STATE OF NEW MEXICO
ADMINISTRATIVE HEARINGS OFFICE
TAX ADMINISTRATION ACT

IN THE MATTER OF THE PROTEST OF
THOMAS W. & LINDA L. KRUMLAND
TO ASSESSMENTS ISSUED UNDER
LETTER ID NOs L0778505776 & L1315376688

v. **D&O 18-30**

NEW MEXICO TAXATION AND REVENUE DEPARTMENT

DECISION AND ORDER

A hearing in the above-captioned protest occurred on May 29, 2018 before Chris Romero, Esq., Hearing Officer, in Santa Fe, New Mexico. Mr. Joe Lennihan, Esq., appeared representing Mr. Thomas W. and Ms. Linda L. Krumland (hereinafter collectively referred to as "Taxpayers" or "Taxpayer"). Taxpayers appeared in person and testified on their own behalf. Mr. Richard Anklam, Dr. Tom Clifford, Mr. Frank Crociata, Mr. James Dubeck, and Mr. Benjamin Roybal appeared and testified on Taxpayers' behalf. Mr. Ed Heldenbrand also appeared, but was not called to testify.

Mr. Marek Grabowski, Esq., appeared representing the Taxation and Revenue Department of the State of New Mexico (hereinafter "Department") and was accompanied by Ms. Alicia Beltran, auditor, who testified on behalf of the Department.

Taxpayer Exhibits 0 through 7 and Department Exhibits A and Z, with exception of Exhibits I, V and Y, were admitted into the evidentiary record. All exhibits are described in the Administrative Exhibit Log. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

Procedural History

1. On August 1, 2016, the Department assessed Taxpayer, Thomas W. Krumland, the amounts of $136,645.77 in gross receipts tax, $27,329.15 in gross receipts tax penalty, and $12,097.31 in gross receipts tax interest, for a total assessment in the amount of $176,072.23 under Letter ID No. L0778505776 for the periods from June 30, 2009 through June 30, 2015. [*See* Administrative File].

2. On August 1, 2016, the Department assessed Taxpayer, Linda L. Krumland, the amounts of $31,381.43 in gross receipts tax, $6,276.29 in gross receipts tax penalty, and $2,783.96 in gross receipts tax interest, for a total assessment in the amount of $40,441.68 under Letter ID No. L1315376688 for the periods from June 30, 2009 through June 30, 2015. [*See* Administrative File].

3. On September 8, 2016, Taxpayers, by and through Mr. Duwayne Sibley (Moss Adams LLP), executed formal protests of the assessments under Letter ID No. L0778505776 and Letter ID No. L1315376688. [*See* Administrative File].

4. On September 21, 2016, the Department acknowledged receipt of Taxpayer, Thomas W. Krumland's protest, under Letter ID No. L0947666480. [*See* Administrative File].

5. On September 21, 2016, the Department acknowledged receipt of Taxpayer, Linda L. Krumland's protest under Letter ID No. L0653368880. [*See* Administrative File].

6. On September 26, 2016, the Department filed Hearing Requests in reference to both protests. It requested that the protests be consolidated and that initial scheduling hearings be set for the purpose of identifying dates for hearings on the merits of Taxpayers' protests and establishing other associated prehearing deadlines. [*See* Administrative File].

7. On September 28, 2016, the Administrative Hearings Office entered separate Notices of Telephonic Scheduling Conference that set separate telephonic scheduling hearings on both protests for October 28, 2016. [*See* Administrative File].

8. On October 28, 2016, two telephonic scheduling hearings occurred at which time the parties did not object that the hearings were within 90 days of the date of Taxpayers' protests and that the hearings satisfied the 90-day hearing requirement. [*See* Administrative File].

9. On October 31, 2016, the Administrative Hearings Office entered separate Scheduling Orders and Notices of Administrative Hearing, which in addition to establishing various prehearing deadlines, set two separate hearings on the merits of Taxpayers' protests for February 14, 2017. [*See* Administrative File].

10. On November 18, 2016, Taxpayer, by and through Mr. Steven Keene (Moss Adams LLP), filed a Motion to Consolidate Assessments. [*See* Administrative File].

11. On November 21, 2016, the Administrative Hearings Office entered a Consolidation Order, Scheduling Order and Notice of Administrative Hearing which consolidated Taxpayers' protests and merged the hearings set to occur on February 14, 2017. [*See* Administrative File].

12. On January 23, 2017, the parties filed a Joint Motion to Enter Amended Scheduling Order in which the parties sought a continuance of the hearing set for February 14, 2017. [*See* Administrative File].

13. On January 24, 2017, the Administrative Hearings Office entered a Continuance Order, Notice of Reassignment, Amended Scheduling Order and Amended Notice of Administrative Hearing which continued the previously scheduled hearing to June 29, 2017 and assigned the consolidated protests to the undersigned Hearing Officer. [*See* Administrative File].

14. On April 14, 2017, the Department filed a Joint Motion to Vacate Hearing and Hold Matter in Abeyance. [*See* Administrative File].

15. On May 3, 2017, the Administrative Hearings Office entered an Order Holding Matter in Abeyance which also vacated the hearing set for June 29, 2017. [*See* Administrative File].

16. On August 16, 2017, the Department filed a Request for Hearing indicating that the consolidated protest was ready for a hearing on the merits. [*See* Administrative File].

17. On August 23, 2017, the Administrative Hearings Office entered an Order Lifting Abeyance, Scheduling Order and Notice of Administrative Hearing, which in addition to various other deadlines, set a hearing on the merits of the protest for April 2, 2018. [*See* Administrative File].

18. On December 11, 2017, Taxpayers' counsel of record filed an Entry of Appearance. [*See* Administrative File].

19. On December 26, 2017, Taxpayers filed a Certificate of Service relevant to Protestants' First Joint Set of Interrogatories, Requests to Admit and Request for Production of Documents. [*See* Administrative File].

20. On January 16, 2018, the Department filed a Certificate of Service relevant to Department's First Set of Requests for Admission, Interrogatories and Requests for Production. [*See* Administrative File].

21. On January 18, 2018, the Department filed a Certificate of Service relevant to Department's Responses to Protestants' First Joint Set of Interrogatories, Requests to Admit and Request for Production of Documents. [*See* Administrative File].

22. On February 20, 2018, Taxpayer filed a Motion to Continue Discovery Deadline

and Formal Hearing. [*See* Administrative File].

23. On February 28, 2018, the Administrative Hearings Office entered a Continuance Order and Amended Notice of Administrative Hearing which in addition to establishing other associated deadlines, set a hearing on the merits of the consolidated protest for May 29, 2018. [*See* Administrative File].

24. On February 28, 2018, Taxpayers filed a Certificate of Service relevant to their responses and objections to the Department's First Set of Requests for Admission, Interrogatories and Requests for Production. [*See* Administrative File].

25. On May 9, 2018, the Administrative Hearings Office issued Administrative Subpoenas requiring the following individuals to appear to testify in the above-captioned protest: (1) Mr. Richard Anklam (New Mexico Tax Research Institute); (2) Mr. Frank Crociata (Gallagher & Kennedy); and (3) Dr. Tom Clifford (Department). The subpoenas were issued upon Taxpayers' request. [*See* Administrative File].

26. On May 14, 2018, Taxpayer filed an Unopposed Motion for Extension of Time to File Prehearing Statement. [*See* Administrative File].

27. On May 17, 2018, the parties filed a Joint Prehearing Statement. [*See* Administrative File].

28. On May 19, 2018, the parties appeared as scheduled to address the merits of the protest. [*See* Record of Hearing].

29. On June 29, 2018, Taxpayer filed Protestants' Summation. [*See* Administrative File].

30. On June 29, 2018, the Department filed New Mexico Taxation and Revenue Department's Proposed Findings of Fact and Conclusions of Law, and New Mexico Taxation and

Revenue Department's Closing Argument. [*See* Administrative File].

31. On June 29, 2018, Taxpayer filed its Proposed Finding of Fact and Conclusions of Law and Protestants' Summation. [*See* Administrative File].

32. On July 20, 2018, Taxpayer filed its Notice of Supplemental Authority suggesting that the merits of the protest might be resolved by the promulgation of a rule under consideration by the Department. [*See* Administrative File].

33. On July 25, 2018, the Department filed New Mexico Taxation and Revenue Department's Response to Notice of Supplemental Authority. [*See* Administrative File].

Background to Taxpayers' Businesses

34. Mr. Thomas W. Krumland and Ms. Linda L. Krumland are married. They reside in Roswell, N.M. and have three adult children. [Testimony of Mr. Krumland].

35. Taxpayers' have engaged in business on their own and in partnership with other persons and entities, particularly Enchantment Equities, LLLP, and Mr. Joe Reiser. [Testimony of Mr. Krumland].

36. As of the date of the hearing, Mr. Reiser is no longer active with the businesses discussed herein. [Testimony of Mr. Krumland].

37. In 2002, Taxpayers formed Enchantment Equities, LLLP, a Colorado limited liability limited partnership. Mr. and Mrs. Krumland each own a 5 percent interest in Enchantment Equities. [Testimony of Mr. Krumland].

38. The Krumland Family Trust ("Krumland Trust") owns the remaining 90% interest in Enchantment Equities. Ms. Magdolena Krumland, Mr. Krumland's mother, established the Family Trust in 2002, appointing Mr. Krumland as Family Trustee, and Mr. Robert A. Lembke as Independent Trustee. [Testimony of Mr. Krumland; Department Exhibit W].

39. Mr. Krumland and Ms. Krumland are the primary beneficiaries of the Krumland Trust. Taxpayers' adult children are successor beneficiaries upon Taxpayers' deaths, as established by the terms and conditions of the Krumland Trust. [Testimony of Mr. Krumland; Department Exhibit W].

40. The Independent Trustee does not actively engage in managing the Krumland Trust, but rather monitors the activities of the Trustee, Mr. Krumland. [Testimony of Mr. Krumland; *See* Department Exhibit W].

41. Taxpayers' adult children have no present-day involvement in the operation of the Krumland trust. [Testimony of Mr. Krumland; *See* Department Exhibit W].

Krumland Businesses

42. Taxpayers own several automobile dealerships, a construction business, and a carwash. As of the date of the audit, Taxpayers owned six dealerships, which increased to a total of seven as of the date of the hearing. [Testimony of Mr. Krumland].

43. Taxpayers' businesses are each owned and operated by and through their own separate and distinct business entities, which in all cases are limited liability companies established in the State of Colorado. Each business pays gross receipts taxes in accordance with New Mexico law, and in the case of each automobile dealership, applicable excise taxes:

a. Jet Equities, LLC operates Roswell Hyundai:

1. Ownership of Jet Equities, LLC is divided among its members as follows: Ms. Krumland owns 5 percent; Mr. Krumland owns 5 percent, Enchantment Equities owns 80 percent; and Mr. Joe Reiser owns 10 percent.

2. Mr. Krumland is designated as the managing member of Jet Equities, LLC.

[*See* Department Exhibit P]

b. The Krumland Company, LLC operates Roswell Toyota:

1. Ownership of The Krumland Company, LLC is divided among its members as follows: Ms. Krumland owns 10 percent; Mr. Krumland owns 80 percent, and Mr. Joe Reiser owns 10 percent.

2. Mr. Krumland is the managing member of The Krumland Company, LLC.

[*See* Department Exhibit S]

c. T&L Motors, LLC operates Roswell Honda:

1. Ownership of T&L Motors, LLC is divided among its members as follows: Ms. Krumland owns 45 percent; Mr. Krumland owns 45 percent; and Mr. Joe Reiser owns 10 percent.

2. Mr. Krumland is designated as the managing member of T&L Motors, LLC.

[*See* Department Exhibit U]

d. Rock Star, LLC operates Roswell Nissan:

1. Ownership of Rock Star, LLC is divided among its members as follows: Ms. Krumland owns 5 percent; Mr. Krumland owns 5 percent; Enchantment Equities, LLLP owns 80 percent; and Mr. Joe Reiser owns 10 percent.

2. Mr. Krumland is designated as the managing member of Rock Star, LLC.

[*See* Department Exhibit R]

e. TK, LLC operates Carlsbad Chevrolet:

1. Ownership of TK, LLC is divided as follows: Ms. Krumland owns 5 percent; Mr. Krumland owns 5 percent; Enchantment Equities, LLLP owns 80 percent; and Mr. Joe Reiser owns 10 percent.

2. Mr. Krumland is designated as the managing member of Rock Star, LLC.

[*See* Department Exhibit T]

f. Kars, LLC operates Carlsbad Ford Lincoln

1. Ownership of Kars, LLC is divided among its members as follows: Ms. Krumland owns 5 percent; Mr. Krumland owns 5 percent; Enchantment Equities, LLLP owns 80 percent; and Mr. Joe Reiser owns 10 percent.

2. Mr. Krumland is designated as the managing member of Kars, LLC.

[*See* Department Exhibit N]

g. Platt, LLC operates Kleen Kar Wash:

1. Ownership of Platt, LLC is divided among its members as follows: Ms. Krumland owns 5 percent; Mr. Krumland owns 5 percent; and Enchantment Equities, LLLP owns 90 percent.

2. Mr. Krumland is designated as the managing member of Platt, LLC.

[*See* Department Exhibit Q]

h. Krumland Auto Group, LLC provides administrative services to the various dealerships.

1. Ownership of Krumland Auto Group, LLC is divided among its members as follows: Ms. Krumland owns 5 percent; Mr. Krumland owns 5 percent; and Enchantment Equities, LLLP owns 90 percent.

2. Mr. Krumland is designated as the managing member of Krumland Auto Group, LLC.

[*See* Department Exhibit M]

i. Linda Chavez Krumland Construction, LLC operates TNT Construction Company. It was established to provide construction services for the various dealerships, but also provides services for other, unrelated parties. [Testimony of Mr. Krumland].

1. Ownership of Linda Chavez Krumland Construction, LLC is divided among its members as follows: Ms. Krumland owns 51 percent; Mr. Krumland owns 5 percent; and Enchantment Equities, LLLP owns 44 percent.

2. Mr. Krumland is designated as the managing member of Linda Chavez Krumland Construction, LLC.

[*See* Department Exhibit O]

44. Taxpayers are not generally involved in the daily operation or management of the several businesses. Rather, each business employs managers and other employees to oversee its day-to-day operations. [Testimony of Mr. Krumland; Testimony of Ms. Krumland].

45. Mr. Krumland perceives his primary role within the auto dealerships as an ambassador to the auto manufacturers with which they conduct business. His next most significant function is to deploy capital for the benefit of the various businesses. [Testimony of Mr. Krumland].

46. Taxpayers receive income from the various businesses by drawing sums of money against future profits. Future profits are estimated by evaluating variables effecting profitably, including the state of the overall economy, oil prices, or other variables. [Testimony of Mr. Krumland].

47. The specific amount of any particular draw is unrelated to the amount of work Taxpayer may perform for the benefit of any particular business. [Testimony of Mr. Krumland].

48. Taxpayers have drawn income from businesses such as Platt, LLC which Taxpayers tend to frequent most regularly as patrons, rather than owners, because their involvement with the business is minimal. In contrast, Mr. Krumland has not drawn income from Linda Chavez Krumland Construction, LLC to which Mr. Krumland has devoted significant time, but whose profitability is more volatile and unpredictable. [Testimony of Mr. Krumland].

49. Mr. Krumland does not perceive himself as an employee, contractor, or an individual engaged in the business of providing services, to his businesses. Rather, he is an owner of his businesses relying on them to generate income. [Testimony of Mr. Krumland; Testimony of Ms. Krumland].

50. To the extent he devotes time to the operation of any businesses, Mr. Krumland does not track his time, invoice the businesses, or attempt to establish a monetary value for activities that might benefit any of the several businesses. [Testimony of Mr. Krumland; Testimony of Ms. Krumland].

51. Mr. Krumland has never received a Form 1099 for any work performed for the benefit of any of the businesses, nor has he ever received an equity interest from any of the businesses as consideration for work performed. [Testimony of Mr. Krumland].

52. Taxpayers are personally obligated for the liabilities of the various businesses. [Testimony of Mr. Krumland].

53. There have been occasions where Taxpayers have not drawn any money from a business, regardless of the amount of work performed for the business. Mr. Krumland described himself as very conservative and careful to draw funds from a business that may need to retain

them to cover future operating expenses. [Testimony of Mr. Krumland].

54. Taxpayers characterized those draws as “guaranteed payments” on their Forms Schedule K-1 (IRS Form 1065). [*See* Department Exhibits A; B; E; F; I; J; K; L].

55. Ms. Krumland is not personally involved in the operation of any of the businesses. Her involvement is strictly limited to ownership. [Testimony of Ms. Krumland].

Tax Reporting

56. For the years relevant to the protest, Taxpayers elected to treat the limited liability companies as partnerships for federal income tax purposes, and Taxpayers' businesses issued Schedule K-1s for the relevant periods at issue. [*See* Department Exhibits A; B; E; F; I; J; K; L].

57. Schedule K-1s generally indicated that during each relevant year, Taxpayers received Ordinary Business Income (Box 1), Guaranteed Payments (Box 4), and Distributions (Box 19). [*See* Department Exhibits A; B; E; F; I; J; K; L].

58. Taxpayers tax reporting established that the businesses paid them the collective sum of $2,508,534.00 in guaranteed payments during the periods relevant to the protest. Mr. Krumland received $2,035,438.00 and Ms. Krumland received $473,096.00 in guaranteed payments. [*See* Department Exhibits B; F; I; J; K, and L].

59. The Hearing Officer identified the following error which caused the amount of underreported gross receipts to slightly vary from the amounts giving rise to the assessments:

a. In 2014, Ms. Krumland received a guaranteed payment in the amount of $20,400.00 from Platt, LLC. [*See* Department Exhibit I-0020 (Box 4)]. However, when the Department input that amount into its computation, it appears it erroneously input the amount as $20,000.00 [*See* Department Exhibit F-0005]. The result was a $400 discrepancy in the total amount purportedly representing under reported gross receipts, excluding tax. [*See* Department

Exhibit F-0004]. Accordingly, Ms. Krumland's alleged unreported gross receipts, excluding tax, is $473,096.00, not $472,696.00, as stated at Department Exhibit F-0004.

60. The Department assessed gross receipts tax on Taxpayers' receipts deriving from guaranteed payments only. [*See* Department Exhibit A; Department Exhibit E].

61. Taxpayers were not assessed gross receipts tax on their receipt of the ordinary business income or distributions as listed in Box 1 or Box 19 of the Form Schedule K-1. [*See* Department Exhibit A; Department Exhibit E].

62. Taxpayers could not explain why their accountant identified payments as "guaranteed payments" on the Schedule K-1s. Taxpayers disclaimed any understanding of the relevant provisions of the Internal Revenue Code, and relied on the expertise of their certified public accountant to report and pay their taxes. [Testimony of Mr. Krumland].

63. Taxpayers paid federal income taxes on their personal income from their various businesses.

Testimony Regarding Tax Policy

64. Tom Clifford is a tax policy advisor under contract with the Department. He reports directly to the cabinet secretary. He formerly served at the Department in various capacities, including chief economist and tax policy director. He was also employed by the department of finance and administration. [Testimony of Dr. Clifford].

65. On various occasions, Dr. Clifford testified before the New Mexico State Legislature. On a least one occasion, he testified in support of a policy that the state of New Mexico should not impose gross receipts tax on income generated by a partnership and subsequent payments from the partnership to its partners as guaranteed payments. [Testimony of Dr. Clifford].

66. The policy that Dr. Clifford advocated has been the position of the state for several

decades. [Testimony of Dr. Clifford].

67. Dr. Clifford has participated in discussions with the Department over the course of his career in which he advised that such payments should not be taxable. [Testimony of Dr. Clifford].

68. Dr. Clifford is not aware of any written rule implementing the policy that guaranteed payments should not be taxable although various regulations and statutes may form the basis for a more complicated evaluation that would establish the exemption of guaranteed payments. [Testimony of Dr. Clifford].

69. Dr. Clifford has never provided guidance on the taxability of guaranteed payments to any taxpayer, nor is he aware of any such guidance being put in writing by any person inside the Department. [Testimony of Dr. Clifford].

70. Mr. Frank Crociata is a former employee of the Department. He served as an attorney in the legal services bureau and as tax policy director during the tenures of former secretary, Ms. Demesia Padilla, and current secretary, Mr. John Monforte. [Testimony of Mr. Crociata].

71. Mr. Crociata recalled addressing the question of guaranteed payments when a bill was introduced in the state legislature that would have purportedly exempted guaranteed payments from gross receipts taxation. [Testimony of Mr. Crociata].

72. Mr. Crociata recalled there being some agreement with respect to the taxability of guaranteed payments and believed that the Department may have been evaluating a regulation that would have more clearly expressed its policy. [Testimony of Mr. Crociata].

73. Mr. Crociata, in his capacity as an employee of the Department, never provided any guidance on the taxability of guaranteed payments to any taxpayer. [Testimony of Mr. Crociata].

74. In his capacity as tax policy director, Mr. Crociata expressed his policy position that guaranteed payments should not be subject to gross receipts tax.

75. Mr. Richard Anklam is the director of the New Mexico Tax Research Institute. He was also formerly employed by the Department as an auditor and assistant secretary director of tax policy. [Testimony of Mr. Anklam].

76. Mr. Anklam's recollection during his time with the Department was that it did not assess gross receipts taxes on guaranteed payments. [Testimony of Mr. Anklam].

DISCUSSION

The primary issue in this protest concerns whether a partner's income from "guaranteed payments", as reported by the partnership on IRS Form, Schedule K-1, are subject to the gross receipts tax for which the recipient partner may be liable. A coherent analysis of the issue begins with relevant provisions of the Internal Revenue Code, and establishing why "guaranteed payments" may be perceived differently than a partner's ordinary business income, or income from distributions, from the partnership. The analysis will conclude with discussion of the Department's new rule addressing the "guaranteed payments", which took effect on September 25, 2018.

In this protest, Taxpayers received ordinary business income and income from distributions in all relevant years. Income from those sources did not contribute to the relevant assessments. Rather, *only* income from "guaranteed payments" resulted in assessments of gross receipts tax. The Department asserts that Taxpayers' are liable for gross receipts tax on "guaranteed payments" because those payments were made in consideration for services. In contrast, Taxpayers assert that receipts from "guaranteed payments" should be treated no differently from ordinary business income or income from distributions.

The first phase of the legal analysis requires a general comprehension of the meaning and significance of "*guaranteed payments*." Section 707 (c) of the Internal Revenue Code provides, that "[t]o the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) [26 USCS §61(a)] (relating to gross income) and, subject to section 263 [26 USCS §263], for purposes of section 162(a) [26 USCS §126(a)] (relating to trade or business expenses)." *See* 26 USCS Section 707(c).

In other words, "guaranteed payments" are payments made by a partnership, to a partner, as compensation for services, or use of capital, without regard for the income of the partnership, or the partner's proportionate ownership interest in the entity.

From the perspective of the partnership, "guaranteed payments" may be deductible as an ordinary or necessary business expense under 26 USCS Section 126(a). *Id.; See also e.g.* IRS Form 1065, Line 10. From the perspective of the partner, the "guaranteed payment" is treated as ordinary income. But the significance of this device does not end there. The most noteworthy distinction is the requirement that "guaranteed payments," if made, be made as compensation for services or for use of capital.

It is also useful to recognize that a partner receiving guaranteed payments consistent with Section 707(c) might realize various tax benefits, which at a minimum could result in decrease to a taxpayer's adjusted gross income, thereby reducing a taxpayer's income tax obligation.

For example, "guaranteed payments" may permit a managing member of a partnership or limited liability company to reduce his or her personal tax liability by availing themselves of the self-employment tax deduction, which deducts the employer-equivalent share of the self-

employment tax from the taxpayer's gross income.[1] This deduction represents one half, or 50 percent, of the self-employment tax as a necessary and ordinary business expense. [*See* Instructions for Form 1040, Line 27; and Schedule SE, Line 6 or Line 13]. If the current self-employment tax rate is 15.3 percent[2], this "above-the-line" deduction may confer significant benefit toward reducing a taxpayer's income tax liability at the federal and state levels, considering that the starting point for determining personal income tax liability in New Mexico is an individual's adjusted gross income as determined at the federal level. *See* NMSA 1978, Section 7-2-2; *See also Holt v. N.M. Dep't of Taxation & Revenue*, 2002-NMSC-034, ¶23, 133 N.M. 11, 59 P.3d 491.

If there was any particular benefit Taxpayers sought by receiving compensation through "guaranteed payments" under the facts of this protest, it remained uncertain. Mr. Krumland testified that he did not know why Taxpayers' accepted compensation in the form of guaranteed payments and the Hearing Officer will not speculate regarding Taxpayers' underlying motivations or tax strategies.

However, the Hearing Officer perceived the Taxpayers to be sophisticated entrepreneurs with a remarkable history of professional and financial accomplishment. The Hearing Officer was simply not persuaded that Taxpayers were genuinely uninformed or ignorant of the benefits they expected to achieve by receiving a portion of their income through "guaranteed payments."

Of course, it is also plausible that Taxpayers do rely entirely on the advice of their tax professionals. However, Taxpayers' similarly did not present themselves as people who would fully entrust their financial wellbeing to others without scrutiny and due diligence. Nevertheless,

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[1] https://www.irs.gov/businesses/small-businesses-self-employed/self-employment-tax-social-security-and-medicare-taxes

[2] *Id*.

to the extent Mr. Krumland was not qualified to address the complexities of the Internal Revenue Code, and particularly 26 USCS Section 707(c), one of Taxpayers' accountants did appear with Taxpayers, but was never called to testify.

Perhaps a clearer understanding of Taxpayers' underlying motivations is unnecessary. The Hearing Officer will infer that Taxpayers' receipt of the "guaranteed payments" was consistent, and in accord, with 26 USCS Section 707(c), meaning that Taxpayers received "guaranteed payments" as compensation "for services or the use of capital." Clearly, Section 707(c) does not permit guaranteed payments for any other purpose.

Observing the same facts from a slightly different perspective, Mr. Krumland, in his capacity of managing member for the various limited liability companies, made "guaranteed payments" to himself and Ms. Krumland, in their capacities as individual members of the several limited liability companies, presumably aware of the law regarding "guaranteed payments" and their purpose. Mr. Krumland, in particular, did so from the vantage point of the relevant partnership, as well as from the individual partner. Any assertion that Mr. Krumland in his capacity as managing member, or Taxpayers as individual members, expended or received "guaranteed payments" with complete ignorance or unfamiliarity of the law is implausible.

Therefore, "guaranteed payments" were made by the partnership to the partners in consideration for services or use of capital. The next issue concerns whether "guaranteed payments," if received in exchange for services or use of capital, and otherwise consistent with the requirements of 26 USCS Section 707(c), are taxable as gross receipts pursuant to the Gross Receipts and Compensating Tax Act. Since the parties' evidence and argument concentrated on the provision of services, rather than use of capital, further analysis will similarly focus on services.

Burden of Proof

Assessments by the Department are presumed to be correct. *See* NMSA 1978, Section 7-1-17. Tax includes, by definition, the amount of tax principal imposed, and unless the context otherwise requires, "the amount of any interest or civil penalty relating thereto." *See* NMSA 1978, Section 7-1-3. *See also El Centro Villa Nursing Ctr. v. Taxation & Revenue Dep't*, 1989-NMCA-070, 108 N.M. 795, 779 P.2d 982. Therefore, the assessment issued to Taxpayer is presumed to be correct, and it is Taxpayer's burden to present evidence and legal argument to show that it is entitled to an abatement.

The burden is also on Taxpayer to prove that it is entitled to an exemption or deduction, if one should potentially apply. *See Pub. Serv. Co. v. N.M. Taxation & Revenue Dep't,* 2007-NMCA-050, ¶141 N.M. 520, 157 P.3d 85; *See also Till v. Jones*, 1972-NMCA-046, 83 N.M. 743, 497 P.2d 745. "Where an exemption or deduction from tax is claimed, the statute must be construed strictly in favor of the taxing authority, the right to the exemption or deduction must be clearly and unambiguously expressed in the statute, and the right must be clearly established by the taxpayer." *See Sec. Escrow Corp. v. State Taxation & Revenue Dep't*, 1988-NMCA-068, ¶8, 107 N.M. 540, 760 P.2d 1306. *See also Wing Pawn Shop v. Taxation & Revenue Dep't*, 1991-NMCA-024, ¶16, 111 N.M. 735, 809 P.2d 649. *See also Chavez v. Comm'r of Revenue*, 1970-NMCA-116, ¶7, 82 N.M. 97, 476 P.2d 67.

Gross Receipts Tax

For the privilege of engaging in business, New Mexico imposes a gross receipts tax on the receipts of any person engaged in business. *See* NMSA 1978, Section 7-9-4 (2002). "Engaging in business" is defined as "carrying on or causing to be carried on any activity with the purpose of direct or indirect benefit." *See* NMSA 1978, Section 7-9-3.3 (2003).

Under the Gross Receipts and Compensating Tax Act, there is a statutory presumption that all receipts of a person engaged in business are taxable. *See* NMSA 1978, Section 7-9-5 (2002). Despite the general presumption of taxability, a taxpayer may qualify for the benefits of various deductions and exemptions.

At all relevant times to this protest, Taxpayers were engaged in business in New Mexico, by and through their various limited liability companies. However, their various companies are not subject of this assessment or protest. Rather, the relevant inquiry is whether the individual Taxpayers were also engaged in business. Having determined that Taxpayers' several businesses made "guaranteed payments" in accord with 26 USCS Section 707(c), the next issue to contemplate is whether Taxpayer received "guaranteed payments" in exchange for services or use of capital.

Considering that Mr. Krumland acted on behalf of the various businesses as managing member, the Hearing Officer infers that when he authorized a "guaranteed payment", he did so with some general understanding of 26 USCS Section 707(c), and that he similarly accepted it with the same understanding, in his capacity as an individual member of the business. The same inference applies to Ms. Krumland. Although she may not have the same degree of involvement as Mr. Krumland, he testified that Ms. Krumland does not get paid, unless *he* pays her.

This would suggest that the acceptance of "guaranteed payments," with a general understanding of their legal significance, is tantamount to an admission that Taxpayers' performed services, as defined by Section 7-9-3 (M). However, Taxpayers expressly denied the assertion that they were engaged in the business of selling services to their businesses. This denial creates a palpable dilemma. Either the "guaranteed payments" were not made in accordance with the requirements of Section 707(c), or Taxpayers should be permitted to adopt inconsistent positions in which they accept "guaranteed payments" for services consistent with requirements of Section 707(c), but subsequently

deny they performed services for the purpose of Section 7-9-4.[3] The Hearing Officer resolves this dilemma by rejecting any suggestion that Section 707(c) was misemployed. Therefore, the Hearing Officer will address the significance of Taxpayers' inconsistent positions: that Taxpayers' evidently accepted "guaranteed payments" as compensation for services, but subsequently denied the performance of services in exchange for "guaranteed payments."

The term, "service" is defined at NMSA 1978, Section 7-9-3 (M) to mean "*all activities engaged in for other persons for a consideration*, which activities involve predominantly the performance of a service as distinguished from selling or leasing property." (Emphasis Added).

After contemplation and consideration of the evidence, the Hearing Officer is persuaded that the "guaranteed payments" were never intended to compensate Taxpayers for services rendered to the various businesses. Taxpayers were clear, and the Hearing Officer was persuaded, that the actual activities they performed were more akin with ownership and oversight, than employment or selling services.

However, offsetting the weight of evidence supporting that conclusion are the facts which establish that the "guaranteed payments" were indeed made for that very purpose. Had they not, then they may have conflicted with 26 USCS Section 707(c). Tilting the balance slightly in favor of the Department are the statements of Taxpayers' representatives which were made to the Department during the audit, indicating that Taxpayers' "received guaranteed payments for the time, effort and expertise they bring in managing the day to day operation of the LLC." *See* Department Exhibit D-0007.[4] This statement, made by Taxpayers' representative during the audit weighs in the

[3] Perhaps the dilemma is a creature of the State, which is subsequently resolved by the Department's clarification or refinement of its interpretation of controlling law.
[4] Although the Rules of Evidence do not apply to hearings under the Administrative Hearings Office Act (*See* NMSA 1978, Section 7-1B-6 D (2)), this statement is not hearsay pursuant to NMRA 2017, Rule 11-801 D (2).

Department's favor because it also suggests that Taxpayers engaged in "all activities ['time, effort and expertise they bring in managing')] … for other persons [Taxpayers' various businesses] for a consideration ['guaranteed payment' as permitted by 26 USCS Sec. 707(c)], which activities involve predominantly the performance of a service as distinguished from selling or leasing property." *See* Section 7-9-3 (M).

The Department also points to various similar statements made by Taxpayers' attorney in responses to its discovery requests. However, the Hearing Officer perceives those statements with more scrutiny. As a general rule, "statements of counsel are not evidence." *See State v. Garcia*, 1978-NMCA-109, ¶4, 92 N.M. 730, 594 P.2d 1186. Moreover, and most significantly, there is no indication from the responses that Taxpayers reviewed or verified their accuracy in the form of a sworn verification. *See e.g.* NMRA 2017, Rule 1-033 C (2). Statements of counsel, as purportedly made in Department Exhibit BB should be afforded no weight for these reasons.

Taxpayers also argued that the Department "takes a surprising position, for the first time, that New Mexico business owners must pay gross receipts on their business income." The Hearing Officer does not perceive Taxpayers' synopsis of the issue to be entirely precise. The Department did not assess tax on Taxpayers' ordinary business income or income from distributions. The issue here is focused solely on "guaranteed payments" made in accordance with 26 USCS Section 707(c) which very much resemble compensation for services subject to gross receipts tax.

In support of their position, Taxpayer presented testimony from witnesses having decades of collective experience working for the Department, and representing taxpayers before the Department. Although the Hearing Officer found their perceptions to be informative, the central focus of their testimony concerned policy matters which the Hearing Officer may not consider in ruling upon the

specific issues in this protest. The only witnesses appearing on Taxpayers' behalf who had personal knowledge of the facts in this particular protest were Taxpayers themselves.

However, the responsibility of the Administrative Hearings Office and the undersigned Hearing Officer is to render a decision in accordance with the law and the evidence presented. *See* NMSA 1978, Section 7-1B-6 (D) (2). In doing so, the Hearing Officer is expressly prohibited from engaging or participating "in any way in the enforcement or formulation of general tax policy other than to conduct hearings." *See* NMSA 1978, Section 7-1B-7 (A).

Woven into the fabric of Taxpayers' policy arguments was specific reference to NMSA 1978, Section 7-9-17 and Regulation 3.2.1.14 (S) (4) NMAC. Section 7-9-17 provides an exemption from gross receipts tax for "receipts of employees from wages, salaries, commissions or from any other form of remuneration for personal services." As of the date of the assessments giving rise to this protest, Regulation 3.2.1.14 (S) (4) NMAC provided the following example which Taxpayers assert to be controlling in this protest: "L is a partner in a partnership. L performs services for third parties as part of L's duties as a partner and is compensated for doing so by the partnership. To the extent that such compensation may be treated as wages for federal income tax purposes, L's receipts from the partnership in the form of compensation are exempt."

However, the Hearing Officer was not persuaded that Taxpayer's construction of Regulation 3.2.1.14 (S) (4) NMAC provided relief from the assessment, primarily because the evidence did not establish that Taxpayers provided services to third parties, in contrast with the example provided by Taxpayer Exhibit 7. For example, Mr. Roybal testified that the facts underlying the correspondence in Taxpayer Exhibit 7, which relied on that regulation, involved a public accounting firm and the services its partners provided to its firm's clients. Consequently, the partners were compensated by the partnership for service renders to third parties, the clients. Those facts are more analogous to the

example provided in Regulation 3.2.1.14 (S) (4) NMAC than the facts underlying the present matter because Taxpayers did not provide service to third parties on behalf of the various businesses.

Accordingly, had there been nothing else to consider, the Hearing Officer's analysis could have concluded, and a final decision could have been entered on this final note. However, the Department took a final step which cannot be overlooked. It enacted an amendment to its regulations which now opposes the position it took in the current protest, *and favors Taxpayers' position*. Its regulation now *excludes "guaranteed payments" from gross receipts*.

The Amended Regulation

On July 20, 2018, Taxpayers filed their Notice of Supplemental Authority in which they brought attention to the Department's proposed rule regarding the status of "guaranteed payments" under the Gross Receipts and Compensating Tax Act. Taxpayer suggested that the proposed rule, if enacted, would be dispositive to the current protest. Accordingly, Taxpayer requested that a decision on the protest be reserved until the Department took final action on the proposed regulation. Taxpayer cited *GEA Integrated Cooling Tech. v. State Taxation & Revenue Dep't*, 2012-NMCA-010, 268 P.3d 48 and *Amoco Prod. Co. v. N.M. Taxation & Revenue Dep't*, 2003-NMCA-092, 134 N.M. 162, 74 P.3d 96 for the proposition that the proposed regulation, if enacted, should be dispositive of the protest. Taxpayers' citations provide no elaboration or legal analysis.

On July 25, 2018, the Department filed its response to the foregoing, indicating that the proposed rule, as of that date, was merely proposed, not enacted. The Department continued with a discussion of additional authority and legal analysis in opposition to Taxpayers' assertion that the proposed regulation, if enacted, should be dispositive.

On September 25, 2018, as the Hearing Officer sifted through evidence and weighed the legal arguments, the proposed regulation became effective. It provided that an owner's receipts from

transactions with the owned entity are gross receipts with an exception made for "guaranteed payments." It states in relevant part:

> **<u>3.2.1.14 GROSS RECEIPTS – GENERAL:</u>**
>
> …
>
> S. Owner's receipts from transactions with owned entity are gross receipts:
>
> …
>
> (2) When a partner or interest holder in an entity is allocated profits *or receives a guaranteed payment* or other distributions for activities undertaken as a partner on behalf of the partnership such as administrative services done solely for the benefit of the partnership or for activities for third-parties transacting business with the partnership*, these receipts of the partner are not gross receipts and are not subject to the gross receipts tax*. When a partner engages in business separately from the partnership any transactions of that partner with the partnership, where the partner is not acting as a partner on behalf of the partnership, are gross receipts[.]
>
> (Emphasis Added)

Although the amended rule has supplanted the prior, the Department's position in this protest, remains unchanged. The question is then whether or not the amended rule has any effect on the outcome of this protest?

<u>Retroactive Application of Amended Rule.</u>

The following issue is whether applying the amended rule would constitute an improper retrospective application of the regulation to the facts in this protest. Our courts have acknowledged that "[a]lthough the presumption of prospectivity appears straightforward, confusion often arises as to what retroactivity means in particular contexts." *See Gadsden Fed'n of Teachers v. Bd. of Educ.*, 1996-NMCA-069, ¶14, 122 N.M. 98, 920 P.2d 1052. A statute is considered retroactive if it impairs vested rights or requires new obligations, imposes new duties, or affixes new disabilities to past

transactions. *See GEA Integrated Cooling Tech. v. State Taxation & Revenue Dep't*, 2012-NMCA-010, ¶18, 268 P.3d 48. "[A] statute does not operate retroactively just because it is applied to facts and conditions existing on its effective date, even though the condition results from events that occurred prior to its enactment." *Id. citing State v. Morales*, 2010-NMSC-026, ¶9, 148 N.M. 305, 236 P.3d 24.

In *GEA*, the New Mexico Court of Appeals considered whether a 2007 amendment to the statute establishing the rate at which tax penalty was to be calculated and assessed should be applied to liabilities arising prior to its effective date, but assessed subsequent to its effective date, and whether such application gave the amendment an improper retroactive effect. *GEA* acknowledged that the Supreme Court's holding in *Crane v. Cox*, 1913-NMSC-089, ¶6, 18 N.M. 377, 137 P. 589 was dispositive, having addressed an analogous issue in which it considered whether there was an impermissible retrospective application of a new law providing for collection of delinquent taxes outstanding as of the enactment of that statue.

In its discussion, *GEA* recognized the long-standing presumption against the retroactive application of a statute, but held that the application of a new law to pre-existing facts did not automatically give the statute retroactive effect. Relying on the reasoning in *Crane*, it agreed that "[a] statute does not operate retroactively from the mere fact that it relates to antecedent events. A retrospective law [is] intended to affect transactions which occurred . . . before it became operative . . . and which ascribes to them affects not inherent in their nature in view of the law in force at the time of their occurrence." *See GEA*, 2012-NMCA-010, ¶20 *quoting Crane*, 1913-NMSC-089, ¶6.

GEA summarized the holding in *Crane*, explaining that "the new act . . . did not operate retroactively because the operation of the statute did not affect any right the taxpayer possessed under

prior law, did not change the taxpayer's status, and did not impose a consequence that was not already anticipated." *See GEA*, 2012-NMCA-010, ¶20.

The Hearing Officer was unpersuaded that *GEA* was on point. *GEA* arose from an amendment to a *statute*. Regulations, although having the force of law, are not statutes. *See City of Albuquerque v. N.M. Pub. Regulation Comm'n*, 2003-NMSC-028, ¶17, 134 N.M. 472, 481, 79 P.3d 297. Rather, regulations are the mechanism through which the Department interprets, exemplifies, implements and enforces the provisions of Tax Administration Act. *See Hammack v. N.M. Taxation & Revenue Dep't*, 2017-NMCA-086, ¶16, 406 P.3d 978; *See also* NMSA 1978, Section 9-11-6.2 A.

This distinction is significant because there is not a new statute affecting rights under prior law, changing a taxpayer's status, or imposing consequences that were not anticipated. In contrast, the amended rule more closely resembles an evolution of the Department's interpretation of the *same law*. This distinction favors the analysis in *Amoco*, which considered the effect of a *new interpretation* of the law, as against the effect of a new law.

Whether the Amended Rule is Interpretive.

One of the various powers of the Department is to issue "regulations, rulings, instructions or orders necessary to implement and enforce any provision of any law" which the Department has authority to administer and enforce. *See* NMSA 1978, Section 9-11-6.2. In the course of exercising that authority, the Department is entitled to the presumption that a regulation, ruling, instruction, or order is a "proper implementation of the provisions of the law that are charged to the [D]epartment, the secretary, any division of the [D]epartment or any director of any division of the [D]epartment." *See* NMSA 1978, Section 9-11-6.2 G; *See Chevron U.S.A., Inc. v. State ex rel. Dep't of Taxation & Revenue*, 2006-NMCA-050, ¶16, 139 N.M. 498, 134 P.3d 785 (agency regulations interpreting a statute are presumed proper and are to be given substantial weight). The presumption, therefore, is

that the rule in effect prior to September 25, 2018 was a proper implementation of the law and the amended rule is entitled to the same presumption. In other words, *both* interpretations are proper implementations of the law, and should be afforded substantial weight.

Amoco is instructive because it explains that rulings and regulations do not diminish or enlarge statutory law. In that case, a taxpayer and the Department quarreled over the retroactive effect of a ruling. The court of appeals recognized that there was no expression of intent for the ruling to be applied retroactively. Yet, it also recognized that the ruling was interpretative and consistent with the law, and that the ruling explained what the taxpayer's obligations have always been under the law. *See Amoco*, 2003-NMCA-092, ¶16 (*citing Am. Stores Co. v. Comm'r of Internal Revenue*, 170 F.3d 1267, 1277 (10th Cir. 1999); *See also Chalamidas v. Envtl. Improvement Div. (In re Proposed Revocation of Food & Drink Purveyor's Permit for House of Pancakes)*, 1984-NMCA-109, ¶13, 102 N.M. 63, 691 P.2d 64.

Similar to the observation in *Amoco*, the law in the present matter *also has not changed*. Neither party suggests that it has. Rather, the amended regulation, similar to the ruling discussed in *Amoco*, interprets the law as it has existed during all times relevant to the protest.

Evaluation of the previous rule and its subsequent amendment illustrate that the new rule is not contrary to the prior rule, but provides additional interpretation on the central factor of this protest, "guaranteed payments." In other words, where the prior rule was silent on the subject of this protest, the new rule addresses it directly in unambiguous terms, neither contradicting nor necessarily reversing the Department's previous interpretation of the law, but rather exemplifying what some former officials believed the interpretation was, or should have always been, referring in particular to Dr. Clifford, Mr. Crociata, and Mr. Anklam.

Unlike other scenarios, in which the Administrative Hearings Office has been more cynical of regulatory changes in the absence of corresponding statutory amendments, the amended regulation at issue in this protest does not conflict or contradict with a prior regulation. *See e.g. In the Matter of HealthSouth Rehabilitation*, Decision and Order, No. 16-16 (non-precedential). Rather, the amended regulation is consistent with its predecessor, merely providing additional elaboration on matters not previously addressed by the prior.

Accordingly, the Hearing Officer finds that the amended regulation, effective September 25, 2018 is interpretive of the law as it has existed during all times relevant to this protest. Similar to the facts in *Amoco*, Taxpayer should be entitled to the benefit of the Department's maturing interpretation of the law, because the law, upon which that interpretation is established, has not changed. The Department contends that "to apply the new regulation to the protest would be to shield Taxpayers from liability completely; this result is incorrect both because it constitutes retroactive application, and because it results in statutory construction that is in favor of the taxpayer." *See* New Mexico Taxation and Revenue Department's Response to Notice of Supplement Authority, Page 3.

Having fully evaluated the Department's argument regarding retroactivity, the Hearing Officer will briefly comment on the final portion of the quotation. Without reservation, counsel for the Department performed diligently and admirably for his client. However, the Department elected to fundamentally resolve the central issue in this protest through promulgation, rather than litigation. To the extent the Department may take issue with a "statutory construction that is in favor of [Taxpayers][,]" the Hearing Officer merely points out that the decision in this protest relies on the *Department's* interpretation of the law, as that law has existed during all times relevant to this protest, and that interpretation should be afforded substantial weight. *See Chevron*, 2006-NMCA-050, ¶16.

Otherwise, there is simply no legal basis or justification to withhold from Taxpayers the benefit of the Departments' enlightened interpretation of the law, as provided in the amended regulation. To do otherwise would exemplify what a court might consider pronouncing arbitrary and capricious. *See Vigil v. Pub. Emples. Ret. Bd.*, 2015-NMCA-079, ¶26, 355 P.3d 67 ("a decision is arbitrary and capricious 'if it provides no rational connection between the facts found and the choices made, or entirely omits consideration of relevant factors or important aspects of the problem at hand.'") *quoting Atlixco Coal. v. Maggiore*, 1998-NMCA-134, ¶24, 125 N.M. 786, 965 P.2d 370. Taxpayers' protest should be GRANTED.

CONCLUSIONS OF LAW

A. Taxpayers filed timely, written protests of the Department's assessments and jurisdiction lies over the parties and the subject matter of this protest.

B. A timely hearing occurred within 90 days of the date of Taxpayer's protest pursuant to NMSA 1978, Section 7-1B-8 (A).

C. Under NMSA 1978, Section 7-9-5 (2002), Taxpayer's gross receipts derived from engaging in business in New Mexico are presumed taxable.

D. A "guaranteed payment" to a partner for activities undertaken on behalf of the partnership are not gross receipts and are not subject to the gross receipts tax. *See* Regulation 3.2.1.14 S (9/25/2018).

For the foregoing reasons, Taxpayers' protest is GRANTED. The Department shall abate tax, penalty, and interest under the assessments.

DATED: October 3, 2018

Chris Romero
Hearing Officer
Administrative Hearings Office
P.O. Box 6400
Santa Fe, NM 87502

NOTICE OF RIGHT TO APPEAL

Pursuant to NMSA 1978, Section 7-1-25 (2015), the parties have the right to appeal this decision by *filing a notice of appeal with the New Mexico Court of Appeals* within 30 days of the date shown above. If an appeal is not timely filed with the Court of Appeals within 30 days, this Decision and Order will become final. Rule of Appellate Procedure 12-601 NMRA articulates the requirements of perfecting an appeal of an administrative decision with the Court of Appeals. Either party filing an appeal shall file a courtesy copy of the appeal with the Administrative Hearings Office contemporaneous with the Court of Appeals filing so that the Administrative Hearings Office may begin preparing the record proper. The parties will each be provided with a copy of the record proper at the time of the filing of the record proper with the Court of Appeals, which occurs within 14-days of the Administrative Hearings Office receipt of the docketing statement from the appealing party. *See* Rule 12-209 NMRA.

CERTIFICATE OF SERVICE

On October 3, 2018, a copy of the foregoing Decision and Order was submitted to the parties listed below in the following manner:

First Class Mail *Interagency Mail*

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