

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

**IN THE MATTER OF THE PROTEST OF
QUALITY EXTERIORS, INC.
ID NO. 02-322159-00-3
ASSESSMENT NO. 2405744**

No. 00-28

DECISION AND ORDER

A formal hearing on the above-referenced protest was held September 21, 2000, before Margaret B. Alcock, Hearing Officer. The Taxation and Revenue Department ("Department") was represented by Javier Lopez, Special Assistant Attorney General. Quality Exteriors, Inc. ("Taxpayer") failed to appear for the hearing. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The Taxpayer is a corporation based in Lubbock, Texas.
2. The Taxpayer is engaged in the business of installing home siding, windows, soffits and fascia. Most the Taxpayer's business is generated by telemarketers located in Texas, although the Taxpayer has a few salesmen who travel into New Mexico to solicit orders.
3. In 1996, the Taxpayer registered with the Department for payment of gross receipts, compensating and withholding taxes, which are reported under New Mexico's Combined Reporting System (CRS).
4. At that time, the Taxpayer operated under the name "Caffey Construction, Inc." and had two shareholders: Danny Caffey and Ron Karvas.
5. In 1997, Ron Karvas and Mike Beasley bought out Danny Caffey's interest in Caffey Construction, Inc. and changed the name of the company to "Quality Exteriors, Inc."

6. Sometime during 1997, the Department's Roswell office performed a routine comparison of building permits issued in the southeastern region of New Mexico with the builders' gross receipts tax reporting.

7. The Department found approximately 20 building permits issued to Mike Beasley, the Taxpayer's vice-president.

8. Based on a discrepancy between the building permits and the gross receipts reported on the Taxpayer's CRS-1 returns, Danny Pogan was assigned to conduct an audit of the Taxpayer.

9. On January 2, 1998, the Department sent the Taxpayer an audit notice that included the following statements: "You will be requested to make your records and books of account available for examination. Generally, the types of records to be examined include: payroll, sales invoices, purchase invoices, books of original entry, general and subsidiary ledgers, financial statements and state and federal income tax returns."

10. Upon receiving the notice, the Taxpayer called Danny Pogan to ask how it had been selected for audit. Mr. Pogan told the Taxpayer it was selected based on a discrepancy between receipts shown on building permits and receipts shown on the Taxpayer's CRS-1 returns. Mr. Pogan stated he also would be looking at the Taxpayer's reporting of compensating, withholding and corporation income taxes.

11. The Taxpayer asked Mr. Pogan for a list of the building permits he had found and a letter indicating what other books and records he would be reviewing during the field audit.

12. On February 11, 1998, Mr. Pogan provided the Taxpayer with the list of building permits and sent the Taxpayer a letter setting out "some of the records and books" he would need to examine, including: "Sales invoices and/or sales contracts on construction projects performed in New Mexico."

13. The audit field work was conducted at the Taxpayer's offices in Lubbock, Texas, on March 25, 26 and 27, 1998.

14. When Mr. Pogan arrived at the Taxpayer's offices, he was met by its president, Ron Karvas, and its vice president, Mike Beasley.

15. Mr. Karvas and Mr. Beasley were the only employees with whom Mr. Pogan worked during the audit. During most field audits, Mr. Pogan works with a taxpayer's bookkeeper, accountant or tax manager, and it was very unusual for the president and vice president of the company to be his only audit contacts.

16. At the commencement of the audit, Mr. Pogan was told there were no general ledgers, sales journals or other summary records available, and so he had to rely on sales documents contained in individual customer files.

17. Mr. Pogan was not given free access to the Taxpayer's records. Instead, he was given files to review by Mr. Karvas, who stated that all records relating to New Mexico sales were kept in the middle drawer of a filing cabinet in his office. When Mr. Pogan finished with one batch of files, he went to Mr. Karvas's office and Mr. Karvas took another batch from the file drawer and gave it to Mr. Pogan.

18. Mr. Karvas gave Mr. Pogan files for all of the jobs covered by the building permits previously located by the Department, plus 20 additional files for New Mexico jobs not covered by building permits.

19. After reviewing the files provided, Mr. Pogan asked Mr. Karvas: "Is this all you have for me? Is this all New Mexico sales?" Mr. Karvas told Mr. Pogan there were no more documents for him to review.

20. On the last day of the audit, Mr. Pogan went over his findings with Mr. Karvas and gave him an estimate of the amount of taxes due. At Mr. Karvas's direction, the company's bookkeeper made out a check for that amount and gave it to Mr. Pogan before he left the office.

21. During Mr. Pogan's initial audit interview, Mr. Karvas said he had consulted with the Taxpayer's attorneys, Modrall, Sperling, Roehl, Harris & Sisk, P.A., concerning the audit and they told him to provide as many invoices as he could. Mr. Karvas told Mr. Pogan the attorneys were also looking into the possibility of changing the Taxpayer's corporate structure to create a separate New Mexico corporation.

22. In May 1998, the Taxpayer's attorneys directed the Department to change the Taxpayer's registration from "Quality Exteriors, Inc." to "Quality Exteriors of New Mexico, Inc."

23. In March 1999, one year after Mr. Pogan completed his audit of the Taxpayer, a former employee of the Taxpayer contacted the Department's Inspector General.

24. The employee told the Inspector General the Taxpayer had withheld information from Mr. Pogan during the 1998 audit and provided the Inspector General with two summary schedules of the Taxpayer's New Mexico receipts: Sales by Customer Detail and Income by Customer Summary.

25. The Inspector General assigned the matter to his audit manager, Rick Salazar, who compared the Taxpayer's CRS-1 returns to the schedules provided by the Taxpayer's former employee. Mr. Salazar found the following discrepancies: in 1996, the Taxpayer reported New Mexico receipts of \$63,000, compared to New Mexico receipts of \$446,000 shown on the schedules; in 1997, the Taxpayer reported New Mexico receipts of \$130,000, compared to New Mexico receipts of \$630,000 shown on the schedules. Mr. Salazar then reviewed the Department's 1998 audit and

found that tax on an additional \$50,000 of receipts had been assessed to the Taxpayer, leaving a balance of unreported receipts in the range of \$1 million.

26. On March 17, 1999, Mr. Salazar contacted the Taxpayer's former employee to obtain additional information. The employee stated that during his employment with the Taxpayer, he became concerned that the Taxpayer was withholding information from the Department. The employee described the Taxpayer's actions as follows:

(a) When the Taxpayer received the Department's notice of audit, the Taxpayer contacted its attorneys and the attorneys coached the Taxpayer on how to handle the audit.

(b) First, the Taxpayer altered its computer records to reflect the majority of New Mexico sales as Texas sales.

(c) The Taxpayer then identified the paper records that would be given to the auditor. These records were limited to jobs for which the Department already had building permits, plus a small number of the New Mexico jobs performed without permits. The documents to be given to the auditor were segregated in a file cabinet in Mr. Karvas's office.

(d) In order to keep the auditor from having access to information from anyone other than Mr. Karvas and Mr. Beasley, the Taxpayer directed its employees to stay home or stay away from the office during the time the auditor was in the office.

27. The employee also told Mr. Salazar that it was the Taxpayer's practice not to obtain building permits for its construction jobs unless questions were raised by a local building inspector or a customer. Accordingly, the Department's comparison of the Taxpayer's building permits to its gross receipts tax returns did not reveal the full extent of the Taxpayer's underreporting.

28. Mr. Salazar asked the employee whether he could provide customer contracts or invoices to verify the schedules of New Mexico receipts the employee had previously provided to the

Inspector General. The employee said that he could and sent Mr. Salazar copies of more than 100 New Mexico contracts that tied to the earlier schedules.

29. After speaking with the employee, Mr. Salazar called Danny Pogan to see whether the auditor could verify the information provided by the employee. Mr. Pogan confirmed the following facts: Mr. Karvas consulted with his attorneys after receiving the notice of audit; the records Mr. Pogan was given to review were limited to the jobs for which the Department had building permits, plus 20 additional jobs performed without permits; all of the records Mr. Pogan was given during the audit were segregated in a single drawer in Mr. Karvas's file cabinet; Mr. Karvas and Mr. Beasley were Mr. Pogan's only contacts during the audit; Mr. Pogan did not see any other employees at the Taxpayer's place of business, with the exception of a few telemarketers working in another part of the building and the bookkeeper, who arrived at the office only after the field work had been completed.

30. Mr. Pogan subsequently reviewed the documents provided by the Taxpayer's employee and found that they included contracts Mr. Pogan had already seen, as well as a substantial number of contracts Mr. Pogan had not been given during the audit.

31. Using the original audit work papers and the schedules and contracts provided by the Taxpayer's employee, Mr. Pogan completed a new audit of the Taxpayer for the period January 1996 through December 1998.

32. On August 4, 1999, the Department issued Assessment No. 2405744 to the Taxpayer in the total amount of \$149,618.90, representing \$83,408.70 gross receipts tax, \$42,213.72 penalty, and \$23,996.48 interest. The penalty portion of the assessment was assessed pursuant to Section 7-1-69(C) NMSA 1978, which imposes a 50 percent civil penalty when the failure to pay tax is based on a willful intent to evade or defeat payment of the tax.

33. On November 2, 1999, pursuant to an extension of time granted by the Department, the Modrall law firm filed a protest on behalf of the Taxpayer. The sole issue raised in the protest was the Taxpayer's liability for the 50 percent civil penalty.

34. On April 12, 2000, a notice scheduling a hearing on the protest for August 10, 2000 was mailed to Curtis Schwartz, an attorney with the Modrall firm. At the request of Timothy Van Valen, one of the firm's other attorneys, the hearing was rescheduled for September 21, 2000. A copy of the new scheduling order was mailed to Mr. Van Valen at the Modrall firm's Albuquerque office on April 19, 2000. A second copy of the scheduling order was mailed to Curtis Schwartz at the Modrall firm's Santa Fe office.

35. On June 8, 2000, Mr. Van Valen filed a Notice of Withdrawal of Representation. No one entered an appearance for the Taxpayer subsequent to the Modrall firm's withdrawal.

36. On September 11, 2000, the Department filed a prehearing statement as required by the scheduling order. The certificate of service indicates a copy of the Department's prehearing statement was mailed to the Taxpayer at the address provided in the Notice of Withdrawal of Representation. The Taxpayer failed to file its own prehearing statement or respond to the prehearing statement filed by the Department.

37. The Taxpayer failed to appear at the September 21, 2000 hearing on its protest.

DISCUSSION

The sole issue to be decided is whether the Taxpayer is liable for the 50 percent civil penalty, commonly referred to as a "fraud penalty", authorized by Section 7-1-69(C) NMSA 1978 for willful intent to evade or defeat payment of any tax. Although Section 7-1-17(C) NMSA 1978 creates a statutory presumption that any assessment of tax by the Department is correct, the presumption does not apply to fraud assessments. Section 7-1-78 NMSA 1978 provides that in any proceeding involving the

issue of whether a person has been guilty of fraud or corruption, “the burden of proof in respect of such issue shall be upon the director or the state.” Section 7-1-78 does not specify the standard or degree of proof required. The common law rule in New Mexico is that proof of fraud in a civil action must be established by clear and convincing evidence. *First National Bank in Albuquerque v. Abraham*, 97 N.M. 288, 292, 693 P.2d 575, 579 (1982). The Department has met its burden of proof in this case.

First, there is clear evidence the Taxpayer understood its legal obligation to pay tax on receipts from jobs performed in New Mexico. In 1996, the Taxpayer registered with the Department for payment of gross receipts tax and began filing CRS-1 returns reporting at least some portion of its New Mexico receipts. The Taxpayer failed, however, to report almost \$1 million of its New Mexico income, representing an underreporting of 80 to 85 percent. The Taxpayer has not denied its liability for tax on those receipts, nor has the Taxpayer made any attempt to explain the cause of such substantial underreporting.

Second, there is evidence that during the Department’s 1998 audit, the Taxpayer intentionally withheld records pertaining to the Taxpayer’s receipts from construction jobs performed in New Mexico. The Taxpayer has admitted that not all documents were provided to the auditor. On page 3 of its protest to the 50 percent fraud penalty the Taxpayer states:

This penalty is evidently based upon the auditor’s observation in the audit narrative that “[r]eceipts from construction projects, in which the taxpayer did not obtain building permits, were not provided to the auditor” during the initial audit. Audit Narrative, pg. DN2. *While on its face factually correct*, the reason is that the auditor did not request such documents during the initial audit.... The auditor was provided everything he asked to review during the initial audit. (Emphasis added)

The Taxpayer makes no claim that its failure to produce all documents relating to its New Mexico receipts was an oversight or due to any lack of knowledge concerning such records. Nor would such

claims be credible when the only persons with whom the auditor dealt were the president and vice president (and the sole shareholders) of the company. The only defense given for the Taxpayer's decision to withhold pertinent records is its statement that "the auditor did not request such documents." This statement is not supported by the evidence.

On January 2, 1998, the Department sent the Taxpayer an audit notice stating:

You will be requested to make your records and books of account available for examination. Generally, the types of records to be examined include: payroll, sales invoices, purchase invoices, books of original entry, general and subsidiary ledgers, financial statements and state and federal income tax returns.

Upon receiving the notice, the Taxpayer called Danny Pogan and discovered that it had been selected for audit based on a comparison of building permits to receipts reported on the Taxpayer's CRS-1 returns. The Taxpayer asked Mr. Pogan for a list of the building permits. The Taxpayer also asked him to identify what other books and records he would be reviewing during the field audit. On February 12, 1998, Mr. Pogan responded with a letter setting out "some of the records and books" he would need to examine, including: "Sales invoices and/or sales contracts on construction projects performed in New Mexico."

There is no question that the Taxpayer's New Mexico sales contracts fall within the category of documents identified in the audit notice and Mr. Pogan's February 1998 letter. There is nothing in either of these documents indicating an intent to limit the Department's audit to jobs for which building permits had been issued. Although the building permits were the original impetus for the audit, Mr. Pogan testified that he asked Mr. Karvas to provide all customer files relating to New Mexico sales. The fact that Mr. Karvas gave Mr. Pogan files for 20 unpermitted jobs, in addition to the 21 jobs for which permits had been issued, negates any contention that Mr. Karvas believed the audit was limited to New Mexico jobs performed under building permits. The only conclusion to be

drawn from the evidence is that the Taxpayer purposely withheld the majority of its New Mexico contracts in order to evade the payment of gross receipts tax.

Further evidence of the Taxpayer's intent to evade payment of tax is found in the information received from the Taxpayer's former employee. According to the employee, the Taxpayer made careful plans designed to prevent the auditor from discovering the true extent of the Taxpayer's underreporting. These plans included altering computer records, withholding documents, and insuring that other employees of the Taxpayer were not available to speak with the auditor. Although this testimony is hearsay, hearsay is admissible in administrative proceedings. An administrative hearing officer may consider evidence that would be inadmissible in a court of law, as long as the hearing officer's decision is supported by some evidence that would be admissible under the rules of evidence. *Bransford v. State Taxation and Revenue Department*, 1998 NMCA-077 ¶18, 125 N.M. 285, 290, 960 P.2d 827, 832. I also note that since the Taxpayer failed to appear to defend its protest, Mr. Salazar's testimony concerning his conversation with the Taxpayer's employee was entered in the record without objection. In *Tyrpak v. Lee*, 108 N.M. 153, 154-155, 768 P.2d 352, 353-354 (1989), the New Mexico Supreme Court held that the district court was entitled to rely on exhibits for which no foundation was laid when the defendant failed to appear and make a timely objection:

Tyrpak argues the three typewritten pages itemizing the amounts claimed by Lee were not competent evidence. We believe, however, even if the consideration of these exhibits without sworn foundational testimony was error, Tyrpak waived any such error by failing to appear and object in a timely manner. Incompetency and inadmissibility may be waived by failure to object, in which case the evidence may be considered if relevant.

In this case, the statements made by the Taxpayer's employee, together with Mr. Pogan's testimony and the Taxpayer's admission that it did not give Mr. Pogan all of the documents relating to its New

Mexico receipts, provides clear and convincing evidence of the Taxpayer's willful intent to evade payment of gross receipts tax due to New Mexico.

Finally, even assuming the Taxpayer's contention that it fully cooperated with the auditor were true, the Taxpayer's apparent belief that it was not required to pay tax on unreported receipts the Department's audit failed to uncover reveals a serious misunderstanding of New Mexico law. New Mexico has a self-reporting tax system. It is the obligation of taxpayers, who have the most direct knowledge of their business activities, to determine their tax liabilities and accurately report those liabilities to the state. *See*, Section 7-1-13 NMSA 1978; *Tiffany Construction Co. v. Bureau of Revenue*, 90 N.M. 16, 17, 558 P.2d 1155, 1156 (Ct. App. 1976), *cert. denied*, 90 N.M. 255, 561 P.2d 1348 (1977). Section 7-1-13(A) provides that "[t]axpayers are liable for tax at the time of and after the transaction or incident giving rise to the tax until payment is made. Taxes are due on and after the date on which the payment is required until payment is made." As noted in Regulation 3 NMAC 1.4.10.1, the words "and after" as used in Section 7-1-13(A) mean that taxes remain due until paid.

A taxpayer that knows it has unreported taxes due to the state has a continuing obligation to correct the reporting error. Tax compliance is not a game, and taxpayers are not entitled to withhold payment of tax until the Department "catches" them. In this case, the Taxpayer knew it had unreported receipts from New Mexico jobs performed without building permits, but failed to either bring the pertinent contracts to the auditor's attention or file amended returns to pay the tax due. In pursuing this course of action, the Taxpayer was clearly acting with willful intent to evade or defeat the payment of tax, and is subject to the 50 percent penalty provided in Section 7-1-69(C).

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest to Assessment No. 2405744, and jurisdiction lies over the parties and the subject matter of this protest.

2. The Taxpayer's failure to pay the gross receipts tax reflected in Assessment No. 2405744 was based on a willful intent to evade or defeat the payment of tax, and the Taxpayer is subject to the 50 percent penalty provided in Section 7-1-69(C) NMSA 1978.

For the foregoing reasons, the Taxpayer's protest IS DENIED.

DATED October 2, 2000.