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The Nuts and Bolts of Capital Improvements in New York

by *Timothy P. Noonan and Joshua K. Lawrence*

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Last year our firm litigated and won an important case in the capital improvement area, in which we successfully argued that a bridge painting project in New York City met all the required tests for capital improvement states in New York.[1] That case immediately raised many interesting questions about the taxable status of other potentially nontaxable construction projects and the issues arising in these kinds of cases. Indeed, for sales tax practitioners, some of our most challenging audit issues continue to surface in the area of contractors and the construction business. But regardless of how complex these issues may get, somewhere at the foundation of the dispute lies the question whether the work in question constituted a capital improvement to real property. Here in New York state, capital improvements and the attendant tax burdens or exemptions represent one of the more litigated areas of the sales tax law and often the most frustrating aspect of a sales tax audit. And for contractors and real property owners, the tax consequences of mischaracterizing a project as a capital improvement rather than a repair or other taxable service can be significant, especially on large-scale projects.

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So with several notable developments arising in the law as recently as last year, we thought it was an appropriate time to provide a nuts-and-bolts overview of the sales tax treatment of capital improvements in New York.

Background

Construction work presents a unique problem in the sales tax paradigm. Although retail sales of tangible personal property trigger sales and use taxes, sales of real property generally don't. So what happens when a construction contractor melds tangible personal property and labor into a single end product: a building or other improvement to real property? The Illinois Supreme Court may have stated the issue the most succinctly: "The process or employment engaged in by a builder results in destroying the identity of the material as personal property and converting it into real estate."[2] In other words, a construction contractor is not treated as reselling a bundle of steel, nails, nuts, and bolts; rather, the contractor is selling the sum of those parts, that is, new, nontaxable real property.

New York shares this view in its approach to capital improvements, with the consequences generally being that: (1) a contractor's charges to a customer for completing a capital improvement are

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[1]*Matter of L&L Painting Co., Inc.*, Tax Appeals Tribunal, June 6, 2011. For the decision, see *Doc 2011-12637* or *2011 STT 114-17*.

[2]*G. S. Lyon & Sons Lumber & Mfg. Co. v. Dept. of Revenue*, 23 Ill.2d 180, 183 (1961).

excluded from sales tax; and (2) a contractor's purchases of property (and services) incorporated into the improvement are generally deemed taxable retail purchases of tangible personal property, and thus the contractor can't be treated as a reseller of those services.[3] However, as will be discussed in this article, there are numerous considerations that apply to scenarios common to the construction industry.

Although New York's tax law attempts to define the term "capital improvement," the statutory definition by no means provides a bright line. That's why it is critical for any practitioner who deals with these issues to fully understand the test for a capital improvement, as well as the various consequences of that designation.

New York's Three-Prong Test

New York sets forth a statutory, three-prong test for determining whether an addition to or alteration of real property constitutes a capital improvement. But before we discuss that test, it is important to know the framework in which it exists and the purpose it serves.

New York imposes tax on retail sales of tangible personal property. New York also taxes some services enumerated in the tax law. These include the services of "installing tangible personal property"[4] and "maintaining, servicing or repairing real property."[5] However, capital improvements are statutorily excluded from the scope of both those services. Taxable installation services do not include charges "for installing tangible personal property, which when installed, will constitute an addition or capital improvement to real property."[6] Also, tax is imposed on "maintaining, servicing or repairing" real property, "*as distinguished from adding to or improving such real property . . . by a capital improvement*."[7]

That brings us to the statutory definition. Section 1101(b)(9)(i) of New York's tax law defines a capital improvement as "an addition or alteration to real property" that:

- substantially adds to the value of or appreciably prolongs the useful life of the real property;
- 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
- is intended to become a permanent installation.

Because the sales tax regulations do not elaborate on these three elements, the interpretation of the test has developed primarily through case law. Significantly, courts have determined that this three-prong test does not represent a discrete *exemption* from tax — one that would have to be construed narrowly against the taxpayer under statutory construction rules — but rather that the test is a step in determining whether a service falls within the scope of a taxable installation, maintenance, or repair service.[8] That distinction is critical because it confirms that the capital improvement test must be construed broadly in favor of the taxpayer when applied to a particular fact pattern.[9]

Interpreting and Applying the Capital Improvement Test

The 'End Result' Test

Applied to a single addition or alteration, the test is fairly self-explanatory; however, when a project involves various services performed on a building or real property, New York's regulations instruct that the test is to be considered in light of the end result of those services. More specifically:

> 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.[10]

The regulations offer a simple but illustrative example: "The replacement of some shingles, or patching of a roof is a repair, but a new asphalt shingle roof is a capital improvement."[11]

In practice, the distinction is rarely that simple. For example, in *Matter of F.W. Woolworth and Co.*,[12] the New York State Tax Appeals Tribunal grappled with the proper treatment of a five-year "exterior maintenance" project on a historic New York City skyscraper. The project involved inspecting each and every exterior terra cotta tile on the 40-story building, along with the masonry and steel behind the tiles, and replacing or repairing both as needed. The Department of Taxation and Finance argued that regardless of the large scale of the project and its $2 million price tag, the activities were in the nature of a repair and a "partial" replacement of the building's exterior and thus could not be considered a capital improvement. The tribunal disagreed, affirming an administrative law judge's decision that not only did the activities meet the three prongs of the statutory

[3]*See* 20 NYCRR sections 541.1(b),(c).
[4]N.Y. Tax Law section 1105(c)(3).
[5]N.Y. Tax Law section 1105(c)(5).
[6]N.Y. Tax Law section 1105(c)(3)(iii).
[7]N.Y. Tax Law section 1105(c)(5) (emphasis added).

[8]*See Building Contractors Association, Inc. v. Tully*, 87 A.D.2d 909 (3rd Dept. 1982); *Matter of L&L Painting Co., Inc.*, *supra* note 1.
[9]*See Matter of L&L Painting*, *supra* note 1.
[10]20 NYCRR section 527.7(b)(4).
[11]*Id.*, Ex. 9.
[12]N.Y. Tax Appeals Tribunal, Dec. 3, 1993.

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definition individually, but also that they satisfied the end result test when viewed in their entirety.

Woolworth also reaffirmed two other critical points relevant to the three-prong test.

First, despite the test's application to additions or alterations to real property, there is no fourth prong inherent in the language requiring that the property be enlarged or literally added onto in order to qualify. In *Woolworth*, the restoring and *replacing* of existing building exterior components was found to qualify as a capital improvement. Ten years earlier, New York's Appellate Division held that even the service of removing construction debris from the site of a capital improvement would qualify as a part of the improvement under the end result test.[13]

If an installation or service meets the test for a capital improvement, it is a capital improvement for tax purposes.

The second critical point regarding the application of the three-prong test — raised in *Woolworth* but established years earlier by the tribunal — is that if an installation or service meets the test for a capital improvement, it is a capital improvement for tax purposes. That is so even if the work involves elements common to maintenance and repair. As the tribunal held in *Matter of Nu-Look Specialists, Inc.*:

> If . . . the determination based on the facts presented is that the activities meet the statutory definition of a capital improvement, then, under the "test" it is a capital improvement. The regulation does not suggest that an activity whose end result satisfied the definition of a capital improvement could nonetheless be a taxable maintenance or repair service.[14]

The issue in *Nu-Look* was whether the work of refacing existing cabinets in a home (that is, removing and replacing existing cabinet drawers and doors) could technically meet the three prongs of the test yet still be viewed as the servicing or maintenance of real property. The tribunal, having agreed that the work added value and resulted in improvements that were permanently affixed and intended to be permanent under the test, stated that it found "nothing in Tax Law or regulations of the Commissioner to indicate that a service which has been found to meet the definition of a capital improvement requires additional proof to remain excluded from tax."

Just last year, the tax department tried to relitigate this issue in the *L&L Painting* case mentioned above, in which it argued that a job that otherwise met the three-part definition still failed to qualify as a capital improvement.[15] But the tribunal reaffirmed *Nu-Look*, holding that based on the statutory test and end result test, the complete removal and replacement of the corrosion-resistant paint on a steel highway bridge constituted a capital improvement, *regardless* of the fact that the tax department's regulations cite painting as an example of taxable maintenance to real property.[16]

This concept — that capital improvement cases live and die by the three-prong test — is critical for practitioners, especially considering the department's efforts to mechanically categorize almost every common service and installation to real property as either a taxable repair, maintenance, or installation service or an exempt capital improvement.[17] As the tribunal has emphasized, capital improvement determinations are made on a case-by-case basis, focusing on the nature of the improvements or alterations at issue.[18]

With that in mind, let's take a closer look at each element of the capital improvement test.

The Three Tests

Adds Value/Prolongs Life

Proving that an addition to real property "substantially adds to the value of or appreciably prolongs the useful life of the real property" would seem a fairly straightforward test. And the courts have indeed interpreted that prong of the test as a fairly simple one to meet. However, as explained below, issues concerning "value" may arise in the case of leasehold improvements made by tenants.

To determine whether an addition or alteration adds to the value of real estate, courts have typically turned to an examination of the cost and installation

[13]*Building Contractors Association*, *supra* note 8; *see also Matter of L&L Painting Co.*, *supra* note 1 (holding that the complete removal and replacement of the corrosion-resistant paint on a steel highway bridge qualified as a capital improvement).

[14]N.Y. Tax Appeals Tribunal, Nov. 3, 1988.

[15]*Matter of L&L Painting, supra* note 1.

[16]The regulations define maintaining, servicing, or repairing real property as: "all activities that relate to keeping real property in a condition of fitness, efficiency, readiness or safety or restoring it to such condition. Among the services included are services on a building itself such as painting; services to the grounds, such as lawn services, tree removal and spraying; trash and garbage removal and sewerage service and snow removal." 20 NYCRR section 527.7(a).

[17]*See* N.Y. Dept. of Taxation & Fin. Pub. No. 862, *Sales and Use Tax Classifications of Capital Improvements and Repairs to Real Property*, Apr. 1, 2001.

[18]*Matter of Empire Vision Ctr., Inc.*, N.Y. Tax Appeals Tribunal, Aug. 23, 1990.

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expenses of the annexed items themselves.[19] Thus, for example, the tribunal had little difficulty in finding that a $2 million roller coaster installed on property owned by an amusement park was found to substantially add to the value of the park.[20] But even smaller-scale additions have been found to meet the test; for example, in *Matter of Dairy Barn Stores*,[21] the addition of a $10,000 to $12,000 refrigerator unit substantially added to the value of a grocery store, and additions of $5,000-$7,000 security/surveillance systems to a variety store satisfied the adds value prong.[22]

The same liberal threshold had been applied to determining whether an addition appreciably prolongs the useful life of real property. As with the test for value, courts have often looked at the useful life of the annexed items themselves. For example, the first prong of the test was deemed satisfied for a gas and electric utility that installed new "superheaters" on its boilers, because the heaters themselves (in addition to costing $140,000) would last for 15 to 20 years.[23]

Permanently Affixed

The second prong of the test presents another objective inquiry, requiring a showing that the addition or alteration "becomes a part of the real property or is permanently affixed to the real property so that removal would cause material damage to the property or the article itself." As the language suggests, the permanent affixation inquiry is focused not merely on whether the article is affixed (for example, screwed, bolted, and so on) to the land or building, but whether its removal would damage either the property or the article itself. This notion (indeed much of the capital improvement test itself) derives from the common law of "fixtures" governing various landlord-tenant matters and related areas. As the tribunal put it in *Matter of Gem Stores, Inc.*:

> To change the character of a chattel to one of a fixture requires more than nailing or bolting it to the floor or to a wall or ceiling. This is normally a precaution against damage of the chattel itself and for the safety of individuals and not an intention to surrender ownership thereof.[24]

As with the adds value prong above, the inquiry of whether the removal would cause damage frequently focuses on the article itself. For example, in *Matter of Raised Computer Floors v. Chu*,[25] the appellate division found that even though a raised flooring system installed in an office building was anchored to the existing floor by bolts or glue, the system failed the test because flooring components could be removed and reinstalled elsewhere without damage resulting from their removal. Conversely, when property is installed and must be cut apart or otherwise damaged to remove it, courts have found the permanently affixed prong to be satisfied.[26] The same was true for the protective coating that was applied to the Pulaski Bridge in the *L&L Painting* case. Obviously, although removal of the coating might not necessarily cause material damage to the bridge, it would destroy the coating. And that's all that is required to meet this test.

Intended as a Permanent Installation

Although the first two prongs of the test focus on arguably objective factors, the third prong of the test considers the *subjective* intent surrounding the addition or alteration. For this, the courts have again turned to the law of fixtures, with the acknowledgment that objective factors are still necessary to determine that intent. As the tribunal has said:

> 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 if the annexation was to make the unit a permanent part of the freehold.[27]

More simply put, the value of an item and its mode of annexation alone can't determine whether an improvement is intended to be permanent. Other

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[19]*See, e.g.*, *Matter of Rochester Gas and Electric Corp. v. N.Y. State Tax Commission*, 128 A.D.2d 238 (3rd Dept. 1989); *Matter of Top Shelf Deli, Inc.*, N.Y. Tax Appeals Tribunal, Feb. 6, 1992; *Matter of Emery Air Freight Corp.*, N.Y. Tax Appeals Tribunal, Oct. 17, 1991; *Matter of Dairy Barn Stores, Inc.*, N.Y. Tax Appeals Tribunal, Oct. 5, 1989; *Matter of Gem Stores, Inc.*, N.Y. Tax Appeals Tribunal, Oct. 14, 1988.

[20]*See Matter of Amusements of WNY, Inc.*, N.Y. Tax Appeals Tribunal, May 26, 2011. For the decision, see *Doc 2011-11909* or *2011 STT 110-24*.

[21]*See Matter of Dairy Barn Stores, supra* note 19.

[22]*See Matter of Gem Stores*, *supra* note 19.

[23]*See Matter of Rochester Gas and Electric Corp.*, *supra* note 19.

[24]*See Matter of Gem Stores*, *supra* note 19.

[25]116 A.D.2d 958 (3rd Dept. 1986).

[26]*See Matter of Emery Air Freight*, *supra* note 19 (removal of freight handling systems would require they be cut apart with acetylene torches and scrapped); *Matter of Dairy Barn Stores*, *supra* note 19 (removal of refrigeration systems would require cutting them apart and reassembling them, which would "damage their insulating capacity and render them useless"); *Matter of L&L Painting Co.*, *supra* note 1 (removal of multilayer corrosion-resistant paint system on a steel bridge would require sandblasting it away, damaging the paint system and the underlying steel).

[27]*See Matter of Dairy Barn Stores*, *supra* note 19 (citing *Vorhees v. McGinnis*, 48 N.Y. 278 (1872); *Marine Midland Trust Co. v. Ahern*, 16 N.Y.S.2d 656 (N.Y. Sup., Dec. 28, 1939).

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considerations include whether the person making the addition is an owner or tenant (the problem of leasehold improvements is a big issue here, and will definitely be a topic for a future article) and the "applicability . . . of the unit to the use to which the property is being put."[28] To illustrate the latter factor, the appellate division found that the superheaters installed onto the gas and electric utility's boilers discussed above not only added value and were permanently affixed but also became an integral part of the boilers, which were, in turn, integral to the utility's business.[29] The same applied to the refrigeration units installed by a convenience store discussed above in *Matter of Dairy Barn Stores*. The tribunal found that the nature of the business (selling eggs, milk, ice cream, and so on) was proof that the units "were adapted and essential to the use to which the building on the property was applied" and thus were intended to become a permanent part of the property.[30] Thus, an important component in proving the permanent intent prong is to demonstrate that the installation is particularly suited to the permanent use of the property.

Audit Issues

Sounds easy, right? Unfortunately, although it's relatively easy to lay out the different rules and how they should work theoretically, it is quite another thing to apply the concepts on the ground, in the throes of a difficult sales tax audit. In fact, for sales tax practitioners and their clients, there may be no audit area that can be as frustrating as the capital improvement area, both because of the amount of documentation required to establish the nature of some projects and the subjective application of the capital improvement tests by individual auditors. Those issues don't often present themselves when you would think, such as in an audit of a contractor or a builder, taxpayers who presumably have to deal with capital improvement issues all the time. Instead, those issues come up in almost every run-of-the-mill audit. A law firm building new space. A hotel renovating a floor. A software company improving space for servers. A restaurant building an addition for a kitchen. In all those audits, the capital improvement issue will rear its ugly head. Here are some particular problems and issues that can arise:

- *End Result Test.* There is a nice discussion of this end result test above, and it really seems like an argument that makes a lot of sense. Of course, we hope that most of what you read in this column makes a lot of sense. Unfortunately, the test is all but ignored in everyday sales tax audits. We have represented several taxpayers for which the very nature of the job screams "capital improvement," such as a company building new headquarters in a free-standing building or a hotel renovating an entire floor. Auditors, however, won't accept that this job is automatically a capital improvement to real property. Instead, it often becomes a nitpick fest, with auditors combing through every contract, subcontract, purchase order, change order, invoice, and so on to find something — anything — that could fall outside the context of the capital improvement. One taxpayer we represented was constructing a brand-new building and, as part of the new building, had a security system installed. Auditors questioned whether some aspects of the security installation didn't qualify as capital improvements because some components of the system were not wired into the building's electrical system. But taken down to this granular level, there are many "improvements" added to a new building that wouldn't, standing alone, meet the capital improvement test. Think about a faceplate covering an outlet, or a door attached to an interior office. Clearly these individual "improvements" wouldn't on their own meet the capital improvement test, but shouldn't the analysis be different if the end result is a capital improvement?
- *Permanently Affixed.* When faced with a capital improvement issue, be prepared to show that the item being added would cause material damage to the underlying property (or to the item itself) if removed. Although that concept sounds relatively straightforward, proving that it is true is another problem altogether. What kind of damage is enough damage? What if an item is simply bolted to a wall? Proving material damage is often subjective, and that's never a good situation to be in during an audit.
- *Credits?* So what happens if an auditor successfully establishes that some portion of your improvement project that you paid for is taxable? Will there be a credit for taxes paid by the contractor? Unfortunately, it's not that easy, regardless of which taxpayer we are talking about. In the case of contractors engaged in capital improvement projects, they generally are required to pay tax on the purchases of materials. And although no tax is separately charged to its customers (assuming the job is treated as a capital improvement), presumably the contractor nonetheless passes the tax through to its customer in the form of increased prices. If, as a result of the audit, an auditor determines that a job should have been taxable, is there any credit for this tax paid? Certainly not for the contractor's customer, because the customer itself didn't pay the tax (even though

[28] *Id.*
[29] *See Matter of Rochester Gas and Electric, supra* note 19.
[30] *See Matter of Dairy Barn Stores*, *supra* note 19.

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the customer bore the economic incidence of the tax). What about the contractor? Possibly, but we doubt that the tax department is going to notify the contractor that it may have overpaid its tax. Moreover, often the contractor's statute of limitations has run anyway, so the tax department ends up getting the tax twice.

- *Capital Improvement Certificates.* Many of our clients who hire contractors to provide what they thought were capital improvements to their real property take solace in the fact that a capital improvement certificate is issued to the contractor in connection with a job. Unfortunately, that certificate won't provide the customer with any additional protection in the event of the audit. Capital improvement certificates are there to relieve the vendor of its obligation to prove that the requirements of the capital improvement tests are met. If a contractor receives a properly completed capital improvement certificate, the contractor is off the hook even if the job is later deemed taxable. However, the same protection doesn't apply to customers. They are required to prove the nontaxability of the job even if a capital improvement certificate is issued. In the same way, however, no negative inference should be drawn if a capital improvement certificate is not issued. Be careful in audits, because auditors will sometimes assert that the failure to provide a capital improvement certificate is somehow harmful to a customer trying to prove the nontaxability of a job. Clearly, however, providing a certificate is not a requirement.

Conclusion

It's not all bad news. The rules, as laid out above, are understandable. Taxpayers who fight these cases often win, as we learned firsthand in *L&L Painting*, in which we were able to prove that a bridge painting project qualified as a capital improvement. But the subjectivity of the tests creates fertile ground for difficulties in sales tax audits. So as you go into your next sales tax audit, be prepared to address capital improvement issues, no matter what type of business the taxpayer is engaged in. ✰

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