taxanalysts noonan's notes on tax practice

Repairing New York's Capital Improvement Rules

by Timothy P. Noonan

In an article earlier this year, I outlined one of the more vexing issues for practitioners in the sales tax area: the sales tax status of capital improvements in New York.[1] That area of law, developed in large part through case law over the past 40 years, is wrought with confusion, inconsistencies, and ambiguity. As practitioners, perhaps we shouldn't complain, because circumstances like this ensure plenty of work for us! But as I watch my clients struggle through audit after audit, it becomes apparent that there should be a better way. This article will examine one solution.

Background: Capital Improvement Law in New York

Let's start with some basic background. Under New York's sales law, tax is imposed on the performance of some enumerated services. Included here are services to repair and maintain real property and the service of installing tangible personal property.[2] The law, however, has an important exclusion: Tax is not imposed on services that result in a capital improvement to real property.[3] The tax law defines the term "capital improvement" as any "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.[4]

Those tests are based largely on concepts from the law of "fixtures," which governs when a person (that is, a tenant) surrenders items of property by making them a permanent part of the real property. For sales tax purposes, a contractor completing a capital improvement is not viewed as selling individual items of tangible personal property to its customer along with the labor to install them; rather, the contractor is viewed as selling the end result of its services; that is, new real property, something that falls outside the scope of the sales tax.

Thus, the tests look at both objective and subjective factors to determine how the property is affixed and whether it can be viewed as a permanent addition. The first prong of the test is concerned with the effect of the addition, that is, whether it substantially adds to the value of the property or increases its useful life. This first test focuses chiefly on the value and useful life of the articles *themselves*, making it a fairly straightforward, objective inquiry. The second prong of the test — whether the property is "permanently affixed" to the property so that its removal will materially damage the real property or the addition itself — is generally less concerned with how the property is secured (that is, bolted, glued, nailed, and so on) and more concerned with the extent of the damage that its removal would cause. For example, when an addition could be removed essentially intact and installed on another project, it would generally not qualify. Although the first two prongs of the test are purely objective tests, the third test is a subjective one: whether the property is intended to become a permanent installation. Although this prong of the test focuses on the subjective intent of the customer in

---

[1] Timothy P. Noonan and Joshua K. Lawrence, "The Nuts and Bolts of Capital Improvements in New York," *State Tax Notes*, Feb. 28, 2012, p. 633, *Doc 2012-1857*, or *2012 STT 34-4*.

[2] N.Y. Tax Law section 1105(c)(3),(5).

[3] *See id.*

[4] N.Y. Tax Law section 1109(b)(9)(i).

carrying out the addition, objective factors such as whether the customer owns the real estate or is just a tenant, and whether the addition is something particularly suited to the particular property, are used to deduce that intent.

When work on real property doesn't involve a single, discrete installation (for example, a new furnace), but rather a combination of services (for example, a restoration project), the regulations provide that it is the end result of all services that governs the determination.[5] Thus, if the end result of the work meets all three prongs of the statutory test, it is a capital improvement, regardless of whether some aspects of the work could qualify as repair or maintenance.

Problems With the Three-Part Test

Outlined that way, the test doesn't appear to be that confusing. We have a test. There are three parts, as well as an end-result test. What's the problem?

The problem arises in the application of the test, and that so much of the "law" in this area has been determined through case-by-case facts — allowing any good practitioner the ability to make the case for nontaxability, and any good auditor to make the case for taxability.

> ***Look at the body of case law and you'll see that essentially anything adds value or prolongs the useful life of the property.***

For instance, it seems apparent that the adds value test has been basically litigated out of existence. Look at the body of case law and you'll see that essentially anything adds value or prolongs the useful life of the property. Examples of what appear to be relatively modest additions that have been found to have value include a $10,000 to $12,000 refrigeration unit installed at a convenience store[6] and a $5,000 to $7,000 security/surveillance system at a variety store.[7]

But even this simple test has recently created some additional questions. For instance, the Tax Appeals Tribunal in 2006 held that the addition of what appeared to be a significant refrigeration system for a supermarket didn't pass the adds value test because the work was on leased property, and it wasn't clear whether the next tenant (someone other than a supermarket) could potentially benefit from the refrigeration and piping facilities being installed. We can argue the merits or demerits of that interpretation (and I think there are many demerits), but I've seen this play out in more unusual situations. Recently, auditors argued that a professional service firm's construction of office space for itself on leased floors of a newly constructed office building didn't pass the adds value test because every new tenant wants to "change things around" when they move in.

Different questions arise regarding the next prong of the test — regardless of whether the installation is affixed to the property so that removal will cause damage to the item or the underlying property itself. If something is bolted into the property, its removal "obviously" can cause damage to it or the underlying property, but do we get an entirely different answer if the contractor chooses to affix the installation with glue? Indeed, here's where we get into the mind-numbing argument about whether a hole in the wall is a significant enough hole to cause material damage. The main problem with this test is that it relies on the judgment of individual taxpayers and individual auditors in determining whether there would be "material damage" to property. In practice, that's simply far too ambiguous a test to apply.

The same type of problem arises with the third test — whether the installation is intended to be permanent. First, understand that for purposes of that test, permanent really doesn't mean *permanent*, because there are cases holding that an installation that lasts 20 years is deemed to be "permanent."[8] Indeed, we've been comfortable (and successful) arguing that "permanent" in the context of the capital improvement test doesn't mean *forever;* it just means that the owner intends the improvement itself to last for the entire useful life of the improvement.[9] That's why something like the bridge-coating job in *L&L Painting* could rise above a mere "repair" or "maintenance" project and constitute a capital improvement (while obviously meeting the other two tests). Whatever the case, the question of what the owner intends regarding a particular improvement becomes fertile ground for more ambiguity and difficulty in audits.

Where does that leave us? The capital-improvement test is obviously inadequate to cover

---

[5]20 NYCRR section 527.7(b)(4).

[6]*Matter of Dairy Barn Stores, Inc.,* N.Y. Tax Appeals Tribunal, Oct. 5, 1989.

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

[8]*See, e.g., Rochester Gas & Electric Corp. v. N.Y. State Tax Commission*, 128 A.D.2d 238 (3rd Dept. 1989); *Matter of L&L Painting*, N.Y. Tax Appeals Tribunal, May 2011; *Matter of Dairy Barn Stores, supra* note 6.

[9]*See Matter of Gem Stores, supra* note 7 (citing *Troncillito v. Farm Family Mutual Insurance Company*, 89 Misc 2d 844, 846 (1977), *aff'd,* 63 A.D.2d 1042 (3rd Dept. 1978), *aff'd,* 47 NY2d 736 (1979)).

the variety of situations that arise when taxpayers are doing work on real property. That leads to an incredible amount of uncertainty for taxpayers, who end up being unable to adequately budget for the sales tax potentially due on construction jobs. It also ends up resulting in protracted audits in which time is wasted — both by auditors and by taxpayers — in the forensic interpretation and analysis of a seemingly simple test. And finally, it can result in a significant double-tax problem. Contractors engaged in this type of work are generally unable to purchase items on a tax-free basis. They can obtain credit for taxes paid only if it is later determined that the work they are doing happens to *not* be a capital improvement. But if that determination is not made until years later (as is often the case), the statute of limitations for making that claim may well have passed. So there's a real potential for both sides to get whipsawed.

> ***The question of what the owner intends regarding a particular improvement becomes fertile ground for more ambiguity and difficulty in audits.***

So it seems that the current set of rules raises problems for everyone involved. Companies like hotels and contractors are engaged in endless battles with Department of Taxation and Finance auditors in which both sides are trying to recreate history and interpret the character of projects that were completed years earlier.[10] That is incredibly frustrating to taxpayers, many of whom would simply prefer certainty. That frustration isn't exclusive to taxpayers, however. Tax department auditors also spend an inordinate amount of time in many sales tax audits trying to figure out how to apply the capital-improvement tests. I have heard from auditors that they spend more time on those questions than on any other area in audits, and often without productive results. It just takes so much time, effort, and negotiation to battle through those questions. And when taxpayers are willing to take on the fight (such as companies like *L&L Painting*), the tax department often ends up on the losing side.

Another Way?

There's got to be a better way. The idea behind the capital improvement test is good: We don't want to tax services to real property that result in capital improvements because, in effect, that would be akin to taxing real property itself. Basically no state tax department does that (at least in the sales tax context). But perhaps there's an easier way to accomplish that goal.

New York actually considered one rather drastic solution a couple years ago, which was essentially a "throw the baby out with the bath water" approach. In his 2010 Executive Budget Proposal, then-Gov. David Paterson proposed an amendment that would have limited the definition of a capital improvement to work that constituted a new construction, a new addition, or a total reconstruction.[11] Admittedly, that would cure much of the ambiguity that arises in the capital improvement context. But it would have done so at a high price tag, with revenue estimates at the time approaching $160 million a year.[12] A tax increase like that, for good reason, wasn't in the cards in 2009. The proposal didn't pass.

Other states have tried their hand at more revenue-neutral solutions. Florida, for example, makes no statutory distinction between repair-and-maintenance work and capital improvement work. Thus, almost all substantive contracting services performed on real property — including services to "erect, construct, alter, repair, or maintain" the property — qualify as "real property contracts."[13] In those transactions, the contractor is treated as the consumer of all materials, tools, and supplies used to carry out the work (regardless of whether the work is a repair, a maintenance project or a new structure), and the customer owes no tax.[14] Florida further simplifies things by statutorily listing more than 40 types of projects that will typically qualify as real property contracts, as well as 17 activities that would not.[15] Although the murkier "fixture"-versus-non-"fixture" question can still arise on contracts in which an appliance or equipment is merely offered along with its installation, Florida tackles the question of "mixed" contracts containing both real property services and sales of non-fixture items by providing a straightforward "predominance" test: If the contract is predominantly a real property contract, the whole contract will be treated as such (and vice versa).[16]

Idaho takes a similar approach, treating nearly all substantive services to real property by contractors — including repairs — as improvements to the

[10]Hotels renovate and improve their properties on a consistent basis to help maintain their customer loyalty base and to attract new customers. That makes hotels somewhat unique, and a prime target for this antiquated sales tax application.

[11]Part PP of the 2009-10 Executive Budget Proposal.

[12]*See* Memorandum in Support of Part PP, Executive Budget Proposal.

[13]*See* Fla. Admin. Code Ann. sections 12A-1.051(2)(d), 12A-1.051(4).

[14]*See id.*

[15]*See* Fla. Admin. Code Ann. section 12A-1.051(17),(18).

[16]*See* Fla. Admin. Code Ann. section 12A-1.051(8).

property, with the result being consistent treatment for both contractors (they pay use tax on all building materials, tools, and supplies) and customers (they do not pay tax).[17] As in Florida, the only time the fixture-versus-non-fixture question arises is in determining whether the contractor is merely making a "retail sale," including installation, of a non-affixed piece of equipment or an appliance rather than a true service to the real property itself.[18]

> ***Under Arizona's approach, tax is uniformly imposed on the same end of the transaction in almost every case, eliminating much of the confusion over who bears the responsibility for the tax.***

Arizona's approach may be the most interesting, though. It takes the opposite approach to the models above and *imposes* a tax on almost all real-property contracting work under a single banner of "prime contracting" services.[19] Yet the tax is imposed at a reduced rate of only 65 percent of the gross revenue from those services.[20] Under Arizona's model, any prime contractor that oversees a project to "alter, repair, add to, subtract from, improve, move, wreck or demolish," real property pays the gross receipts tax (with numerous available exemptions from the taxable base).[21] Correspondingly, no tax is due on the services of subcontractors performing work under the supervision of a prime contractor.[22] Nor is tax due on sales of building materials or other property to a contractor (or the prime contractor) that will be incorporated into the prime contractor's work.[23] Thus, under Arizona's approach, tax is uniformly imposed on the same end of the transaction in almost every case, eliminating much of the confusion over who bears the responsibility for the tax — that is, vendors, subcontractors, prime contractors, or customers.

A New Percentage-Based Test?

Another interesting approach has been making its way around in tax practitioner circles in New York over the last few years. That approach looks somewhat like Arizona's "prime contracting" tax, in which taxability is based on more objective and certain criteria without the need to resort to confusing and difficult-to-administer tests.

Under this approach, broadly speaking, *all* work on real property (whether it be maintenance, repair, or a "capital improvement") is taxed, but essentially at a lower rate, with only a set percentage of the receipts from those services being taxable. That would obviously expand the tax base to cover many categories of now-exempt real property work. In essence, the capital improvement exclusion in Tax Law section 1105(c)(5) would go away. The change would also reduce the amount of tax currently levied against other types of now-taxable real property work under Tax Law section 1105(c)(5), since under the proposal, all work on real property would receive special treatment. Also, contractors and others performing services related to real property would be entitled to purchase all materials sales-tax-free, as sales for resale — whereas now, those vendors cannot purchase anything for resale.

Here are some of the important nuts and bolts:

- **Exclusion for Purchases of Materials/Component Parts**: Contractors are now generally limited from purchasing any items for resale, except in cases of work for exempt entities or in other limited circumstances. That would be changed. Contractors would be entitled to purchase all raw materials sales tax-free. Contractor supplies, tools, and other items consumed by the contractor would, of course, remain fully subject to tax.
- **Tax on *All* Real Property Work**: *All* work on real property would be subject to sales tax, but not on the full contract price. Instead, tax would be based on a to-be-determined taxable percentage. The idea behind the percentage would be to have a number that ends up being "revenue neutral," meaning that the actual amount of taxes collected in the future should not be any different than current collections. This shouldn't be a tax cut or a tax increase. It would be designed as a "good-government" initiative. Perhaps a number in the 60 percent range would be sensible, though further study would be needed to ensure the number is revenue neutral.
- **No More 'Capital Improvement' Distinction.** Gone would be the days of exempt "capital improvement" projects. All work on real property, regardless of its nature, gets taxed on the agreed-on percentage.
- **Reduced Tax on Real Property Maintenance and Repair:** This works in the other direction as well. Work that, under current law, is now fully taxable would be subject to tax at the reduced percentage.
- **Sales of Tangible Personal Property:** It will remain the case, however, that in the course of performing real property work, a contractor will sell items of tangible personal property on

---

[17]*See* Idaho Admin. Rules section 35.01.02.012.01.
[18]*See* Idaho Admin. Rules section 35.01.02.012.05-.07.
[19]*See* Ariz. Rev. Stat. Ann. section 42-5075 *et seq.*
[20]Ariz. Rev. Stat. Ann. section 42-5075(B).
[21]*See* Arizona Rev. Stat. Ann. section 42-5075(B),(P).
[22]Ariz. Admin. Code R15-5-602(C)(1).
[23]Ariz. Rev. Stat. Ann. section 42-5061(A)(27).

Table 1.

Type of Project	Purchases of Materials	Purchases of Supplies	Sales Tax on Project
Construction of New Office Building	Nontaxable	Taxable	Sales tax due from owner on 60 percent of contract price.
Purchase and Installation of TVs and Other Audio/Visual Equipment	Nontaxable	Taxable	Fully taxable, since TV and AV equipment will remain tangible personal property after installation.
Repair Work on Homeowner's Roof	Nontaxable	Taxable	Sales tax due from owner on 60 percent of contract price.
Replacement of Homeowner's Roof	Nontaxable	Taxable	Sales tax due from owner on 60 percent of contract price.

a stand-alone basis, and that property will remain tangible personal property after the project is completed. That type of sale would remain fully subject to tax.

A chart illustrating some examples of how this would play out is included at Table 1. For purposes of the examples in the chart, we have assumed that the taxable percentage is statutorily defined at 60 percent. Again, whatever the percentage is, the goal would be for it to be revenue neutral.

The benefits to a proposal like this are numerous. No longer would there be protracted battles about the capital improvement tests. Contractors and property owners could plan with certainty about the tax effects of projects. That could effectively eliminate tax from the decision-making process when planning for a project, and whether it would be viewed as a repair, renovation, or capital improvement. The difficult and confusing provisions requiring contractors to pay tax on all purchases and claim credits later — which often leads to double-tax problems — would also go away. And sales tax auditors would no longer have to waste their time combing through construction records fighting about whether work "adds value" or is "permanent." Instead, they could spend their time on more productive efforts in the sales and expenses area. This proposal would replace the process with simplified and comprehensive guidelines, bring certainly to a complex issue, and allow the department to collect the tax upfront (on a timely basis) with less need for audits. That could have the side benefit of increasing revenue from those other areas — which auditors currently might not otherwise have time to address because of time wasted on capital improvement questions. And, of course, the more thorough the audit, the more likely it is that taxpayers will increase their compliance in all areas.

As stated by Michael Scott, former branch manager of the Dunder Mifflin Scranton branch on NBC's *The Office*, it's the proverbial "win-win-win" situation. Taxpayers win because the new rules would allow them more certainty in planning, less hassle in audits, and more assurance that double-tax problems will be avoided. The tax department wins because the new rules would provide clarity in an increasingly confusing area and increase auditor productivity. And I win because, well, I'm the one who came up with this darn good idea.

Conclusion

There is, perhaps, no more difficult an area in the state tax world than sales tax. Dig deeper, and you'll find so much confusion and ambiguity in the sales tax area in the context of real property work and capital improvements — especially in New York. This article outlines one idea for a solution. It is obviously just a starting point. But assuming all sides can agree on a way to do this in a revenue-neutral fashion — which seems like an achievable goal — it's an idea that deserves consideration. Indeed, most of my clients in this area aren't looking to avoid their tax responsibilities. They just want to know what those responsibilities are. They don't abhor more taxes per se; they abhor uncertainty about more taxes. We'll never be at the point where there will be absolute certainty in the sales tax area. It's just too difficult to legislate or regulate for all possible permutations. But here's one area where we can do better and make things clearer. It would be great if we could give it a go in New York. ✩

Noonan's Notes on Tax Practice is a column by Timothy P. Noonan, a partner in the Buffalo and New York offices of Hodgson Russ LLP.