Petty v. Commissioner, 73 T. C. 958 (1980)

Homeowners cannot deduct sales taxes paid by contractors on materials used in constructing a personal residence because the contractor, not the homeowner, is considered the consumer under tax law.

Summary

In Petty v. Commissioner, the Tax Court denied homeowners a deduction for sales taxes paid by their contractor on materials used to build their residence. The petitioners, Jerry and Audrey Petty, claimed a $3,511 sales tax deduction for 1976, arguing they were jointly liable with the contractor or that the contractor acted as their agent. The court found that under North Carolina law, the sales tax was imposed on the contractor, not the homeowners, and the contractor was not their agent. Therefore, the sales taxes were part of the contractor's costs and had to be capitalized, not deducted by the homeowners.

Facts

Jerry and Audrey Petty contracted with Sherman Pardue & Co. for architectural services and Erskine Richardson Construction Co. for construction of their personal residence in Charlotte, N. C. The construction contract required the Pettys to reimburse the contractor for the cost of work, including sales taxes, plus a $20,000 fee. The contractor purchased materials and was invoiced directly by suppliers, with sales taxes stated separately. The Pettys financed the project with a construction loan from Mutual Savings & Loan Association, with funds disbursed monthly upon the contractor's invoices and the architect's certification. On their 1976 tax return, the Pettys claimed a $4,428. 46 sales tax deduction, of which $3,511 was disallowed by the IRS as it related to the contractor's purchases.

Procedural History

The IRS issued a notice of deficiency on May 15, 1979, disallowing $3,511 of the Pettys' claimed sales tax deduction. The Pettys filed a petition with the U. S. Tax Court to contest the deficiency. The Tax Court heard the case and issued its opinion on the sole issue of the deductibility of the sales taxes paid by the contractor.

Issue(s)

1. Whether the Pettys were jointly and severally liable with the contractor for sales taxes under N. C. General Statutes section 105-164. 6(3), thus entitling them to a deduction under I. R. C. section 164(a)(4)?
2. Whether the contractor acted as the Pettys' agent in purchasing materials, making the Pettys the ultimate consumers and entitled to deduct the sales taxes under I. R. C. section 164(b)(5)?

Holding

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1. No, because the sales taxes at issue were North Carolina sales taxes imposed on the contractor's suppliers, not use taxes jointly imposed on the contractor and the Pettys.
2. No, because the contractor was not an agent of the Pettys; the contractor independently purchased materials and was not controlled by the Pettys.

Court's Reasoning

The court applied North Carolina law to determine that the sales tax was a privilege tax on retailers, not consumers, and was passed on to the contractor by the suppliers. The Pettys' argument of joint liability under the use tax statute was rejected because the taxes in question were sales taxes, not use taxes. The court cited North Carolina cases to distinguish between sales and use taxes and noted that the use tax would be reduced by any sales taxes paid, which was not relevant here as no use tax was at issue. Regarding the agency argument, the court found that the contractor was not an agent of the Pettys because the Pettys did not control the contractor's actions or have the right to do so. The contract terms and the lack of control over the contractor's performance led the court to conclude that the contractor independently purchased materials and incurred sales tax liabilities as part of its costs. The court relied on established principles of agency law and prior cases like Armentrout v. Commissioner to support its conclusion that the contractor, not the Pettys, was the consumer for tax purposes. The court also noted that the contractor's sales taxes were required to be capitalized, not deducted by the Pettys.

Practical Implications

This decision clarifies that homeowners cannot deduct sales taxes paid by contractors on materials used in personal residence construction. It impacts how homeowners and their tax advisors should analyze potential deductions related to home building. The ruling emphasizes the importance of understanding state tax laws and the specific nature of the taxes involved (sales vs. use taxes). It also highlights the significance of the contractual relationship between homeowners and contractors, particularly regarding control and agency. Tax practitioners should advise clients to carefully review contracts and state tax laws before claiming deductions for taxes paid by third parties. Subsequent cases have followed this reasoning, reinforcing that sales taxes paid by contractors on behalf of homeowners are not deductible by the homeowners but must be capitalized by the contractor.

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