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Fixing New York's Scaffold Tax

by Timothy P. Noonan and Joshua K. Lawrence

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Anyone who's lived or worked in a metropolitan area knows the "sidewalk bridges" that shuttle pedestrians safely through and around construction sites are a fact of everyday life — as are the towering scaffolding systems frequently built atop them. For construction contractors, these structures are a necessary and expensive component of most construction and repair jobs. When a tall building or skyscraper is involved, the cost to erect and dismantle a scaffolding and bridge system can add hundreds of thousands of dollars to the cost of a project. For years, the New York State Department of Taxation and Finance has taken a cut of the revenue generated by this work in the form of sales tax imposed on scaffolding companies' charges to prime contractors. That occurs even when the underlying project qualifies as a tax-exempt capital improvement to real property, or when the work is being done for an exempt entity.

The lack of clarity in how sales tax has been applied to scaffolding, pedestrian walkways (that is, sidewalk bridges), hoisting equipment, and other "temporary facilities" has long been a source of consternation for the construction industry and tax practitioners working in the area. But the department has taken positive steps in the past two years toward solving this. In fact, in an advisory opinion released just a few months ago, the tax department signaled a change in policy that could have a major impact on construction projects in New York. In that opinion,[1] the department held that contracts to erect and dismantle scaffolding and sidewalk-bridge systems at a construction site were substantively labor contracts, not rentals of equipment akin to renting a bulldozer or a crane. As such, the department held, none of the labor involved should be subject to tax, as long as the underlying construction work was exempt as a capital improvement.

A closer look at the decision and the saga of New York's treatment of scaffolding and related structures leading up to it demonstrates how varying interpretations of a seemingly inconsequential sales tax exemption can affect an entire industry.

Background: The 'Temporary Facilities' Exemption

The source of the long-running dilemma over the tax treatment of scaffolding is simple to trace: New York generally imposes sales tax on the service of "installing tangible personal property."[2] But New York does not impose tax on installations that result in a capital improvement to real property.[3] A three-part test is provided in the statute to determine whether an addition to real property constitutes a capital improvement.[4] The test requires that the work result in an addition or alteration that adds substantial value to or prolongs the useful life of the property, is permanently affixed such that its removal would damage the property (or the addition itself), and is intended as a permanent installation.[5] In applying this test, the end result of all the project's components is considered.

So where do construction site installations like scaffolding, hoisting equipment, pedestrian walkways, temporary plumbing, and electrical facilities fit into that formula? Technically, none of those temporary structures at a construction site can meet the statutory test, since they're removed from the property at the end of the job. But as part of a

[1]TSB-A-13(11)S.
[2]N.Y. Tax Law section 1105(c)(3).
[3]N.Y. Tax Law section 1105(c)(3)(iii).
[4]N.Y. Tax Law section 1101(b)(9).
[5]N.Y. Tax Law section 1101(b)(9)(i).

sweeping set of regulations promulgated in 1982 to help clarify the applicability of sales tax to construction contractors, the department adopted a provision that seemed tailor-made for these types of temporary facilities at construction sites. It provides, in part, that:

> 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 a part of the capital improvement to real property. Charges for installation of materials and the labor to provide temporary heat, temporary electric service, temporary protective pedestrian walkways, and temporary plumbing by a subcontractor are therefore not subject to tax.[6]

The regulation clarifies that even though temporary, these types of facilities "are generally considered part of the capital improvement," and thus a labor contract to install them is not taxable as long as the underlying work qualifies as a capital improvement.[7] A simple example accompanies the regulation:

> A subcontractor agrees to furnish to the prime contractor the materials and labor necessary to furnish temporary light and electrical facilities throughout a building under construction so that the various trades may have light, communications and power facilities necessary for them to perform their work and operate their tools. The charges are a constituent part of the capital improvement and are not subject to tax.

Although the purpose and wording of the exemption seem straightforward, the construction and application of the regulation since its adoption has never been entirely certain. And until just the last two years, the department's interpretation of the exemption's scope has been so narrow that almost no facilities tested under the exemption had ever been found to qualify in the 30 years it has been in place.

What Facilities Are Covered?

The first roadblock in administering the exemption had been the department's longstanding interpretation that the only types of structures covered by the exemption were the four facilities explicitly listed in the regulation: temporary heating, plumbing, and electrical facilities, and protective pedestrian walkways. Neither scaffolding nor hoisting equipment (perhaps the most costly of all temporary construction site structures) are listed.

The first published decision to analyze the scope of the temporary facilities regulation (issued almost 10 years after the rule was adopted) set the stage for this narrow interpretation. In an advisory opinion issued to *Yates Group Ltd.*,[8] an exterior restoration contractor asked the department for a decision on whether charges by its subcontractors to erect and dismantle the scaffolding necessary for its jobs were exempt under the regulation. With little analysis, the department advised simply that "the providing of scaffolding and the installation of scaffolding are not considered to fall within the definition of 'temporary facilities'" as defined in the regulation.[9] Thus, according to the decision, the provision of scaffolding is taxable "regardless of whether [the taxpayer] owns the scaffolding or rents the scaffolding and regardless of whether [the taxpayer] is performing a capital improvement or a repair."[10] The implication was that the four explicitly listed facilities represented the only ones intended to be exempt, as opposed to serving as examples in a more far-reaching exemption.

This narrow reading of the regulation stood for almost another 20 years. It ultimately took litigation to undo it.

In *Matter of L&L Painting Co. Inc.*,[11] the New York Tax Appeals Tribunal addressed the scope of 20 NYCRR section 541.8 for the first time. The issue in the case was whether a subcontractor's labor to install a multimillion-dollar temporary protective platform and debris-containment system on a bridge-coating job was subject to sales tax. The contractor argued that the work qualified as an exempt "temporary facility," because it was both a temporary facility at a construction site and "a necessary prerequisite to the construction of a capital improvement" to the bridge. Although the primary issue in the case concerned whether the project qualified as a capital improvement (which the tribunal ultimately determined it did), the department also took the position that the list of facilities in 20 NYCRR section 541.8 was exclusive, and that since the platform and containment system was not among them, the exemption did not apply. The tribunal, however, rejected this reading, and, applying common law statutory construction principles, held that the "examples" listed in the regulation were not intended to be exclusive and that the department's "restrictive reading would render the entire first sentence [of the exemption] superfluous."[12]

A year later, in an advisory opinion issued to a scaffolding contractor, the department conceded —

[6]20 NYCRR section 541.8(a).
[7]*Id.*
[8]TSB-A-92(71)S.
[9]*Id.*
[10]*Id.*
[11]N.Y. Tax Appeals Tribunal (2011).
[12]*Id.*

based in part on the result in *Matter of L&L Painting* — that not only scaffolding but also hoisting systems and safety netting could qualify as exempt temporary facilities if the underlying work qualified as a capital improvement.[13] This was reaffirmed in the advisory opinion issued just this past April. This was a positive step, and the department should be commended for taking this action to address the scaffolding question. But it was just a first step, because there's another issue often arising in these projects: whether the scaffolding was rented or not.

Rental Versus Labor: The 'Poison Pill'

This second obstacle has arguably rendered the temporary facilities exemption obsolete over the past 20 years. The department's position, expressed in a line of advisory opinions before the one issued this April, was basically that subcontractors furnishing scaffolding, hoisting equipment, and sidewalk-bridge systems were not charging for a service covered by exemption (that is, "charges for the installation of materials and the labor to provide [temporary facilities]"), but rather merely renting equipment, the charge for which included incidental installation and dismantling.[14] In other words, if any aspect of a rental was involved, the right to the exemption disappeared.

This created a problem because many scaffold and sidewalk-bridge contracts incorporate some form of rental charge on the installed structures. In part, this is to compensate the scaffolding provider if the equipment remains on site beyond the expected date and is thus unavailable for other jobs. The rental charge is typically expressed as a minimal fraction (that is, 3 percent-5 percent) of the total contract charge for labor to install and dismantle the structures. In other words, labor typically represents more than 90 percent of the cost in a scaffolding/bridge contract, making any rental charge incidental to the labor charges, not the other way around. And in the typical case, the customer is not separately invoiced for rent (if at all) unless the structures remain on site for longer than a specified period. Thus, a typical contract might specify a $250,000 lump sum charge to "furnish, install, and dismantle" scaffolding, with three months' rental included. Then a monthly rental of $12,500 (that is, 5 percent of the labor) might be separately invoiced thereafter.

Until the decision issued in April, some auditors took the position that any aspect of a rental in a scaffolding contract acted as a sort of poison pill, turning what would otherwise be a labor contract to install tangible personal property into a mere rental of tangible personal property. The effect has been for the department to hold all charges by a scaffolding provider subject to tax — even when the charges for installation labor, dismantling labor, and rent are separately stated and invoiced. This has been the case even though the service of dismantling tangible property in other contexts has been confirmed to be a nontaxable, non-enumerated service.[15]

Thus, between the "rent-as-poison-pill" problem and the narrow view the department had been taking toward structures defined as temporary facilities, the interpretation of the temporary facilities exemption has placed contractors and scaffolding companies on shaky ground (pun intended). On its face, the exemption would appear to cover these costly components of a capital improvement project (especially in the case of sidewalk bridges, which are specifically listed). Yet advisory opinions issued over the past 20 years have interpreted the exemption too narrowly to apply to even a simple, standard contract. Our firm worked with many contractors and scaffolding providers caught up in six- and seven-figure audits resulting solely from uncertainty over the applicability of this seemingly straightforward regulation.

But the department in the past two years appears to have recognized a problem, and it has taken several positive steps toward clarifying the significance and intended scope of the exemption.

A Fix to the Rental Problem

In 2012 a scaffolding and sidewalk bridge provider sought an advisory opinion from the department. It asked two things. First, it asked the same question asked in the *Yates Group* opinion 20 years earlier: Is scaffolding a temporary facility? Second, it asked whether it could solve the poison-pill problem by simply segregating its labor activities (installation and dismantling) and its rental activities into separate legal entities.[16] This would allow the labor company to invoice strictly for labor to install and dismantle scaffolding and sidewalk bridges, claiming the temporary facilities exemption on capital improvement jobs, and would allow the rental company to invoice and charge tax on the rental fee only, rather than on the entire contract price.

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[13]TSB-A-12(18)S.

[14]*See* TSB-A-09(9)S; *Regional Scaffolding & Hoisting Co., Inc.*, TSB-A-03(31)S; *Shroid Construction, Inc.*, TSB-A-02(30)S.

[15]*See Creative Staging Services, Inc.*, TSB-A-07(17)S (holding that an audio-visual provider's charges for dismantling, as opposed to installing, rented lighting and sound equipment was taxable only if not separately stated from the installation charge or other taxable charges); *Gilbert Displays*, TSB-A-05(28)S (holding that a separately stated charge for dismantling equipment by a company that rented, assembled, and dismantled trade show exhibit booths was a charge for a non-enumerated service not subject to tax).

[16]*See* TSB-A-12(18)S.

The department answered yes to both questions. Referencing the Tax Appeals Tribunal's decision in *Matter of L&L Painting Co.*, the department, for the first time, held that scaffolding, hoisting equipment, and safety netting — none of which are explicitly listed in the regulation — were temporary facilities that could qualify for the exemption if installed at the site of a capital improvement.[17]

Moreover, the department acknowledged that the use of separate but affiliated entities to isolate the rental activities would allow the labor charges invoiced by the "labor" company to be analyzed separately from the rent charges (something that would not be possible with a single company separately stating the charges for installation, dismantling, and rent). Correspondingly, the charge by the labor company to install scaffolding or a sidewalk bridge would be exempt if the underlying work was a capital improvement, and the charge for dismantling would be excluded without need for 20 NYCRR section 541.8, since dismantling property is not an enumerated taxable service. According to the opinion, rent would be due on the rental company's invoices as retail sales of tangible personal property.

The opinion made it clear that the separate legal existence of the two entities was key to the analysis. Specifically, the department emphasized the fact that the petitioner's customers were free to contract with one of the affiliated companies but not the other. Thus a customer could rent equipment from one entity without the requirement to use the other for labor, and vice versa.

A Brand New View?

While the 2012 advisory opinion suggested a corporate structure that scaffolding providers could implement to reduce the overall cost of their contracts, the most recent advisory opinion issued by the department suggests a more straightforward fix. The recent opinion concluded that the petitioner, a company that "installs, rents, then dismantles sidewalk bridges" and charges a single, lump- sum price for the service, is charging "primarily for the provision of the service of installing and dismantling temporary pedestrian walkways for its customers," as opposed to merely renting equipment with installation included.

As such, the department concluded that under 20 NYCRR section 541.8, the company need not collect tax on *any* of that lump sum charge, provided the structures are installed at the site of a capital improvement and necessary for the completion of the project. The only time sales tax would arise in such a situation, according to the decision, would be if the company stated the charges for rent separately from the charges for installation and dismantling (the way such contracts are typically structured). In that case, the department concluded, only the separately stated charge for rent would be subject to tax. The opinion went further to confirm the same would apply to scaffolding, safety netting, and hoisting equipment.

Conclusion

Having followed the scaffolding saga for years (our firm actually litigated *Matter of L&L Painting* and has assisted numerous contractors and scaffolding providers with this issue), the April decision came as a welcome surprise. Although not expressly overruling any of its former guidance, the department reached a conclusion that seems to reflect the original intent of the "temporary facilities" exemption — that is, to grant structures that are a necessary component of an exempt capital improvement project the same status as the underlying project. There still may remain issues about whether something really is rent despite language in the invoices or contract, so we will likely continue seeing issues arising in this context. But we know that the department had been struggling internally to figure out how to solve the scaffolding issue question for years, and these new advisory opinions signal that it has finally come to a practical and sensible approach. Kudos to the department for doing so.

Of course, it's not all sunshine and roses yet. This new guidance really is not "guidance" per se. Advisory opinions are binding on the tax department only regarding the taxpayer to whom they are issued and only on the specific facts provided. So the analysis technically doesn't apply to everybody, as would a technical services memorandum or a tax bullitin. However, as the department explains at the end of each advisory opinion, opinions are based on "the law, regulations and Department policies in effect as of the date of the Opinion." And it's our understanding that the department indeed is in the process of drafting more general taxpayer guidelines to formalize its policy in this area. This should be welcome news for the construction industry. ☆

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[17]The opinion emphasized that only "fixed" scaffolding and hoisting systems would be deemed to fall within the exemption, not movable or mobile equipment (that is, a crane or movable scaffolding).