Potential Refund Opportunity Foreshadowed by Connecticut Tax Court Decision

In a recent Connecticut Tax Court decision, Judge Arnold Aronson questioned the DRS position that services rendered outside the state are properly subject to the Connecticut sales tax. This gives rise to a potential refund opportunity for taxpayers who may have paid tax on training or similar services provided to their Connecticut personnel where the services were provided and received outside the state.

Background – The DRS Position

The backdrop to this situation is that the Connecticut Department of Revenue Services has for many years contended that services taxable under the Connecticut Sales and Use Taxes are taxable where the services are "received and enjoyed." Although this position has never been promulgated in a regulation, it is widely known that the DRS will apply it as expansively as possible to include purchases in the Connecticut tax base.

The taxable receipt and enjoyment is usually said to be the purchaser's place of business: In the case of a consulting service, the corporate headquarters where decisions are made; in the case of business management services, where the managed business unit is located; in the case of employee training services, where the employee works; and in numerous other variations depending on where the service is actually performed.

At one time the DRS carried this position to the point of asserting that tax-preparation services (no longer taxable) were taxable when rendered by an out-of-state return preparer to a nonresident if the services were rendered in connection with a Connecticut return. See SN 1991 (17) Sales and Use Taxes on Tax Preparation Services.

Key Air – DRS Presses Its Position in a Dubious Case

The decision that challenges this position is Key Air, Inc. v. Law, Conn. Super. LEXIS 3101, Super. Ct. No CV 05 4009597 S (J.D. New Britain, Dec. 5, 2007), which involved the interpretation of an exception to the definition of taxable business management services. Key Air is a certificated air carrier operating aircraft under contract with the owners of various midsize jet aircraft, all of which have maximum certificated takeoff weight of 6,000 pounds or more. As part of the arrangement, Key Air undertook the costs of pilot training, which took place out-of-state, and charged these costs back to the owners of the aircraft for reimbursement.

There is not much question that pilot training is job-related training, which is a taxable service because it is included in the regulatory definition of human resources management services, included in the taxable category of management services. See, Conn Agencies Regs. § 12 407(2)(i)(J)-1(i)(1) (as amended in 1999). However, the statute excludes from the definition of management services those rendered in connection with an aircraft leased or owned by a certificated air carrier or in connection with an aircraft with a maximum certificated takeoff weight of 6,000 pounds or more. Conn. Gen. Stat. § 12-407(a)(37)(J)(iii).

The Commissioner argued that the services were "used and consumed" by Key Air rather than the owners of the aircraft and were thus not rendered in connection with the qualifying aircraft. The court viewed this as a distinction without a difference and had no difficulty determining that the pilot training was excepted from tax as connected with the operation of the aircraft.

The Court Questions DRS's Basic Premise

Why the Commissioner chose to hazard an important position on a weak case involving a very small segment of taxpayers is difficult to fathom, but it was an essential element of her case that the training services were taxable in Connecticut even though they were performed outside the state. In that regard, her argument was that the purchaser, Key Air, was located in Connecticut and so must have consumed the services there. This argument was a bit too facile for Judge Aronson, who observed that "[p]ilots receiving the education or training in

other states would be fully qualified to operate the aircraft upon successfully completing the training program outside Connecticut, not when the pilots return to Connecticut." Thus, he thought it more plausible to assert that the training was consumed where it was received.

Transactional Nexus is a Constitutional Question

Judge Aronson's basic decision in Key Air rests on statutory interpretation—whether the exception for aircraft management services applies to the taxpayer. However, the question whether services rendered out-of-state are taxable in Connecticut is one of constitutional dimension because it involves transactional nexus, of which the Supreme Court has said: "In the case of an activity, there must be a connection to the activity itself rather than a connection only to the actor the State seeks to tax." Allied Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 778 (1992).

There are state court decisions that uphold taxation of a service provided outside the state. See, e.g., Quotron Systems v. Limbach, 62 Ohio State. 3d 447 (1992); Western Wireless Corp. v. Sioux Falls Cellular Comm. Co., 665 N.W.2d 73 (S.D. 2003), cert. den., 540 U.S. 1074. However, the United States Supreme Court has never approved the imposition of a sales tax on services by a state in which no part of the service was performed.

DRS Has Appealed Key Air – Protective Claims May Be Wisest Course of Action

The DRS has appealed Key Air. Its appeal lies to the Appellate Court, but the Connecticut Supreme Court very frequently exercises its authority to remove state-level tax cases to itself. If it does so here, we will likely see a decision rendered in late 2008 or early 2009. If not, and the losing party ultimately appeals to the Supreme Court, a final decision could come much later. Taxpayers may wish to consult their tax attorneys regarding steps they may take to preserve their rights to a potential refund.

For more information, please contact John Shaughnessy at jshaughnessy@rc.com or at (860) 275-8314.