements can be made to deem the work permanent to take advantage of the exemption for capital improvements.

Exempt Organizations

In New York, governmental entities, international organizations, and other exempt organizations (i.e., certain religious, charitable and scientific companies) are exempt from paying sales tax on material and labor regardless of whether the project is considered a capital improvement.⁸ The exemption for governmental entities and exempt organizations is broader than the exemption for capital improvements, as it covers materials and supplies that are not exempt for capital improvements, and in many cases, penetrates deeper as it exempts the tax paid by the contractor to the supplier.

Contractors performing work for a governmental entity should not pay tax to the supplier and should not charge tax to the customer. In support, contractors may rely on the contract document as sufficient proof that purchases made pursuant to the contract are exempt.⁹ If the contractor is using trade contractors to perform the work, a signed document between the contractor

and subcontractor identifying the project, location and exempt owner is required for the subcontractor to purchase the property that is to be incorporated into the project free of tax.¹⁰ At the time the material is purchased, the contractor or subcontractor, as the case may be, must issue a properly completed contractor exempt purchase certificate to the supplier.¹¹

Contractors performing work for exempt organizations are not required to charge sales tax to the organization, but must still pay tax for material at the time of purchase unless such material consists of tangible personal property that is to become an integral component part of the organization's building or structure. For instance, glass purchased by a contractor to repair a broken window would be exempt from sales tax; lumber purchased by a contractor to build concrete forms is not exempt since it would not become a component part of the structure. As a practical matter, a contractor should request a properly completed exempt organization certification, issued by the exempt organization, as evidence of the organization's exempt status.¹²

In order to obtain the full benefit of the sales tax exemption, including the tax imposed on consumable items, the contractor must act as "agent" for the tax exempt organization. Under such arrangements, all purchases or rentals of material, equipment, tools and supplies are exempt, whether such will become an integral component part of the organization's building or not, and the contractor is not required to pay sales tax to the supplier or charge sales tax to the customer.¹³

To determine whether a valid principal/agency relationship exists between the exempt organization and the contractor, a four-part test is prescribed. First, purchases should be invoiced by the vendor directly to the exempt organization. If invoices are instead addressed to the contractor, they must clearly note that the invoice is to the contractor "as agent for" the exempt organization. Second, payment must be made to the vendor directly from the organization. If payment is made by the contractor to the vendor, such payment must be made from a special fund that is created by the organization. Third, delivery of the material, equipment, tools or supplies should

be made to the job site. If delivery is made to an off-site location, the invoice submitted by the vendor must identify the place of delivery, the organization's name and address, and the job site location where the material will ultimately be delivered. Fourth, the contractor is required to supply the vendor with the exempt organization certification with a statement by the organization that identifies the contract and represents that the contractor is acting as agent for the organization.¹⁴

Summary of Rules

- On capital improvement projects, sales tax is paid to the supplier but the owner is exempt from sales tax on the material and labor sold by the contractor;
- On projects owned by a governmental entity, no sales tax is paid to the supplier and no sales tax is charged by the contractor to the governmental entity;
- On projects owned by an exempt organization, sales tax is paid to the supplier and no sales tax is charged by the contractor to the exempt organization;
- However, no sales tax is paid to the supplier for tangible personal property that is to become an integral component part of the building; and
- No sales tax is paid to the supplier if the contractor is acting as agent for the exempt organization.

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1. N.Y. Tax Law Section 1105(a); N.Y. Tax Law Section 1105(c)(3).
2. 20 NYCRR § 527.7(b)(4).
3. 20 NYCRR § 527.7(a)(3).
4. 20 NYCRR § 541.8.
5. Matter of L&L Painting Co., New York Division of Tax Appeals, Tax Appeals Tribunal, DTA Nos. 822266 and 822227, June 2, 2011.
6. 20 NYCRR § 541.2(l).
7. Publication 862 (4/01).
8. 20 NYCRR § 541.3(a)-(c).
9. 20 NYCRR § 541.3(a).
10. 20 NYCRR § 541.3(d).
11. *Id.*
12. 20 NYCRR § 541.3(c).
13. 20 NYCRR § 541.3(d)(4).
14. *Id.*