BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO

IN THE MATTER OF THE PROTEST OF
RICHEY CONSTRUCTION COMPANY, INC. **NO. 00-01**
ID. NO 02-113799-00 4, PROTEST TO
ASSESSMENT NO 2082085

DECISION AND ORDER

This matter came on for formal hearing on December 14, 1999 before Gerald B. Richardson, Hearing Officer. Richey Construction Company, Inc., hereinafter, "Taxpayer", was represented by Mr. Clinton Richey, its Vice-President, Chief Operating Officer and General Manager. The Taxation and Revenue Department, hereinafter, "Department", was represented by Bruce J. Fort, Special Assistant Attorney General. Based upon the evidence and the arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The Taxpayer is a general construction contractor whose principal offices are located in Gilbert, Arizona with a branch facility located in Kirtland, New Mexico.

2. On February 13, 1996, the Department wrote the Taxpayer notifying it that it had been selected for an audit In the notification letter the Department informed the Taxpayer that the types of records to be examined included sales and purchase invoices, books, general and subsidiary ledgers, financial statements and state and federal income tax returns.

3. Department auditor Sue Solosky conducted the audit of the Taxpayer at the Taxpayer's offices in Gilbert, Arizona on April 22 and 23, 1996.

4. Annette Anselman, an employee of the Taxpayer who prepares the Taxpayer's returns filed with the Department under its combined reporting system, worked with the Department's

auditor during the conduct of the audit at Taxpayer's offices to provide information, documents, answer the auditor's questions, etc.

5. Although Ms. Anselman was familiar with New Mexico's gross receipts tax at the time of the audit, she was not at all familiar with New Mexico's compensating tax, and the Taxpayer had never reported or filed tax returns with the Department reporting and paying compensating tax.

6. The Department's auditor found several audit exceptions relating to work the Taxpayer had done with respect to the construction of housing on Indian reservations in New Mexico. The Taxpayer had acted as a prime contractor under a contract with the All Indian Housing Authority to construct homes on Sandia Pueblo. The Taxpayer had not reported gross receipts tax on its receipts from this project because it believed that imposition of the tax was preempted by federal law. Because the Department's auditor considered the All Indian Housing Authority to be a federal agency, the auditor believed that the Taxpayer's receipts from this project were subject to gross receipts tax.

7. The other exceptions found by the Department's auditor related to three Indian housing projects on the Navajo Reservation in which the Taxpayer acted as a subcontractor, performing site grading, installation of main sewer lines and lateral lines to individual houses, construction of street curbs and gutters and asphalt paving of the streets. In two of the projects, the prime contractor was Hunt Building Corporation and in the third, the prime contractor was Joe E. Woods Construction Company.

8. With respect to the housing construction projects on the Navajo Reservation, the Taxpayer purchased some of the materials off reservation, either in New Mexico or Arizona, for use in the construction projects on the reservation. Some of the materials purchased off-reservation in New Mexico were purchased by the Taxpayer using a Type 6 Nontaxable

Transaction Certificate ("NTTC"). This enabled the vendor of those materials to claim a deduction from gross receipts tax on the sale of those materials, consequently enabling the Taxpayer to purchase those materials free of the cost of passed on gross receipts tax. In other instances, the sale of the materials to the Taxpayer was subject to gross receipts tax imposed upon the vendor of the materials.

9. The Department periodically sends CRS-1 filers kits to all taxpayers who report to the Department under the Combined Reporting System. The Combined Reporting System covers the gross receipts, compensating and withholding tax programs which the Department administers.

10. The Department's CRS-1 filers kits instruct taxpayers that Type 6 NTTCs support a deduction from gross receipts tax upon the sale of construction materials to a person in the construction business. The instructions further provide that it is a requirement that the materials become a part of a construction project and that upon its completion, the construction project must be subject to the gross receipts tax.

11. The Department's auditor proposed to assess compensating tax on the value of materials which were purchased off reservation in New Mexico in transactions which had not been subject to gross receipts tax and which were used by the Taxpayer in the construction projects on the portion of the Navajo Reservation falling within the borders of New Mexico.

12. The Department's auditor is of oriental descent and for whom English is a second language. Ms. Anselman had considerable difficulty communicating with and understanding the auditor.

13. Ms. Anselman cannot recall whether the Department's auditor requested to see the purchase invoices for materials used in the Navajo Reservation projects. Some of them would

have been available on the Taxpayer's premises during the conduct of the audit, and some would have been in archival storage off the Taxpayer's business premises.

14. The communication difficulties between the Department's auditor and Ms Anselman, together with Ms. Anselman's lack of understanding of New Mexico's compensating tax caused a breakdown in communication between the Taxpayer and the Department with respect to the need for the actual purchase invoices so that the amount of compensating tax to be assessed could be calculated with precision.

15. Because the Department's auditor did not have available to her the actual purchase invoices to establish the value of the materials purchased off-reservation in New Mexico for the construction work the Taxpayer performed on the Navajo Reservation, the auditor calculated the amount of the compensating tax to be assessed by estimating that 50% of the Taxpayer's receipts for those projects represented the value of those materials purchases.

16. As a result of the Department's audit, on October 31, 1996, the Department mailed Assessment No 2082085 to the Taxpayer, assessing $68,453.25 in gross receipts tax, $130,459.73 in compensating tax, $19,891.32 in penalty and $86,136.69 in interest for a total assessment of $304,940.99 for the reporting periods of January, 1990 through December, 1995.

17. On November 22, 1996, the Taxpayer filed a timely, written protest to Assessment No 2082085 with the Department.

18. The Department has agreed that because the All Indian Housing Authority is an Indian entity, that its assessment of gross receipts tax on the receipts from that project is preempted by operation of federal law and it has been abated.

19. The Department has agreed that its original estimate that 50% of the Taxpayer's receipts from the construction projects on the Navajo Reservation represents the value of materials is too high. It has also agreed that only the portion of materials which were purchased

off-reservation within New Mexico in transactions which were not subjected to gross receipts tax are appropriate for the imposition of compensating tax.

20. At the formal hearing the Taxpayer presented credible evidence to demonstrate that it purchased materials in the amount of $350,099.61 for incorporation into its construction projects on the Navajo Reservation, which purchases were made in off-reservation transactions, from sources within New Mexico and which transactions were not subjected to the imposition of gross receipts tax. This amount represents 8.627% of the value of the Taxpayer's receipts from the construction projects on the Navajo Reservation.

21. Applying the statutory 5% compensating tax rate to the value of materials purchased off-reservation within New Mexico for use by the Taxpayer in its construction projects on the Navajo Reservation results in $17,504.98 in compensating tax.

22. The Department's auditor determined that during 1990, the Taxpayer had $298,608.24 in unidentified revenues and included that amount in the tax base to which the 50% estimate of value of materials purchases was applied for purposes of calculating the amount of compensating tax assessed by the Department. The auditor arrived at the amount of unidentified revenues by comparing the amounts of gross revenues carried on the Taxpayer's books to the gross receipts reported by the Taxpayer

23. Mr. Richey testified credibly that the unidentified revenues represented compensation owed the Taxpayer for amounts retained by its customers for warranty retainers on projects completed prior to the audit period. Mr. Richey further credibly explained that the discrepancy in gross revenues and gross receipts was attributable to the fact that the Taxpayer's books are kept on an accrual basis and its gross receipts are reported on a cash basis and the unidentified revenues represented amounts which had been reported in the Taxpayer's records during periods prior to the audit period.

24. Ms. Anselman, who prepared the Taxpayer's CRS-1 returns for filing with the Department, never sought legal advice from Mr. Richey, who was the General Manager of the Taxpayer, or from any other legal counsel or accountants concerning whether compensating tax should be reported and paid with respect to construction materials which it used in the Indian housing projects where it acted as a subcontractor.

DISCUSSION

The issues which this case presents are largely the result of misunderstandings between the Taxpayer and the Department, both during and after the Department's audit of the Taxpayer. Those misunderstandings were exacerbated by the fact that the Taxpayer's activities upon which tax was assessed were in connection with construction projects on Indian reservations within New Mexico, thus involving the complex and confusing area of state jurisdiction to tax activities involving Indian tribes and their members.

The first area of misunderstanding arose during the audit with respect to the Taxpayer's receipts as a prime contractor constructing housing on Sandia Pueblo for the All Indian Housing Authority. The auditor thought that the All Indian Housing Authority might be a federal agency, in which case, in accordance with ***Blaze Construction Co v. Taxation and Revenue Department of New Mexico***, 118 N.M. 647, 884 P.2d 803 (1994), *cert. denied* 514 U.S. 1016, 115 S.Ct. 1359 (1995), the Taxpayer's receipts would be subject to tax. Because the Taxpayer did not have documentation to establish the nature of the All Indian Housing Authority, gross receipts tax was assessed. It has now been abated by the Department on the basis of federal preemption. *See,* ***Ramah Navajo School Board v. Bureau of Revenue,*** 458 U.S. 832, 102 S.Ct. 3394 (1982) (gross receipts tax imposed upon non-Indian construction company building a school for the Navajo Tribe on the Navajo Reservation preempted by operation of federal law).

The second area of misunderstanding arose during the audit with respect to the assessment of compensating tax on the value of materials used by the Taxpayer on the other Indian housing construction projects in which it acted as a subcontractor. Some of the materials were purchased by the Taxpayer using NTTCs, resulting in the vendor failing to charge passed on gross receipts tax on the purchase to the Taxpayer, some were purchased in Arizona, and some were purchased in New Mexico but without the use of NTTCs. The auditor did not review all of the purchase invoices from these projects to determine the amount of compensating tax assessed, because the invoices were not made available at the time of the audit, but simply estimated that all materials had been purchased in New Mexico free of gross receipts tax and estimated the amount of materials at 50% of the Taxpayer's receipts from those projects. Although the Department had sent a letter prior to the audit to have all records and invoices available for the auditor when the audit occurred, apparently the auditor did not ask for the invoices when she was there to do the audit and the issue only came up during the exit interview between the auditor and Ms. Anselman. Ms. Anselman was unfamiliar with the operation of the compensating tax and so probably did not understand the significance of the invoices to demonstrate how a more accurate amount of compensating tax could have been calculated for purposes of assessment. This is especially so since the Taxpayer did not believe that the housing construction activities being performed on the Indian reservations were taxable, let alone the materials which went into those construction projects.

All of these misunderstandings led to an impasse between the Department and the Taxpayer which lasted for several years until the matter was set for hearing. Finally, in early November, 1999, the Taxpayer brought to the Department a detailed listing of the purchase invoices for the materials it purchased in New Mexico for its use in the New Mexico construction projects, together with copies of the invoices, in an attempt to avail itself of the

amnesty program the Department was administering at that time. Because of the volume of requests for amnesty, the volume of the materials brought in by the Taxpayer, and the lack of personnel at the Department who would be available to review these materials in the short amount of time before the close of the amnesty period, the Department refused to review the materials to recalculate the amount of compensating tax owing and allow the Taxpayer to apply for amnesty as to the penalty and interest owing on any recalculated amount of compensating tax. Thus, the matter came on for hearing.

At the hearing, the Taxpayer presented credible evidence to demonstrate that it purchased materials in the amount of $350,099.61 for incorporation into its construction projects on the Navajo Reservation, which purchases were made in off-reservation transactions from sources within New Mexico, and which transactions were not subjected to the imposition of gross receipts tax. This amount represents 8.627% of the value of the Taxpayer's receipts from the construction projects on the Navajo Reservation. The Taxpayer's evidence was quite thorough, with purchase invoices for all purchases for the Navajo Reservation projects, except those occurring in Arizona, which demonstrated whether the materials were purchased in transactions on which gross receipts tax was charged or not. The Department conceded that no compensating tax would be owing on materials purchased in Arizona, but it argued that since the Taxpayer's records produced at the hearing did not actually contain copies of the Arizona invoices to demonstrate that the materials were, in fact, purchased in Arizona, the percentage of error to be applied to arrive at the correct amount of compensating tax should be "fudged up" to 10% to account for this discrepancy. Because I find that the Taxpayer's evidence was highly credible and substantially complete with regard to its off-reservation materials purchases, I find that the Taxpayer has met its burden of proving that the Department's assessment of compensating tax was overstated and should be reduced to $17,504.98 in compensating tax principle.

With respect to the basis for the compensating tax assessment, compensating tax was assessed pursuant to § 7-9-7(A)(3), which provides in pertinent part:

> A. For the privilege of using tangible personal property in New Mexico, there is imposed on the person using the property an excise tax equal to five percent of the value of tangible property that was:
> (3) acquired as the result of a transaction which was not initially subject to…the gross receipts tax but which transaction, because of the buyer's subsequent use of the property, should have been subject to…the gross receipts tax.

In this case, the Taxpayer made materials purchases from suppliers located within New Mexico and outside of the boundaries of the Navajo Reservation, and it issued Type 6 NTTCs to some of its materials vendors when making such purchases. The Type 6 NTTC allows the vendor to claim a deduction from gross receipts tax pursuant to § 7-9-51 NMSA 1978, which provides as follows:

> A. Receipts from selling tangible personal property may be deducted from gross receipts if the sale is made to a person engaged in the construction business who delivers a nontaxable transaction certificate to the seller.
> B. The buyer delivering the nontaxable transaction certificate *must incorporate the tangible personal property as:*
> (1) an ingredient or component part of a construction project *which is subject to the gross receipts tax upon its completion* or upon the completion of the overall construction project of which it is a part; or
> (2) an ingredient or component part of a construction project which is subject to the gross receipts tax upon the sale in the ordinary course of business of the real property upon which it was constructed.
> (emphasis added).

In this case, both the Department and the Taxpayer agree that the Indian housing construction project itself, being built on the Navajo Reservation for the tribe, would not be subject to gross receipts tax under the implied federal preemption doctrine applied in the ***Ramah*** case cited above. Because the construction project was not subject to gross receipts tax, compensating tax

would be imposed based upon the Taxpayer's initial purchase not being subject to gross receipts tax because of the NTTC it issued to its supplier, and the Taxpayer's subsequent use of the materials for incorporation into a construction project which was not subject to the gross receipts tax upon its completion.

The Taxpayer argues that the compensating tax should be preempted on the same basis that imposition of the gross receipts tax on the prime contractor would be preempted under the implied federal preemption doctrine. There is, however, a distinct territorial aspect to the implied federal preemption doctrine, which does not apply to preempt state taxes on transactions occurring off reservation. *See,* ***Mescalero v. Jones,*** 411 US. 145, 93 S.Ct. 1267 (1973). In this case, the Taxpayer first used the materials at issue when it purchased them off-reservation and transported them from their place of purchase to the reservation. Thus, the taxable incident occurred off-reservation and the compensating tax is not preempted.

The Taxpayer also asks for relief from the imposition of penalty and interest on the compensating tax assessed, based upon the confusing nature of the compensating tax and the complexity of the taxability issue in this case because of the overlay of federal Indian law.

The imposition of penalty is governed by the provisions of NMSA 1978, Section 7-1-69(A) NMSA 1978, which imposes a penalty of two percent per month, up to a maximum of ten percent:

> In the case of failure, due to negligence or disregard of rules and regulations, but without intent to defraud, to pay when due any amount of tax required to be paid or to file by the date required a return regardless of whether any tax is due,....

This statute imposes penalty based upon negligence (as opposed to a willful or fraudulent intent) for failure to timely pay tax. Thus, there is no contention that the failure to report and pay taxes was based upon any conscious attempt by the Taxpayer to underreport taxes. What remains to be determined is whether the Taxpayer was negligent in failing to report its taxes properly. Taxpayer

"negligence" for purposes of assessing penalty is defined in Regulation 3 NMAC 1.11.10 (formerly TA 69:3) as:

> 1) failure to exercise that degree of ordinary business care and prudence which reasonable taxpayers would exercise under like circumstances;
> 2) inaction by taxpayers where action is required;
> 3) inadvertence, indifference, thoughtlessness, carelessness, erroneous belief or inattention.

In this case the Taxpayer's failure to report and pay taxes was based upon Ms. Anselman's lack of knowledge about New Mexico's compensating tax. Ms. Anselman admitted that prior to the Department's audit, she had no knowledge or understanding of the compensating tax. Thus, even aside from the Indian law issues, she would not have understood that NTTC's should not be used to purchase materials unless the construction project itself will be subject to gross receipts tax. New Mexico has a self-reporting tax system which requires that taxpayers voluntarily report and pay their tax liabilities to the state. Because of this, the case law is well settled that every person is charged with the reasonable duty to ascertain the possible tax consequences of his actions, and the failure to do so has been held to amount to negligence for purposes of the imposition of penalty pursuant to Section 7-1-69 NMSA 1978. ***Tiffany Construction Co. v. Bureau of Revenue***, 90 N.M. 16, 558 P.2d 1155 (Ct. App. 1976), *cert. denied*, 90 N.M. 255, 561 P.2d 1348 (1977). Thus, at the very least, Ms. Anselman should have sought advice to determine whether the nontaxable nature of the housing construction project itself would have any tax consequences for it as a subcontractor purchasing materials for use in the project. She admitted that she did not do so, and that amounts to negligence for purposes of the imposition of penalty.

Section 7-1-67(A) NMSA 1978 addresses the imposition of interest on tax deficiencies and provides as follows:

> A. If any tax imposed is not paid on or before the day on which it becomes due, interest ***shall*** be paid to the state on such amount from the first day following the day on which the tax becomes due,

> without regard to any extension of time or installment agreement, until it is paid. (emphasis added).

It is a well settled rule of statutory construction that the use of the word "shall" in a statute indicates that the provisions are intended to be mandatory rather than discretionary, unless a contrary legislative intent is clearly demonstrated. ***State v. Lujan,*** 90 N.M. 103, 560 P.2d 167 (1977). Applying this rule to Section 7-1-67, the statute requires that interest be paid to the state on any unpaid taxes and no exceptions to the imposition of interest are countenanced by the statute. Thus, it doesn't matter why taxes were not paid in a timely manner. Interest is imposed any time that taxes are not paid when they are due, and for the period of time that they are unpaid. Thus, there is no basis for adjusting the interest assessed in this matter.

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest to Assessment No. 2082085 and jurisdiction lies over both the parties and the subject matter of this protest.

2. The Taxpayer was subject to the imposition of compensating tax on its purchases of construction materials off-reservation within New Mexico using a Type 6 NTTC, enabling it to purchase those materials in transactions upon which gross receipts tax was not imposed.

3. The Taxpayer overcame the presumption of correctness which attached to the assessment of compensating tax on its off-reservation materials purchases when it presented competent and credible evidence to support a compensating tax assessment in the amount of $17,504.98.

4. The Taxpayer's failure to report and pay compensating tax was based upon its own negligence and the imposition of penalty with respect to the compensating tax assessment was proper.

5. The imposition of interest was proper.

For the foregoing reasons, the Taxpayer's protest IS GRANTED IN PART AND DENIED IN PART. The Department IS HEREBY ORDERED to abate all but $17,504.98 in compensating tax, and to abate the penalty and interest relating to the amount of compensating tax ordered to be abated.

DONE, this 11th day of January, 2000.