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Tax Legal Update

Court Says "No" to Double Tax on Construction Contracts

Those who contend with the vexing issues surrounding the hiring of "nonresident contractors" will applaud the recent decision of the Connecticut Supreme Court in *Rainforest Café, Inc. v. Department of Revenue Services*, SC 18153 (Sept. 8, 2009). The statutes require that anyone hiring a "nonresident contractor" either obtain from the contractor a certificate showing payment of a bond to the DRS or withhold and pay over to the DRS 5 percent of the contract price. Failure to withhold results in liability, not just for the sales taxes on the contractor's services but also for other potentially unpaid taxes, such as the contractor's liability for Connecticut income tax withholding and sales tax on materials.

Taxpayers Bear a Heavy Burden

The taxpayer is assumed to know whether the contractor is a "nonresident," and avoidance of liability for the contractor's taxes requires that the taxpayer perform due diligence to determine whether the contractor is indeed a resident contractor or not. This is not an easy task because, although having a regular place of business in Connecticut avoids the bonding and withholding requirement, "regular place of business" is narrowly defined to include only a:

bona fide office, factory, warehouse or other space in this state at which a contractor is doing business in its own name in a regular and systematic manner, and which place is continuously maintained, occupied, and used by the contractor in carrying on its business through its employees regularly in attendance to carry on the contractor's business in the contractor's own name.

The term does not include a temporary office or location used by the contractor only for the duration of the contract, or an office of an affiliate.

In this surreal world, where an established office is not a regular place of business and the customer is presumed to be familiar with the internal working of a contractor's office, the DRS position has been that the fact that a contractor is registered as a Connecticut retailer provides no protection for the contractor's customer. Further, the DRS provides to taxpayers no assistance whatsoever in determining whether a contractor is a "nonresident" until several years later when an auditor sets up a deficiency based on the nonresident contractor statute and places on the taxpayer the burden of proving that contractor was not a nonresident.

Discrimination Not an Issue

This enforcement scheme not only places heavy burdens on taxpayers but also quite clearly discriminates against out-of-state businesses who happen to be construction contractors; however, the parties in *Rainforest Café* did not raise this issue and the Supreme Court did not address the question whether that discrimination violates the equal protection and interstate commerce clauses of the U.S. Constitution. Nevertheless, the court did rule that a taxpayer who hired a nonresident contractor was not required to withhold.

Rainforest Café: The Facts

The predecessor to Rainforest Café retained the services of PCL Construction Services, Inc. (PCL) to construct a restaurant in the Westfarms Mall in Farmington. PCL was a Minnesota corporation that had been conducting business in Connecticut since 1996 and had registered as a retailer with the Department of Revenue Services. Having no "regular place of business" in Connecticut, however, made it a "nonresident contractor" within the meaning of the nonresident contractor statute, Conn. Gen. Stat. § 12-430(7).

The taxpayer paid Connecticut sales tax to PCL for its services on an invoice on which the tax was separately stated, as required by Conn. Gen. Stat. § 12-411(1) and (2). The Rainforest Café then opened for business in 2000 and a subsequent audit by the DRS resulted in a deficiency assessment that included tax on PCL's services, on the basis that the taxpayer had not complied with the withholding provisions of Conn. Gen. Stat. § 12-430(7).

One Sales Tax Payment Is Enough

The court noted that the taxpayer had complied with section 12-411, which provides that a "retailer engaged in business in this state," which PCL was, shall collect the tax from the customer and give to the customer a receipt showing the tax has been paid. The court then observed that the DRS assessment of tax under section 12-430(7) effectively subjected the taxpayer to paying Connecticut sales tax twice on the same transaction. Although there is no prohibition against double taxation, it is a principle of statutory construction that the legislature is presumed not to have intended to enact a double tax.

With that as background, the court then concluded that sections 12-411 and 12-430(7) should be construed so that both are effective and workable, and determined that a taxpayer who complies with section 12-411 and obtains the necessary receipts is relieved of the additional obligation of withholding under section 12-430(7), at least insofar as sales tax is concerned.

Remand to Consider Other Taxes

The case had come before the Supreme Court as an appeal from a motion by the DRS for summary judgment. Having reversed the Superior Court on the substantive basis just described, the Supreme Court then remanded the case to the Superior Court for consideration of taxes other than the sales tax on PCL's services. Consideration of this issue involves the question whether the statute of limitations has expired, which in turn involves a factual determination whether the taxpayer filed returns for the early years of the audit period, and, as a result, is not appropriate for summary judgment. [1](#)

Decision Provides Opportunities

This decision presents the opportunity of a potential refund for taxpayers who have actually paid the sales tax a second time under section 12-430(7) for any period that is still open or who have paid within the past six months a second tax under that provision for any year. Such taxpayers should consult their tax advisors about filing a claim for a refund before the period of limitations expires.

Further, taxpayers should note that the decision does not grant a license to ignore the requirements of Conn. Gen. Stat. § 12-430(7) and to comply only with Conn. Gen. Stat. § 12-411, because the Supreme Court's double-tax holding protects the taxpayer only from paying the sales tax twice. The door is still open to assessment of taxes other than sales taxes that were allegedly not paid by the contractor; however, taxpayers should also consider ways in which they may revise their contracts to protect against inadvertent failure to withhold on a payment to a nonresident contractor.

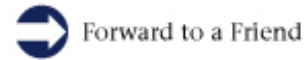
¹ The trial court's decision had been that the assessment was not barred by the three-year statute of limitations because the taxpayer's failure to comply with section 12-430(7) amounted to an attempt to evade the tax. The Supreme Court reversed that holding also, pointing out in a footnote that it involved an incorrect reading of its decision in *Leonard v. Commissioner*, 264 Conn. 286, 823 A.2d 1184 (2003).

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