NEW YORK STATE SALES TAX ISSUES AND RECENT DEVELOPMENTS AFFECTING THE CONSTRUCTION CONTRACTOR

Sales and use tax rules are complex and oftentimes frustrating for contractors — particularly in New York — because the interpretation and application of those rules can vary among construction jobs.

MARK S. KLEIN AND JOSHUA K. LAWRENCE

Construction contractors face a unique and particularly challenging set of issues when it comes to state sales and use taxes. In New York state, even that's an understatement. The reason that sales and use tax rules are so complex and oftentimes frustrating for contractors — particularly in New York — is that, although contractors' transactions are generally governed by an explicit set of rules and regulations, the interpretation and application of those rules can vary as much as the character of each individual construction job.

MARK S. KLEIN, Esq. *is a partner in the tax department of Hodgson Russ LLP, where his practice is concentrated in New York state and New York City tax matters. He is admitted to practice law in New York, Florida, and before the United States Supreme Court. He has over 25 years of experience with federal, multistate, state, and local taxation and may be best known for his public speaking on tax topics. Mr. Klein splits his time between the firm's Buffalo and New York City offices. He has written numerous books, articles, and treatises on the subject of multistate taxation. He is the editor of* New York Tax Highlights, *the contributing editor of* CCH's Guidebook to New York Taxes, *and the co-author of the* ABA Sales & Use Tax Desk Book, *CCH's* New York Residency and Allocation Audit Handbook, *CCH's* New York Sales and Use Tax Answer Book, *and the* New York State Bar Association's Contesting New York Tax Assessments. *He is also a contributor to CCH's* New York Tax Analysis *and a member of* The CPA Journal *Editorial Review Board.*

JOSHUA K. LAWRENCE, Esq. *is an associate at Hodgson Russ LLP and a member of the firm's state and local tax practice group, where he counsels businesses and individuals on a range of state and local tax matters, focusing on New York state and New York City taxation. He represents clients in disputes with the New York State Department of Taxation and Finance and New York City Department of Finance and is experienced in handling sales tax, corporate franchise tax, personal income tax, and residency audits. He speaks frequently on state tax issues and is the co-author of CCH's* Sales and Use Tax Answer Book *as well as a contributor to* State Tax Notes, The Trusted Professional, *and other publications.*

A contractor's obligations to collect tax on its charges to customers and to pay tax on its purchases of labor and equipment both depend on a range of variables, including, but not limited to:

- whether the work constitutes a capital improvement to real property as opposed to a repair;
- whether the customer is a property owner or a tenant;
- whether or not the customer is an exempt entity;
- whether certain exemption certificates apply and can be accepted in good faith; and
- whether particular materials or labor can be purchased tax-free for resale.

This article will provide an overview of these rules and variables, focusing on some recent developments in the area that could impact most contractors doing business in New York.

A special case: The scaffolding dilemma

One of the most interesting sales tax developments impacting contractors within the past two years involves the treatment of scaffolding and protective pedestrian walkways (aka "sidewalk bridges") installed at construction sites. Such structures are ubiquitous at large-scale construction sites, particularly in urban areas, and can represent a significant portion of the total project cost. But the tax treatment of scaffolding and similar "temporary facilities" at construction sites remains an unsettled area in New York. And since the scaffolding issue puts the spotlight on virtually the whole range of sales tax issues and considerations facing construction contractors, it provides a convenient window through which to examine New York's rules as a whole.

The issue came to the forefront in 2011, when the New York State Tax Appeals Tribunal (New York's highest administrative body for tax appeals) cancelled a more-than-$1 million sales tax assessment against a New York City painting contractor.[1] The contractor, L&L Painting Co., Inc., specialized in large-scale painting/coating projects for states and municipalities. L&L was audited by the New York State Department of Taxation and Finance (the "Tax Department") for a three-year period. Like most sales and use tax audits in New York, the audit examined two areas: (1) whether the taxpayer properly collected sales tax on its services and (2) whether the taxpayer properly *paid* use tax on its purchases (both capital purchases and recurring expenses). In the end, almost the entire liability asserted against L&L stemmed from a single purchase made during the agreed-to test period: It was a progress payment to a scaffolding company for the installation of a protective platform on a bridge-painting project, which was designed to contain sandblasting materials and other construction debris. The additional use tax asserted on that one labor charge was extrapolated and applied to the entire audit period, resulting in a use tax assessment of more than $1 million.

In the end, the tax liability came down to two related issues: (1) whether the work of sandblasting the bridge of outdated lead paint and applying a new corrosion-resistant protective coating system constituted a capital improvement to the bridge or just a repair and (2) whether the platform provided by the subcontractor could be considered a constituent part of the capital improvement and thus exempt under the sales tax regulations. The tribunal's ruling, in addition to resolving some longstanding questions regarding scaffolding, also provided insight into the important question of how the capital improvement test is applied. As we move through the basic rules affecting contractors in New York state, we'll revisit the *L&L Painting* case and related rulings to illustrate the real-world application of those rules.

Capital improvements vs. repair and maintenance

Capital improvements, generally. Since the designation of construction work as either a capital improvement or a mere repair or maintenance job represents the most significant factor in determining the

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sales tax implications on any construction project, an overview of the capital improvement rules is an appropriate starting point.

Under New York's sales and use tax structure, the sale of real property is not subject to tax, but all retail sales of tangible personal property are presumed taxable.[2] Certain enumerated services, including "installing tangible personal property" and "maintaining, servicing or repairing real property" are also subject to tax.[3] A contractor's receipts for installing a capital improvement are excluded from this framework, however. That is because a contractor constructing an improvement to real property is not viewed, conceptually, as selling a bundle of individual screws, nails, wood, and materials to a property owner, along with the labor to install them. Rather, the contractor is viewed as selling the finished product: namely new, nontaxable real property. More concretely, the statutes defining the taxable services of "installing" property or "maintaining, servicing or repairing" real property specifically exclude work that constitutes a capital improvement to the property.[4]

IT IS EXTREMELY IMPORTANT FOR CONTRACTORS TO UNDERSTAND HOW NEW YORK DISTINGUISHES BETWEEN EXEMPT CAPITAL IMPROVEMENTS AND TAXABLE INSTALLATION AND REPAIR SERVICES.

The sales and use tax consequences of a project qualifying as a capital improvement are generally that: (1) the contractor's charges to a customer for both the property (e.g., a new furnace and related hardware) as well as all labor to complete the job (e.g., the installation services) are exempt but (2) the contractor's purchases of tools, materials, and equipment either consumed or installed are taxable to the contractor, and the contractor will not be deemed to be reselling any of those materials to the customer.[5] Conversely, when a project constitutes a mere repair or maintenance to real property, the contractor must charge tax on its labor and any property transferred to the customer.[6] Yet, the contractor may be entitled to a credit for any tax paid on the property that is transferred to the customer on that job. In order to qualify for this "resale" exclusion, however, the property purchased must either: (1) become a physical component of the property upon which the services are performed or (2) be actually transferred to the purchaser.[7]

As an example of the above rules, if XYZ Contracting installs a new roof for a homeowner, the homeowner would pay no tax on the charge by the contractor, whether for the shingles, any supplies or materials used, or the labor to complete the roof. However, XYZ will owe tax on the shingles, tools, and other supplies purchased to complete the job, whether or not they ultimately become property of the homeowner. Although the contractor can ultimately pass that tax cost on to the homeowner, the contractor is prohibited from indicating any itemized charge for "tax" on its invoice for a capital improvement project; instead, a contractor will typically adjust the total price for the work to reflect the tax cost.

The tax burdens shift where work constitutes a taxable maintenance or repair service. Suppose XYZ Contracting is called on to patch a leak on the homeowner's roof rather than to perform a complete replacement. The contractor must charge tax to its customer on its total invoice, including shingles, materials, and labor. And since construction contractors in New York are always required to pay tax up-front on their purchases of materials and supplies, XYZ Contracting would be entitled to a credit for any tax paid on shingles and other materials that were actually incorporated into the homeowner's roof.

Because of this framework and the associated tax burdens, it is extremely important for contractors to understand how New York distinguishes between exempt capital improvements and taxable installation and repair services.

The capital improvement test. New York sets forth a statutory three-prong test for determining whether work performed on real property constitutes a capital improvement. Under the test, an "addition or alteration" to real property qualifies as a capital improvement if it:

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.[8]

The first and second prongs are largely objective, straightforward tests. Establishing the value of the additions themselves and their own useful lives has generally been found sufficient to satisfy the "adds-value" prong.[9] Similarly, the "permanently affixed" prong looks objectively at how the additions are affixed (i.e., glued, bolted, attached to building systems, etc.), but the key focus typically centers on the damage that the property's removal would cause.[10] The third prong of the test—whether the addition is intended to be permanent—can be the most difficult of the three prongs to meet, since the inquiry is a subjective one that looks to the subjective intent of the customer. For example, a costly refrigeration system installed by a contractor building out leased commercial space for a supermarket tenant might meet the second prong of the test (i.e., being affixed such that its removal would damage the units themselves or the building systems) but fail to meet the "permanent installation" prong, since the customer is a merely a tenant and not an owner.[11] The tenant status could also affect whether the improvements were deemed to add substantial value to the property, particularly if the lease requires their removal at the end of the term.[12] The unique case of leasehold improvements is discussed in more detail later. But even where the customer is an owner and not tenant, it is important for a contractor to understand each of the prongs and how they are applied. Capital improvement determinations are fact-intensive and decided on a case-by-case basis, with each prong of the test given due consideration.[13]

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Additionally, since large-scale construction projects are rarely limited to one specific "addition or alteration," the regulations provide that the project's designation as a capital improvement or otherwise depends on the "end result" of all services performed. Put simply:

> 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.[14]

The "end-result" test is a key concept to understand, since sales tax auditors in New York often take the approach of zeroing in on each component of a construction job, isolating components that, alone, might resemble taxable maintenance or repair work. The regulations illustrate the "end-result" test via a simple example, noting that: "The replacement of some shingles, or patching of a roof is a repair, but a new asphalt shingle roof is a capital improvement."[15] Often the inquiry is far more nuanced. For example, in one leading case, the Tax Appeals Tribunal held that a five-year, $2 million "exterior maintenance" project on a New York City skyscraper — a project that involved inspecting each and every terra cotta tile on the 40-story building and replacing each where necessary — constituted a capital improvement under the "end-result test," even though some of the work, in isolation, clearly could have met the definition of taxable "maintaining, servicing or repairing" real property.[16] Other New York case law has confirmed that if a project as a whole meets the three-prong statutory test for a capital improvement, then it *is* a capital improvement as a statutory matter.[17] This concept was most recently reaffirmed in the *L&L Painting* case.

In that case, the Tax Department had argued that since New York's sales tax regulations list "painting" (along with snow removal, tree removal, sewer service, and waste removal) as an example of "maintaining, servicing or repairing real property,"[18] it was inappropriate to substitute the three-prong capital improvement test to a painting job. But the tribunal confirmed that since the end result of the extensive sandblasting and complete re-coating of the bridge met all three prongs of the capital improvement test — prolonging the life

of the bridge with a permanently affixed, corrosion-resistant coating system designed to last 20 to 40 years — it could not also simultaneously constitute a taxable repair service.

The "temporary facilities" exemption. As we've seen, in order to meet the test for a capital improvement in New York, the addition or alteration in question must become permanently affixed to the property. But what about the numerous structures common at construction sites that are necessary to complete a project but are removed at the end of the work? Such structures include scaffolding, hoisting systems, protective pedestrian walkways, and temporary electrical and plumbing facilities. New York state has attempted to address this problem via a specific regulation that exempts "[s]ubcontracts to provide temporary facilities at construction sites, which are a necessary prerequisite to the construction of a capital improvement."[19] Installing such temporary structures would normally constitute the taxable service of "installing tangible personal property"; however, the "temporary facilities" regulation deems such facilities to be "a part of the capital improvement" and therefore not subject to tax.[20]

SEVERAL MONTHS AGO, THE TAX DEPARTMENT ISSUED AN ADVISORY OPINION CONFIRMING THAT IT WOULD CONSIDER MOST FIXED SCAFFOLDING AND HOISTING SYSTEMS TO FALL WITHIN THE SCOPE OF THE EXEMPTION.

For a contractor on a major construction project who would normally pay sales tax on its purchase of labor and materials for scaffolding, hoisting, and sidewalk bridges, the exemption should represent a significant area of savings. However, prior to the *L&L Painting* case (and even more recent guidance from the Tax Department) the scope of the "temporary facilities" regulation remained unclear. For one, prior interpretations by the Tax Department had limited its applicability to the four discrete examples listed in the regulation: protective pedestrian walkways, temporary heat, temporary electric service, and temporary plumbing. In fact, prior advisory rulings had specifically ruled that scaffolding and hoisting equipment fell outside the scope of the regulation.[21] However, as a result of *L&L Painting* and more recent guidance from the Tax Department itself, it is now clear that the list of exempt "temporary facilities" is not limited to the examples in the regulations and can apply to any temporary structure, so long as it is a "necessary prerequisite" to a capital improvement project. In *L&L Painting*, the Tax Appeals Tribunal found that the protective bridge platform at issue was both a prerequisite in L&L's bridge-painting contract with New York City and necessary for public-safety purposes. Several months ago, the Tax Department issued an advisory opinion to a New York City-based scaffolding company, confirming that it would consider most fixed scaffolding and hoisting systems to fall within the scope of the exemption, provided that other elements of the regulation are met.[22]

Despite these rulings, we have seen continued confusion in our own practice regarding how scaffolding and pedestrian walkways are treated in sales tax audits — confusion that has produced six- and even seven-figure tax assessments for scaffolding subcontractors and contractors who depend on them. One of the still-unsettled issues is whether a scaffolding contract that provides for a nominal rental charge on the structures after installation (which such contracts often contain) can still meet the exemption as a "subcontract" for installation of the structures or whether the contract is a mere "rental" of property. Under New York's sales tax law, the rental of tangible personal property is considered a taxable "retail sale."[23] And under the regulations applicable to contractors, any charges associated with a rental of equipment, including the labor to install and dismantle the equipment, are considered part of the total receipt for the rental and are also subject to tax.[24] Recent guidance from the Tax Department on the scaffolding issue suggests that placing any "rental" activity into a separate legal entity from that providing the labor to install and dismantle the structures could address the "rental" problem, provided customers are truly free to contract with one entity for labor or rental and may contract elsewhere for the other component.[25]

Leasehold improvements. As noted above, leasehold improvements present another

challenge for contractors in determining the taxable status of their work in New York. A project that would normally satisfy all three elements for a capital improvement may fail the test merely because the customer is a tenant and not the property owner. The problem presented in the case of leasehold improvements lies in the third prong of the test: whether the addition is "intended as a permanent installation." New York's policy, stemming from longstanding case law, is that improvements made to leased property are presumed to be temporary "unless a contrary intention is expressed."[26]

Generally, the provisions of the lease agreement will dictate the result in leasehold improvement cases. Specifically, a "contrary intention" (i.e., an intention that improvement is to be permanent) will be found if the lease contains provisions to the effect that: (1) the title to tenant improvements vests with the landlord immediately upon installation and (2) tenant improvements become part of the real property and remain with the landlord upon termination of the lease.[27] In contrast, a lease provision requiring a tenant to remove all leasehold improvements and restore the property to its original condition will support the presumption that such improvements are temporary and thus not exempt as capital improvements.[28] Case law also suggests that leasehold improvements specific to one type of tenant may not satisfy the first prong of the capital improvement test — the "adds-value" prong — either, since the improvements may only be suited for the particular tenant's unique trade or business.[29]

Contractors should be aware of these distinctions when performing improvements on leased property in New York, whether the work is associated with a new commercial building or an established building.

Documenting exempt sales and purchases

Capital improvement certificates. Another issue faced not only by scaffolding companies, but all contractors, is how to document and/or prove the exempt status of a construction project. As already discussed, a contractor cannot collect tax on its total charges to its customer if the work constitutes a capital improvement to real property. But considering the fact-intensive nature of the inquiry and the numerous variables involved, how can contractors gain comfort that they are not making a potentially costly misclassification on a project?

Generally, the responsibility for determining the status of an installation as an exempt capital improvement rests with the customer, and not the contractor. Thus, New York state provides generally that if a contractor accepts from its customer a properly executed Certificate of Capital Improvement (Form ST-124), the contractor is relieved of any obligation to collect tax on the work, and the burden of proving the work was exempt is transferred solely to the customer.[30] But these benefits are only extended to a contractor when it accepts the Certificate of Capital Improvement in good faith. A certificate cannot be accepted in good faith if the contractor has "knowledge that the exemption certificate...is false or fraudulently presented."[31] Such knowledge is not imputed to a contractor simply because he may be in a better position to assess the nature of the work; however, contractors may need to use their own judgment on whether acceptance of a capital improvement certificate in certain circumstances is appropriate. It should be noted that, although a properly complete Certificate of Capital Improvement relieves the contractor of the burden of proof, the *lack* of such a certificate does not mean a contractor is prevented from proving the exempt nature of the work by other means.[32]

GENERALLY, THE PROVISIONS OF THE LEASE AGREEMENT WILL DICTATE THE RESULT IN LEASEHOLD IMPROVEMENT CASES.

Work for exempt entities. 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. Certain categories of organizations, including qualified international organizations and governmental, charitable, educational, and scientific entities and associations, 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.[33] The issue of whether the contractor's purchases relating to work for an 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 — often resulting in substantial sales tax liabilities.

Generally, contractors working for a tax-exempt organization may purchase supplies and materials tax-free only where the property will be incorporated into real property owned by the exempt organization.[34] This can include property that is installed onto the property but that does not qualify as a capital improvement. For example, if ABC Windows is hired to repair broken windows at a municipal building, no tax will be due on the otherwise taxable repair work. Moreover, the glass may be purchased by ABC tax-free since it will be installed onto a building owned by a governmental entity. However, ABC would be required to pay tax on any equipment rented (e.g., a crane) or temporarily installed (e.g., scaffolding), since neither purchase involves property that will be incorporated onto the building.

One of the common misconceptions among contractors and subcontractors is that the property owner's tax-exempt status automatically carries over to the prime contractor, such that all purchases of materials and labor become tax-exempt. Such a blanket exemption can exist but *only* in cases where the tax-exempt organization 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 exempt organization with respect to purchases.[35] In order for 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 that the contractor is purchasing "as agent for the exempt organization";
2. The exempt organization 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 exempt organization's status, along with a statement signed by an officer of the organization confirming the contractor's status as agent.[36]

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

THE RULES GOVERNING SALES TAX COMPLIANCE FOR CONTRACTORS WORKING IN NEW YORK STATE ARE COMPLEX AND FRAUGHT WITH PITFALLS.

Conclusion

As all of the above shows, the rules governing sales tax compliance for contractors working in New York state are complex and fraught with pitfalls. The scaffolding industry presents just one example of how many considerations can come into play in determining the nature and taxability of a transaction. A mischaracterization of a project as a capital improvement rather than a taxable repair (or vice versa) can result in substantial liability for a contractor in a subsequent audit — a fact demonstrated in the *L&L Painting* case. Thus, contractors doing any business in New York state should become familiar with at least the basic framework discussed here in order

to avoid common mistakes, which, depending on the scale of the project, can become very costly. ■

NOTES

[1] *Matter of L&L Painting Co., Inc.*, N.Y. Tax Appeals Tribunal, June 2, 2011. This case was litigated by Hodgson Russ LLP, the law firm at which the authors practice.

[2] N.Y. Tax Law § 1105(a).

[3] N.Y. Tax Law § § 1105(b)(3),(5).

[4] N.Y. Tax Law § § 1105(b)(3)(i), 1105(b)(5).

[5] See 20 NYCRR § 541.1(d).

[6] See 20 NYCRR § 541.1(b).

[7] N.Y. Tax Law § § 1101(b)(4), 1119(c).

[8] N.Y. Tax Law § 1101(b)(9)(i).

[9] See e.g., *Matter of Rochester Gas and Electric Corp. v. N.Y. State Tax Commission*, 128 A.D.2d 238 (3d Dept. 1989) (holding $140,000 heaters with a 15-to-20 year useable life installed on steam boilers added value and prolonged the life of a utility plant); *Matter of Dairy Barn Stores*, N.Y. Tax Appeals Tribunal, Oct. 5, 1989 (holding $10,000 freezers installed at a mini-market added sufficient value to the premises).

[10] See e.g., *Matter of Raised Computer Floors, Inc. v. Chu*, 116 A.D.2d 958 (3rd Dept. 1986) (holding a raised flooring system did not meet the "permanently affixed" test, because even though panels were bolted to the existing floor, the panels could be removed and reused elsewhere).

[11] See *Matter of Supermarket General Corp. Pathmark Stores*, N.Y. Tax Appeals Tribunal, Nov. 9, 2006.

[12] *Ibid.*

[13] See *Matter of Gem Stores, Inc.*, N.Y. Tax Appeals Tribunal, Oct. 14, 1988.

[14] 20 NYCRR § 527.7(b)(4).

[15] *Ibid.*, ex. 9.

[16] See *Matter of F.W. Woolworth and Co.*, N.Y. Tax Appeals Tribunal, Dec. 3, 1993.

[17] See *Matter of Nu-Look Specialists, Inc.*, N.Y. Tax Appeals Tribunal, Nov. 3, 1988; *Op. cit.* note 1.

[18] See 20 NYCRR § 527.7(a), examples.

[19] 20 NYCRR § 541.8(a).

[20] *Ibid.*

[21] See *Yates Group, Ltd.*, TSB-A-92(71)S, Oct. 22, 1992.

[22] See TSB-A-12(18)S, Aug. 3, 2012.

[23] 20 NYCRR § 526.7.

[24] 20 NYCRR § 541.9(c)(1)(iv).

[25] *Op. cit.* note 22.

[26] See *Matter of Flah's of Syracuse, Inc.*, 89 A.D.2d 729 (3rd Dept. 1982); TSB-M-83(17)S, June 15, 1983.

[27] *Ibid.*

[28] *Op. cit.* note 26.

[29] *Op. cit.* note 11.

[30] 20 NYCRR § 541.5(b)(4)(i).

[31] 20 NYCRR § 532.4(b)(2)(i).

[32] 20 NYCRR § 541.5(b)(4)(iii).

[33] 20 NYCRR § § 541.3(d)(1),(3).

[34] 20 NYCRR § § 541.3(d)(2)(i)-(iii).

[35] See 20 NYCRR § 541.3(d)(4)(i).

[36] *Ibid.*

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