

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-97((67)S
Sales Tax

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. S970811C

On August 11, 1997, the Department of Taxation and Finance received a Petition for Advisory Opinion from Hodgson, Russ, Andrews, Woods & Goodyear, LLP, 1800 One M & T Plaza, Buffalo, NY 14203-2391. Petitioner, Hodgson, Russ, Andrews, Woods & Goodyear, LLP, provided additional information pertaining to the Petition on September 11, 1997.

The issue raised by Petitioner is whether certain services purchased by Petitioner in connection with the reconstruction of two floors of its headquarters are for the installation of property which, when installed, constitute capital improvements to real property, and therefore are exempt from sales tax.

Petitioner submits the following facts as the basis for this Advisory Opinion.

Petitioner acquired a leasehold interest in the 15th, 16th, 17th, 18th and 20th floors of an office building (the "Building") to be used as Petitioner's headquarters. In the recent past, Petitioner occupied the 17th, 18th and 20th floors. Prior to its current lease including the 15th and 16th floors, Petitioner's headquarters staff was split between two offices in different buildings but in the same city.

As part of unifying Petitioner's headquarters staff in one building, Petitioner found it necessary to substantially remodel the space it would occupy in the Building, including the 15th and 16th floors it had recently acquired by lease. The lease contemplated such tenant improvements, and pursuant to the lease, the landlord consented that Petitioner as part of the approved project, remove and replace all fireproofing on the 15th and 16th floors. The original fireproofing contained asbestos, all of which was removed and disposed without incident.

The 15th and 16th floors were the first floors to be remodeled. Those floors were gutted, and all the fireproofing was removed. New fireproofing was applied, and the contractors constructed new interior walls and built-out the space in a fashion consistent with its intended use as a headquarters office. Petitioner then moved the occupants of the 17th and 18th floors down to the 15th and 16th floors in order to gut and rebuild the 17th and 18th floors in a manner similar to the 15th and 16th floors. The lease provided that at the end of its term, the improvements made on the 15th through 18th floors become the property of the landlord and Petitioner will not be permitted or required to remove such improvements.

Shortly after the 15th and 16th floors were occupied, it was discovered that there were serious problems with the new fireproofing (i.e., the fireproofing was found to be contaminated). The problem was sufficiently severe that the only feasible and appropriate remedy was to completely gut again the 15th and 16th floors, remove the fireproofing, replace it with new fireproofing,

and build out the space. Petitioner and its landlord agree that the reconstruction improvements on the 15th and 16th floors constitute "Initial Tenant Improvements" as such term is defined in the lease and Petitioner will not be permitted or compelled by the landlord to remove such improvements upon the termination of the lease. In connection with this work, Petitioner has hired (and will pay, with reimbursement from Petitioner's insurer) several contractors to perform the work. The build-out of the 15th and 16th floors includes insulation of the walls (fireproofing), installation or replacement of walls, installation of millwork, including baseboards, painting new walls, installation of heat, ventilation and air conditioning (HVAC) and plumbing, and floor covering. A generic description of the major contractors and the work they will perform is as follows.

1. "General Contractor" is the general contractor/construction manager on this project. General Contractor's work and billings on the project are in certain discrete areas generally described as follows: (a) an approximately \$1.2 million "build-out" phase of the project which is a not-to-exceed price, for contract work that will be performed on the 15th and 16th floors after the fireproofing is removed and new fireproofing is installed; (b) "change order" work in connection with the redesign and build-out of portions of the 17th floor as a result of Petitioner's need to reconfigure the 17th floor to approximate the 15th floor (e.g. library, administrative and computer services) to enable Petitioner to operate while work is being done on the 15th and 16th floors. Costs for the change order work include costs for additional architectural and engineering work in connection with redesigning the 17th floor to approximate the 15th floor, and a major amount of additional HVAC and electrical service to accommodate a change in the floor's use from office space to administrative and computer functions. These latter functions require a great deal more involved HVAC and electrical systems than the originally intended use of the 17th floor required (i.e. office space). The library, administrative and computer functions will remain on the 17th floor after all work has been completed. Petitioner and its landlord agree that the reconstruction improvements on the 17th floor constitute "Initial Tenant Improvements" as such term is defined in the lease and Petitioner will not be permitted or compelled by the landlord to remove such improvements upon the termination of the lease. Thus, the change order work is intended to be permanent; and (c) fireproofing removal and re-fireproofing, including project oversight, supervision, etc., related to the cost plus fee portion of the contract (performed primarily by General Contractor's subcontractor "Fireproofing Contractor"). In connection with General Contractor's work, it will salvage a small portion of the improvements on the 15th and 16th floors from the prior build-out, and to the extent possible reincorporate the salvaged parts (mostly doors and other hard-surface salvageable materials) in the current build-out. General Contractor's bill for this labor will include removal, cleaning and reinstallation of the salvaged materials and is likely to be roughly \$20,000.

2. "Fireproofing Contractor" is a subcontractor to General Contractor and is removing the existing fireproofing and installing the new fireproofing on a cost plus fee basis. Fireproofing Contractor's bills are passed through General Contractor to Petitioner (and on to Petitioner's insurer). As a component of General Contractor's contract for Fireproofing Contractor's work, General Contractor receives a 9% fee for its services, including responsibility for overall project supervision.

3. "Remediation Engineer" is the project engineer for the portion of the remedial work involving removing the existing fireproofing and installing the new fireproofing. In connection with this work Remediation Engineer performs air sampling and air quality assurance. Remediation Engineer is billing on an hourly basis and is passing through the cost of its consultants (air quality experts, microbiologists, laboratory testing and other disbursement expenses) on its monthly bill, along with a fixed percentage mark-up. A majority of Remediation Engineer's costs relate to hours spent on supervising the removal of the contaminated fireproofing and installation of the replacement fireproofing on the 15th and 16th floors.

4. "Architect" is the architect responsible for issuing architectural drawings, approving payments and inspecting the construction work after it is ultimately completed. Architect's fees will be calculated on an hourly basis, and are expected to be less than \$50,000.

Article 14 of Petitioner's lease provides, in part:

Subject to Tenant's rights in Article 16.00 [relating to tangible personalty and trade fixtures], all alterations, additions, fixtures, and improvements whether temporary or permanent in character, made in or upon the Premises either by Tenant or Landlord, will immediately become Landlord's property and at the end of the Term will remain on the Premises without compensation to Tenant. By notice given to Tenant no less than thirty (30) days prior to the expiration of this Lease, Landlord may require that Tenant remove any or all alterations, additions, fixtures and improvements which are made in or upon the premises subsequent to the ACM Removal and re-fireproofing and the installation and construction of the HVAC Improvements and the Initial Tenant Improvements to the 15th, 16th, 17th and 18th Floors of the Building... .

Applicable Laws and Regulations

Section 1101(b)(9) of the Tax Law provides, in part:

Capital improvement. (i) An addition or alteration to real property which:

(A) Substantially adds to the value of the real property, or appreciably prolongs the useful life of the real property; and

(B) Becomes part of the real property or is permanently affixed to the real property so that removal would cause material damage to the property or article itself; and

(C) Is intended to become a permanent installation.

* * *

(iii) Notwithstanding the provisions of subparagraph (i) of this paragraph: (A) Floor covering, such as carpet, carpet padding, linoleum and vinyl roll flooring, carpet tile, linoleum tile and vinyl tile, installed as the initial finished floor covering in new construction or a new addition to or total reconstruction of existing construction shall constitute an addition or capital improvement to real property, property or land; and

(B) Floor covering, such as carpet, carpet padding, linoleum and vinyl roll flooring, carpet tile, linoleum tile and vinyl tile, installed other than as described in clause (A) of this subparagraph shall not constitute an addition or capital improvement to real property, property or land.

Section 1105 of the Tax Law provides, in part:

Sec. 1105. Imposition of sales tax.--... there is hereby imposed and there shall be paid a tax ... upon:

* * *

(c) The receipts from every sale, except for resale, of the following services:

* * *

(3) Installing tangible personal property . . .or maintaining, servicing or repairing tangible personal property, . . . except:

* * *

(iii) for installing property which, when installed, will constitute an addition or capital improvement to real property, property or land, as the terms real property, property or lands are defined in the real property tax law as such term capital improvement is defined in paragraph nine of subdivision (b) of section eleven hundred one of this chapter. . .

* * *

(5) Maintaining, servicing or repairing real property, property or land, as such terms are defined in the real property tax law, whether the services are performed in or outside of a building, as distinguished from adding to or improving such real property, property or land, by a capital improvement as such term capital improvement is defined in paragraph nine of subdivision (b) of section eleven hundred one of this chapter

Section 527.7(b)(4) of the Sales and Use Tax Regulations provides, in part:

The imposition of tax on services performed on real property depends on the end result of such service. 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.

Section 541.14 of the Sales and Use Tax Regulations provides, in part:

(a)(1) The installation of floor covering is subject to sales tax, regardless of the method of installation or the surface over which the floor covering is installed, unless the installation qualifies for exemption under subdivision (b) of this section.

* * *

(ii) The term floor covering does not include flooring such as wood flooring, ceramic tile, terrazzo, marble, concrete or other similar flooring. Accordingly, the provisions of this section do not apply to the installation of flooring. See section 527.7 of this Title for the rules to determine whether such flooring qualifies as a capital improvement.

(b)(1) The installation of floor covering is exempt from sales tax only if the following criteria are met:

(i) the installation must be of the initial finished floor covering; and

(ii) the installation must be made in:

(a) the new construction of a building or structure; or

(b) the new construction of an addition to an existing building or structure; or

(c) the total reconstruction of an existing building or structure.

(2) For purposes of this Subchapter:

(i) "New construction of a building or structure" means the original construction of a building or structure that did not exist before such construction.

(ii) "New construction of an addition to an existing building or structure" means the original construction of a new room, wing or other discrete, substantial unit of a building or structure which enlarges the exterior of the existing building or structure.

(iii) "Total reconstruction of an existing building or structure" means the complete rehabilitation or replacement of most of the major structural elements of an existing building or structure, such as the roof, ceiling trusses, floor joists, walls, support columns, support beams, girders and the foundation.

* * *

Example 6: A tenant enters into a bare-wall lease to rent the entire third floor of a new office building. The tenant has the right to finish the third floor of the building to suit its needs. When the lease terminates, all improvements made by the tenant will become the property of the owner of the building. As part of finishing the premises, the tenant arranges with a building contractor for the installation of a suspended ceiling, construction of offices, paneling the walls, installation of complete electrical, plumbing, heating and air-conditioning systems and for the installation of wall-to-wall carpet. The new ceiling, offices, paneling and electrical, plumbing, heating and air-conditioning systems qualify as capital improvements in accordance with section 527.7 of this Title. The new wall-to-wall carpet qualifies as a capital improvement in accordance with subdivision (b) of this section because it is the installation of the initial finished floor covering in new construction.

Example 7: Assume that the tenant in Example 6, in the tenth year of the lease, hires a contractor to renovate the premises. The existing ceiling, overhead lighting, wall paneling and carpet are to be replaced. The new ceiling, lighting and paneling qualify as capital improvements in accordance with section 527.7 of this Title. However, the charge by the contractor for the new carpet and its installation is subject to sales tax because the renovation is not new construction, an addition or a total reconstruction.

Opinion

In the instant case, Petitioner had the 15th and 16th floors of the space it leased for offices remodeled. Those floors were gutted, and all the fireproofing was removed. New fireproofing was applied, and the contractors constructed new interior walls and built-out the space in a fashion consistent with its intended use as a headquarters office. After the 15th and 16th floors were occupied, it was discovered the new fireproofing was contaminated. The problem was sufficiently severe that the only feasible and appropriate remedy was to completely gut again the 15th and 16th floors, remove the fireproofing, replace it with new fireproofing, and build out the space. Petitioner and its landlord agree that the reconstruction improvements on the 15th, 16th and 17th floors constitute "Initial Tenant Improvements" as such term is defined in the lease and Petitioner will not be permitted or compelled by the landlord to remove such improvements upon the termination of the lease. In connection with this work, Petitioner has hired (and will pay, with reimbursement from Petitioner's insurer) several contractors to perform the work. The build-out of the 15th and 16th floors includes insulation of the walls (fireproofing), installation or replacement of walls, installation of millwork, including baseboards, painting new walls, installation of HVAC and plumbing, and floor covering. The 17th floor will be reconfigured to look like the 15th floor (e.g. library, administrative and computer services) to enable Petitioner to operate while work is being done on the 15th and 16th floors. This work includes redesign of the 17th floor to resemble the original 15th floor design, and a redesign of the HVAC and electrical service to the 17th floor to accommodate its new use.

The build-out of the 15th and 16th floors and the change order work on the 17th floor, except the installation of floor coverings, will constitute the installation of a capital improvement. These improvements substantially add to the value of the real property and their removal would cause damage to both the real property and to the items themselves. Assuming that these improvements are "Initial Tenant Improvements" for purposes of Petitioner's lease, they are intended to be permanent since the lease provides that all of these improvements become the property of the landlord upon termination of the lease and Petitioner does not have the option (nor is required) to remove the improvements upon termination of the lease. See Empire Vision Center, Dec Tx App Trib, November 7, 1991, TSB-D-91(87)S. This would include the charges associated with the removal, cleaning and reinstallation of the doors and other hard-surface salvageable materials. However, the floor covering does not meet the criteria set forth in Section 1101(b)(9)(iii) of the Tax Law and Section 541.14(b) of the Sales and Use Tax Regulations for exemption from tax since the floor covering is not part of a new construction of a building or structure, an addition to an existing building or structure or a total reconstruction of an existing building or structure. Therefore, charges to Petitioner for the installation of floor covering are subject to sales tax.

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In addition, pursuant to Section 527.7(b)(4) of the Sales and Use Tax Regulations, Matter of Building Contractors Association v. Tully, 87 AD2d 909 and KPMG Peat Marwick, LLP, Adv Op Comm T & F, September 12, 1996, TSB-A-96-(54)S, the charges for removing the fireproofing and other debris from the 15th and 16th floors, and charges for air testing and related services to be performed by the Remediation Engineer in connection with the removal of the fireproofing, will not be subject to sales tax since such services are being performed in connection with the installation of capital improvements.

The charges for engineering and architectural services are not enumerated services subject to sales tax under section 1105 of the Tax Law. Section 1105(c)(7) of the Tax Law provides, however, that when an architect or engineer performs an interior design service that does not come within the Education Law's definition of architecture or engineering, sales tax must be collected on such services. In the present case, if the Architect performs interior design services, such as the design and planning of furniture, fixtures and other furnishings which are not permanently attached to the Building, such services would be subject to tax.

DATED: November 4, 1997

/s/
John W. Bartlett
Deputy Director
Technical Services Bureau

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.