Wise v. Commissioner, T.C. Memo. 1982-85

For federal income tax purposes, the deductibility of state sales taxes in construction contracts hinges on state law's definition of 'consumer'; if state law deems the contractor the consumer, the homeowner cannot deduct sales taxes paid by the contractor on materials.

Summary

The Tax Court held that homeowners could not deduct sales taxes paid by their contractor on materials used for a home addition. The court reasoned that Michigan law, which governs the case, defines contractors as the 'consumers' of building materials. Under Internal Revenue Code Section 164(b)(5), sales taxes are deductible by the consumer. Since Michigan law treats the contractor, not the homeowner, as the consumer, and the tax was imposed on the sale to the contractor, the homeowners were not considered to have paid a deductible sales tax. This case clarifies that deductibility of sales tax in construction projects depends on state-specific definitions of 'consumer' and the party legally obligated to pay the sales tax at the retail level.

Facts

Petitioners, the Wises, contracted with Wesley Graham to build an addition to their home. The contract stipulated a fixed contractor's fee plus the net cost of labor and materials. Graham purchased all materials, though some were selected by the Wises, and invoices were in Graham's name. Graham paid sales tax on these materials to his suppliers, which was separately stated on invoices. The Wises reimbursed Graham for all costs, including the sales tax, and sought to deduct this sales tax on their federal income tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Wises' federal income tax for 1973, disallowing the sales tax deduction. The Wises petitioned the Tax Court, arguing they were the ultimate consumers and thus entitled to the deduction.

Issue(s)

1. Whether the petitioners, as homeowners, are considered the 'consumer' of building materials under Michigan law for the purpose of deducting sales taxes under Section 164(b)(5) of the Internal Revenue Code.
2. Whether the federal definition of 'consumer' in tax regulations supersedes state law in determining sales tax deductibility in this context.

Holding

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1. No, because under Michigan law and administrative rules, building contractors are deemed the consumers of materials they use in construction projects.
2. No, because while federal law sets the standard for deductibility, it incorporates state law to define who the ‘consumer’ is for sales tax purposes in transactions like construction contracts.

Court’s Reasoning

The court reasoned that Section 164(b)(5) allows a deduction for sales taxes if they are separately stated and paid by the ‘consumer.’ However, the determination of who the ‘consumer’ is depends on state law. The court analyzed Michigan sales tax law, regulations, and rules, which clearly state that contractors are considered the ‘consumers’ of materials used in construction. The court cited Michigan Administrative Code Rule 205.71, stating, “Contractors are consumers of the material used by them, therefore, all sales of tangible personal property to contractors are taxable, regardless of the type of contract entered into by the contractor…” The court rejected the Wises’ argument that they were the ‘ultimate users’ because they ultimately benefited from the home addition. The court emphasized that the sales tax was imposed on the sale to Graham, the contractor, not on a sale directly to the Wises. The court distinguished the federal standard for deductibility from the state law definition of ‘consumer,’ finding no conflict and concluding that Michigan law correctly identified Graham as the consumer for sales tax purposes. The court also dismissed the argument that the Uniform Commercial Code provisions on title transfer changed the sales tax liability.

Practical Implications

This case highlights the importance of state law in federal tax determinations, specifically regarding sales tax deductibility. For legal professionals and taxpayers in the construction industry, it clarifies that: 1) The ‘consumer’ for sales tax purposes in construction is defined by state law, not necessarily the homeowner or final beneficiary. 2) Homeowners cannot automatically deduct sales taxes paid by contractors unless state law explicitly designates them as the sales tax ‘consumer.’ 3) Tax planning in construction contracts should consider state sales tax rules to understand deductibility. This case reinforces that federal tax law often defers to state law to define the legal relationships and obligations that determine federal tax consequences. Later cases and IRS guidance would need to consider the specific state’s sales tax statutes and regulations when determining deductibility in similar construction scenarios.

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