Wise v. Commissioner, 78 T. C. 270 (1982)

A homeowner cannot deduct sales taxes paid by a contractor on materials used in home construction under IRC section 164(b)(5).

Summary

The Wises contracted with Graham to build an addition to their home, agreeing to pay the net cost of materials and labor, which included sales taxes paid by Graham to his suppliers. The issue was whether the Wises could deduct these taxes under IRC section 164(b)(5). The Tax Court held that they could not, as the taxes were imposed on Graham's suppliers, not the Wises, and were paid by Graham, not the Wises. This decision clarifies that under Michigan law, the contractor is considered the consumer of materials, impacting how sales taxes are treated for deduction purposes.

Facts

In 1973, Benjamin and Rosemarie Wise contracted with Wesley D. Graham, a building contractor, to construct an addition to their home in Richland, Michigan. The contract stipulated a $5,000 fixed fee plus the net cost of all labor and materials. Graham purchased the materials, including those selected by the Wises, and paid the Michigan sales taxes on these purchases. The Wises paid Graham $61,999. 62, which included $1,268. 27 in sales taxes that Graham had paid to his suppliers. The Wises sought to deduct these taxes on their 1973 federal income tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Wises' 1973 federal income tax and denied their deduction for the sales taxes. The Wises petitioned the U. S. Tax Court for a redetermination of the deficiency. The Tax Court heard the case and issued its opinion on February 22, 1982, ruling in favor of the Commissioner.

Issue(s)

1. Whether the Wises may deduct under IRC section 164(b)(5) the Michigan sales taxes paid by Graham on materials used in constructing an addition to their residence.

Holding

1. No, because the Michigan sales taxes were imposed on Graham's suppliers, and the Wises did not pay these taxes directly to the suppliers.

Court's Reasoning

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The court applied IRC section 164(b)(5), which allows a deduction for sales taxes if they are imposed on the seller but paid by the consumer to the seller. The court determined that under Michigan law, the sales tax was imposed on Graham's suppliers, who were the sellers in the taxed transactions. The court also noted that Michigan law treats contractors as the consumers of materials used in construction, as stated in Mich. Admin. Code R 205. 71, rule 21. The Wises did not pay the taxes to the suppliers; instead, Graham paid the taxes to his suppliers, and the Wises reimbursed Graham. Therefore, the Wises were not the consumers for the purpose of the tax deduction. The court rejected the Wises' argument that they were the ultimate users or purchasers, stating that the federal standard for deduction aligns with state law in identifying the consumer in the taxed transaction. The court also distinguished prior cases like Armentrout and Petty, emphasizing the importance of state law in determining who the consumer is for tax purposes.

Practical Implications

This decision impacts how homeowners and contractors should handle sales taxes in construction projects. Homeowners cannot deduct sales taxes paid by contractors on materials, as the contractor is considered the consumer under state law. This ruling necessitates careful contract drafting to specify tax responsibilities and may influence how contractors price their services to account for non-deductible taxes. Legal practitioners should advise clients on the tax implications of construction contracts, ensuring clarity on who bears the tax burden. This case has been cited in subsequent decisions to clarify the deductibility of sales taxes in similar scenarios, reinforcing the principle that the consumer in the taxed transaction, as defined by state law, is the one eligible for the deduction.

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