

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

TSB-A-81(60)S  
Sales Tax  
December 1, 1981

STATE OF NEW YORK  
STATE TAX COMMISSION

ADVISORY OPINION

PETITION NO. S810703A

On July 3, 1981, a Petition for Advisory Opinion was received from Hershey Enterprises, Inc., 642 Kreag Road, Pittsford, New York 14534.

The issue raised is whether Petitioner's "Fuel Savings Participation" method of sale is subject to sales tax as a lease of tangible personal property or exempt from sales tax as a capital improvement to real property.

Petitioner is engaged in the design and installation of energy conservation control systems for existing heating and air conditioning facilities. These systems are installed and sold by two separate methods. A customer may pay the full purchase price for the system upon completion of the installation. Alternatively, under the Fuel Savings Participation method, the customer pays a portion of the purchase price (normally 30%) upon completion of the installation, and the balance of the purchase price is paid in monthly amounts which are equal to the actual fuel savings achieved by the system during the prior month. Such payments continue until the full purchase price of the system has been paid. This latter method of payment is made under the terms of a lease agreement with a purchase option entered into between the customer and Petitioner.

Petitioner contends that the installation of an energy conservation control system ultimately results in a more efficient heating and air conditioning system which serves to enhance the value of the system. By increasing the efficiency of the system, its useful life is necessarily prolonged. The method of installation, moreover, is such that the control system becomes an integral and permanent part of the heating and air conditioning facility. The control system consists of several component parts which are installed in various locations throughout the existing heating/air conditioning facility. Its installation requires both the removal of elements of the existing units and the permanent addition of control system components to that system. Once installed, it cannot be removed without significant damage to the original heating system. Any removal would require substantial modifications and replacements to the original system so as to restore it to its original state. Petitioner has never had occasion to completely remove any system that it has installed, or to attempt to restore a heating/air conditioning facility to its original state.

Under the terms of the lease agreement, the lessor leases the "heat control system" to the lessee. The rental for the system is payable monthly. Pursuant to section 4 of the Fuel Savings Participation Agreement, title to the heat control system remains with the lessor during the initial term of the lease agreement or any renewal thereof. Section 4 also provides that the heat control system remain personal property, even though it may be affixed to the realty.

The Agreement also contains restrictions on the transfer of the heat control system to any other person or corporation, removal of the system from the facility in which it is initially installed, and assignment by the lessee. Upon termination of the lease agreement, the lessee must deliver the system to lessor complete and in good condition unless the purchase option is exercised. Lessee shall have the right at the termination of the agreement to purchase the heat control system on an as-is where-is basis.

Petitioner contends that the installation of an energy conservation control system constitutes a capital improvement and that the receipts from such transactions are exempt from sales tax regardless of the method of payment.

The Tax Law and the Sales and Use Tax Regulations define the term "capital improvement" as "an addition or alteration to real property (i) which substantially adds to the value of the real property, or appreciably prolongs the useful life of the real property and, (ii) which 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 (iii) is intended to become a permanent installation." Tax Law §1101(b)(9) and 20 NYCRR 527.7(a)(3).

The Regulations also provide that: "The terms 'rental, lease, license to use' refer to all transactions in which there is a transfer of possession of tangible personal property without a transfer of title to the property. Whether a transaction is a 'sale' or 'a rental, lease or license to use' shall be determined in accordance with the provisions of the agreement." 20 NYCRR 526.7(c).

When Petitioner sells and installs an energy conservation control system under the Fuel Savings Participation method, the terms of the agreement entered into between the customer and Petitioner clearly indicate that title to the system remains vested in Petitioner and that the customer has the option to purchase the system upon termination of the agreement. Therefore, the Agreement constitutes a "rental, lease or license to use" pursuant to section 1101(b)(5) of the Tax Law and section 526.7(c) of the Sales and Use Tax Regulations.

As the system is leased to the customer, it is a sale of tangible personal property and sales tax must be collected on the total charge to the customer including installation. This type of transaction is not a capital improvement as title to the system has been reserved to Petitioner, and there is no intent to sell the system as a permanent addition to real property or otherwise. In such a lease/purchase agreement, each payment is subject to State and local sales and use tax at the rate in effect where the installation is made.

However, when Petitioner's customer subsequently elects to exercise the option to purchase the system, the customer will be considered to be purchasing a capital improvement. Accordingly, the option payment made to Petitioner by the customer at that time will be exempt from State and local sales tax. Further, Petitioner, as a contractor, is liable for tax on the equipment and materials transferred to the customer as a capital improvement pursuant to the exercise of option. Such tax shall be based on Petitioner's depreciated value of the equipment and materials (using standard depreciation method) as of the effective date of the exercise of option by the customer.

DATED: November 13, 1981

s/LOUIS ETLINGER  
Deputy Director  
Technical Services Bureau