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

IN THE MATTER OF THE PROTEST OF
TOBACCO PATCH **No. 01-17**
ID NO. 02-397117-00 7
ASSESSMENT NO. 2611399

DECISION AND ORDER

A formal hearing on the above-referenced protest was held August 8, 2001, before Margaret B. Alcock, Hearing Officer. Tobacco Patch was represented by its owner, Vicki C. Grogan ("Taxpayer"). The Taxation and Revenue Department ("Department") was represented by Bruce J. Fort, Special Assistant Attorney General. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. In 1991, the Taxpayer began doing business under the name Paw Paw Patch, a retail business that sold pet supplies and provided pet grooming services.

2. In November 1997, the Taxpayer expanded her business to include the sale of tobacco products. The Taxpayer subsequently terminated the pet supply and grooming side of the business and changed the name of her store to the Tobacco Patch.

3. The Taxpayer purchased her inventory of cigarettes from cigarette wholesalers. Because of laws governing the sale of tobacco products, the Taxpayer could not buy cigarettes directly from the manufacturer.

4.. The Taxpayer entered into "shelf display" and "buydown" contracts with the manufacturers of cigarettes she carried.

5. Under the terms of her buydown contracts (also referred to by some manufacturers as a "price promotion" or "discount program"), the Taxpayer agreed to reduce the price of certain brands of cigarettes by a specified dollar amount for a specified period of time. The Taxpayer also agreed to cooperate with the cigarette manufacturer in posting signs to advertise the discounted price. In return, the manufacturer agreed to pay the Taxpayer the difference between her usual retail price and the discounted price of the cigarettes covered by the agreement.

6. The amount of the buydown was determined by calculating the Taxpayer's inventory of covered cigarettes on the day the promotion began, adding inventory purchased during the promotion and then subtracting the inventory remaining at the end of the promotion. The resulting figure, which equaled the number of cigarettes sold at the discounted price, was then multiplied by the amount of the discount.

7. Because the Taxpayer was reimbursed the exact amount of the sales discount, the buydown program did not generate additional profit for the Taxpayer on a per pack or per carton basis. The Taxpayer did benefit, however, from the increased traffic and sales volume that resulted from selling cigarettes at a discounted price.

8. When selling cigarettes under the terms of a buydown contract during the audit period, the Taxpayer charged her customers gross receipts tax on the discounted price and did not include the buydown amount she received from the manufacturer when reporting her gross receipts to the Department.

9. Under the terms of her shelf-display contracts (also referred to by some manufacturers as a "marketing plan contract" or a "retail leaders program"), the Taxpayer allowed cigarette manufacturers to place free-standing, movable shelves at designated places in the store and temporary displays on the counter or hanging from the ceiling. The manufacturer with the highest

sales volume of cigarettes had first choice as to shelf and advertising placement and was also allowed more feet of shelf space; the manufacturer with the second highest sales volume chose its placement next, and so on.

10. Each manufacturer's representative set up and stocked its own shelf-display. The representative had access to the shelves during the Taxpayer's regular business hours, which were 6:00 a.m. to 6:00 p.m. six days a week, but could not access the shelves when the store was closed.

11. Because the sales representative visited the Taxpayer's store only once a month, the Taxpayer agreed to keep the shelves stocked with the manufacturer's cigarettes and to keep the shelves dusted and in good order.

12. The Taxpayer's shelf-display contracts ran for a period of one year.

13. During the audit period at issue, the Taxpayer did not pay gross receipts tax on the payments she received from her shelf-display contracts.

14. On June 20, 2000, the Department conducted a field audit of the Taxpayer.

15. On December 22, 2000, the Department issued Assessment 2611399 to the Taxpayer in the total amount of $194,560.95, representing $145,214.39 gross receipts tax, $14,528.98 penalty, and $34,817.58 interest for tax periods January 1994 through May 2000.

16. Most of the tax assessed was attributable to the fact that the Taxpayer had erroneously deducted her expenses and reported net, rather than gross, receipts on her gross receipts tax returns. $23,931.86 of the tax assessed was based on the Taxpayer's unreported receipts from buydown contracts, and $555.23 of the tax assessed was based on the Taxpayer's unreported receipts from shelf-display contracts.

17. The Taxpayer filed a written protest to the portions of the assessment relating to receipts from her buydown and shelf-display contracts, as well as the entire amount of penalty and interest assessed. The Taxpayer's protest was received by the Department on January 5, 2001.

DISCUSSION

The Taxpayer raises the following issues in support of her protest: (1) payments the Taxpayer received under the terms of her buydown agreements with cigarette manufacturers served to reduce the cost of the Taxpayer's inventory and are not taxable gross receipts; (2) payments the Taxpayer received under the terms of her shelf-display contracts with cigarette manufacturers were receipts from the lease of real property and are deductible under Section 7-9-53 NMSA 1978; (3) the six-month delay between the date the field audit started in June 2000 and the date the assessment was issued in December 2000 was unreasonable, and the Taxpayer should not be liable for interest and penalty accrued after June 2000; (4) the Taxpayer should not be penalized for her lack of knowledge and honest mistakes.

Burden of Proof. Section 7-1-17(C) NMSA 1978 states that any assessment of taxes made by the Department is presumed to be correct, and it is the taxpayer's burden to overcome this presumption. *Archuleta v. O'Cheskey*, 84 N.M. 428, 431, 504 P.2d 638, 641 (Ct. App. 1972). 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. *Wing Pawn Shop v. Taxation and Revenue Department*, 111 N.M. 735, 740, 809 P.2d 649, 654 (Ct. App. 1991). Accordingly, it is the Taxpayer's burden to come forward with evidence and legal arguments to show that the Department's assessment is incorrect.

Buydown Contracts. The Taxpayer argues that the payments she received under the terms of her buydown contracts with cigarette manufacturers represented a reduction in the cost of her inventory rather than receipts from the sale of cigarettes. The Taxpayer maintains the discounted price at which she sold cigarettes to her customers should be accepted as the full measure of her taxable receipts. The Department responds that the buydown payments cannot represent a reduction in the cost of the Taxpayer's inventory because the Taxpayer did not purchase her inventory from the manufacturers. It is the Department's position that the taxable value of the cigarettes sold by the Taxpayer is not limited to the discounted price charged to the customer, but includes the manufacturer's buydown payment. Alternatively, the Department argues that the buydown payments were consideration for promotional services provided by the Taxpayer.

Section 7-9-4 NMSA 1978 imposes an excise tax on the gross receipts of any person engaging in business in New Mexico. The definition of gross receipts is set out in Section 7-9-3(F) NMSA 1978 and provides, in pertinent part:

> F. "gross receipts" means the total amount of money or the value of other consideration received from selling property in New Mexico, from leasing property employed in New Mexico, from selling services performed outside New Mexico the product of which is initially used in New Mexico or from performing services in New Mexico. In an exchange in which the money or other consideration received does not represent the value of the property or service exchanged, "gross receipts" means the reasonable value of the property or service exchanged.
>
> (1) "Gross receipts includes: ...
>
> (a) ....
>
> (b) the total commissions or fees derived from the business of buying, selling or promoting the purchase, sale or leasing, as an agent or broker on a commission or fee basis, of any property service, stock, bond or security....
>
> (2) "Gross receipts" excludes:
>
> (a) cash discounts allowed and taken; ....

The issue to be determined is whether the buydown payments received by the taxpayer come within this statutory definition of "gross receipts."

Reduction in Cost of Inventory. The Taxpayer maintains that manufacturers' buydown payments were a reduction in the cost of her inventory rather than receipts from the sale of cigarettes. As the Department correctly points out, however, the Taxpayer purchased her inventory from cigarette wholesalers and not from the manufacturers. To qualify as a reduction in the cost of inventory, the payments would have to come from the wholesaler. The Taxpayer argues that the Department's position is unfair because the laws governing tobacco sales prevent her from buying cigarettes directly from the manufacturer. While this may be true, it does not change the fact that the wholesalers from whom the Taxpayer purchased her inventory were not parties to the buydown contracts. Nor did those contracts have any effect on the price the Taxpayer paid the wholesalers for cigarettes. Under these circumstances, the buydown payments cannot be characterized as a reduction in the cost of inventory.

Value of Goods Sold. The Taxpayer's second argument is that the buydown payment she received on each package of cigarettes was a "cash discount allowed and taken" and is specifically excluded from gross receipts pursuant to the definition in Section 7-9-3(F)(2) NMSA 1978. The Taxpayer maintains the discounted price at which she sold cigarettes to her customers should be accepted as the full measure of her taxable receipts. The phrase "cash discount allowed and taken" is not defined in the Gross Receipts and Compensating Tax Act. Department Regulation 3.2.1.14(I) NMAC does discuss the term in relation to the use of discount coupons:

> I. **Discount coupons**. The gross receipts attributable to a sale in which a seller accepts discount coupons provided by the buyers are measured by the cash received plus the value of the coupon. However, if the discount coupon is not redeemable by the seller, the acceptance of the coupon constitutes a cash discount allowed and taken and is excluded from gross receipts.

It is the Department's position that a manufacturer's agreement to reimburse the Taxpayer the full amount of the sales discount on each package of cigarettes sold by the Taxpayer has the same effect as a discount coupon. Because the manufacturer absorbs the entire cost of the discount, the Taxpayer receives the full retail price for the product sold and this is the taxable value on which gross receipts tax must be paid.

The Department's interpretation of the term "cash discount allowed and taken" to exclude discounts for which the seller is reimbursed by a third party is consistent with the definition of gross receipts in Section 7-9-3(F) NMSA 1978 as "the total amount of money *or the value of other consideration* received from selling property in New Mexico" (emphasis added). It is also consistent with the presumption in Section 7-9-5 NMSA 1978 that "all receipts of a person engaging in business are subject to the gross receipts tax." When a retailer discounts an item and absorbs the cost without reimbursement from the manufacturer, the retailer's receipts are measured by the discounted sales price—there is no "other consideration." When a retailer discounts an item and is reimbursed for the discount, the retailer's receipts are measured by the discounted sales price plus the "other consideration" received in the form of the manufacturer's reimbursement.

The Taxpayer objects to treating the manufacturer's buydown payment as part of the sales price of the cigarettes because she can only charge her customers gross receipts tax on the discounted sales price. The Taxpayer maintains she will lose money if she has to pay tax on buydown payments because her reimbursement is limited to the amount of the sales discount and she does not receive any profit on the transaction. First, it must be recognized that New Mexico's gross receipts tax is imposed on the seller of goods and services, not on the buyer. In reality, the tax is simply part of the seller's cost of doing business. Although it is a common practice for sellers to pass the cost of the

gross receipts tax on to the buyer, the seller's ability to separately charge or obtain reimbursement of the tax does not affect the seller's legal obligation to pay tax to the state. Second, the Taxpayer acknowledged that she is not required to enter into buydown contracts with cigarette manufacturers, but chooses to do so because selling cigarettes at a discounted price increases the traffic and sales volume in her store. The Taxpayer has made a conscious business decision that participating in a manufacturer's buydown program results in an economic benefit to her even though the program does not generate additional profit on a per pack or per carton basis. As part of this decision, the Taxpayer must factor in the cost of paying additional gross receipts tax that she may not be able to collect from her customer or the manufacturer. If this cost outweighs the benefits of the program, she is under no obligation to participate.

It is also worth noting that the position taken by the Department is no different than that taken by a number of other states that include the amount of manufacturer reimbursements in computing tax due on retail sales. *See, e.g.,* New York's Publication 79, *A Guide to Handling Coupons and Food Stamps for Retail Food Stores (6/99)* (found at www.tax.state.ny.us/ pubs_and_bulls/Publications/ sales_pubs.htm) at page 3. This publication makes the same distinction as Regulation 3.2.1.14(I) NMAC between store coupons, which do not provide reimbursement for the retailer, and manufacturers' coupons, which do provide reimbursement. The publication includes the following discussion relating to situations where the retailer receives an undisclosed reimbursement:

> When you issue a coupon entitling your customer to a discount on the price of an item you are selling and you are going to receive reimbursement from the product's manufacturer but *this fact is not revealed on the coupon*, treat the coupon the same way you would treat a store coupon. That is, collect sales tax from the customer based on the discounted price of the product. However, you are required to remit sales tax in an amount equal to the tax that would be due on

> the selling price of the item computed without regard to the discount attributable to the coupon. (emphasis in the original)

Some states have publications addressing the specific issue of cigarette buydowns. California's Publication 31, *Tax Tips for Grocery Stores (6/99)* (found at www.boe.ca.gov/staxpubs.htm) sets out the following instructions at pages 5-6:

> If you sell cigarettes and receive a "buy-down rebate" from the manufacturer or other third party in exchange for reducing the selling price of your cigarettes, you are liable for tax on the rebate amount received.... The tax amount due is based on your "gross receipts" for the sale—that is, the rebate amount and the amount paid by your customer.

See also, South Dakota's January 2001 *Taxation News* (found at www.state.sd.us/revenue/btaxpub.htm) which states at page 3:

> Buydowns or reimbursements you receive from a manufacturer are gross receipts subject to sales tax. Example: Your business buys cigarettes from a local wholesaler. Once a month you receive a "buydown" from the manufacturer, which you apply to the selling price of the cigarettes. State and municipal sales tax is due on the full retail price of the cigarettes, prior to the buydown.

In each case, the retailer is required to pay tax on the full amount the retailer receives from the sale of its cigarettes, whether paid by the customer or paid by the manufacturer.

Promotional Services. Even if the discounted price paid by the Taxpayer's customers were accepted as the full retail value of the cigarettes sold, this would not end the inquiry in this case. Clearly, the manufacturers' buydown payments were not intended as gifts to the Taxpayer. If the payments do not represent additional consideration for the sale of cigarettes, they must be consideration for the Taxpayer's agreement to promote the sale of the cigarettes for the manufacturers. This conclusion finds support in the terms of the contracts themselves. The Philip Morris buydown contract (Taxpayer Exhibit 3) specifically refers to the payments made as "promotion allowance payments." In addition to reducing the price of certain Philip Morris

cigarettes, the retailer must: "Place and maintain the point-of-sale items designated on the reverse side of this page in agreed-upon locations during the entire promotion period(s)." The Brown & Williamson contract (Taxpayer Exhibit 4) sets out a number of requirements that must be met by the retailer, including the obligation to "maintain adequate advertising, as acceptable by B&W, reflecting the price of the product bought-down." The Newport "Buydown Promotion Worksheet" (Taxpayer Exhibit 2) states that the retailer agrees, among other things, to:

> Maintain agreed P.O.S. [point of sale] materials for duration of Buydown period.
> Reduce Newport's retail selling prices during the Promotional Period by $4.50 per carton and 45 cents per pack.
> Communicate the reduced price via Lorillard P.O.S. materials or other store supplied P.O.S. acceptable to Lorillard.
> Retailer agrees to change price points in the event there is a price increase during the Buydown period.
> Promotional product is to be sold to consumers only, with a limit of two (2) cartons per purchase.
> Furnish itemized invoices as agreed to by your Lorillard Representatives....

Under each of the contracts quoted above, the Taxpayer must perform certain promotional services for the manufacturer in order to receive the buydown payments. The gross receipts tax applies to the sale of services as well as the sale of goods, including the service of "promoting the purchase, sale or leasing, as an agent or broker on a commission or fee basis, of any property service, stock, bond or security." Section 7-9-3(F) NMSA 1978.

Whether the buydown payments the Taxpayer received during the audit period are characterized as additional consideration for the sale of cigarettes or as consideration for performing promotional services for the manufacturer, those payments come within the statutory definition of gross receipts and are subject to tax.

Shelf-Display Contracts. The Taxpayer argues that the payments she received under the terms of her shelf-display contracts with cigarette manufacturers were receipts from the lease of real

property and are deductible under Section 7-9-53 NMSA 1978. The Department maintains the manufacturers' use of floor and counter space within the Taxpayer's store was a license to use and does not meet the requirements for a lease of real property.

The Gross Receipts and Compensating Tax Act defines leasing as "any arrangement whereby, for a consideration, property is employed for or by any person other than the owner of the property, except that the granting of a license to use property is the sale of a license and not a lease." Section 7-9-3(J) NMSA 1978. In *Cutter Flying Service, Inc. v. Property Tax Department,* 91 N.M. 215, 219, 572 P.2d 943, 947 (Ct. App. 1977), the court defined a lease as "an agreement under which the owner gives up the possession and use of his property for a valuable consideration and for a definite term." Under a lease, the tenant must acquire some definite control and dominion of the premises. *Id.*, 91 N.M. at 219-20, 572 P.2d at 947-48. As noted in 3 Thompson on Real Property, § 1032 (Thompson ed. 1994):

> [T]he difference between a license and a lease is that a lease gives to the tenant the right of possession against the world, while a license creates no interest in the land, but it is simply the authority or power to use it in some specific way.

See also, Jon W. Bruce & James W. Ely, Jr., *The Law of Easements and Licenses in Land*, ¶ 11.01 (Rev.Ed. 1995):

> A lease conveys exclusive possession of the premises to the tenant, and thus, the tenant holds an estate. In contrast, a licensor retains legal possession of the land, and the licensee has only a privilege to enter for a particular purpose.

In this case, the Taxpayer's shelf-display contracts permitted cigarette manufacturers to place free-standing, movable shelves at designated places in the store and temporary displays on the counter or hanging from the ceiling. The manufacturer's representative set up and stocked the shelves and designated the additional advertising signs to be displayed in the store. The

representative had access to the shelves during the Taxpayer's regular business hours, which were 6:00 a.m. to 6:00 p.m. six days a week, but could not access the shelves when the store was closed. Because the sales representative visited the Taxpayer's store only once a month, the Taxpayer agreed to keep the shelves stocked with the manufacturer's cigarettes and to keep the shelves dusted and in good order.

Based on these facts, the cigarette manufacturers did not acquire the dominion and control necessary to constitute a leasehold interest in the Taxpayer's premises. Although each manufacturer was given a specific location to set up its shelves and temporary displays, the manufacturer did not have exclusive possession or the right to restrict access to that area of the store. The manufacturer's rights were closer to those of a licensee than those of a lessee of real property. As stated in Thompson's treatise, *supra*: "a license creates no interest in the land, but it is simply the authority or power to use it in some specific way." Here, the shelf-display contracts did not convey an interest in real property, but merely gave the manufacturers the authority to use certain designated areas of the Taxpayer's store for product and advertising displays. Accordingly, the Taxpayer is not entitled to claim the deduction in Section 7-9-53 NMSA 1978.

Assessment of Interest and Penalty. The Taxpayer maintains that even if gross receipts tax is due, she should not be liable for interest or penalty because the Department took more than six months after the field audit began on June 20, 2000 to issue an assessment. The Taxpayer's argument is based on a misunderstanding of New Mexico's self-reporting tax system. It is the obligation of taxpayers, who have the most accurate and direct knowledge of their activities, to determine their liability for tax and accurately report that liability to the state. *See*, Section 7-1-13(B) NMSA 1978. There are insufficient resources available for the Department to continually audit every citizen to determine whether he or she has fully complied with the state's tax laws, and taxpayers are

not entitled to wait for the Department to determine the extent of their tax liabilities before paying the taxes due. *See*, *Vivigen, Inc. v. Minzner, Secretary of Taxation & Revenue*, 117 N.M. 224, 228, 870 P.2d 1382, 1386 (Ct.App. 1994) (a taxpayer is not excused from payment of tax because of a delay in the Department's audit; notice of a taxpayer's liability is provided by New Mexico statutes).

Interest. Section 7-1-67 NMSA 1978 (1996) governs the imposition of interest during the period at issue and states, in pertinent part:

> 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).

The legislature's use of the word "shall" indicates that the assessment of interest is mandatory rather than discretionary. *State v. Lujan*, 90 N.M. 103, 105, 560 P.2d 167, 169 (1977). The assessment of interest is not designed to punish taxpayers, but to compensate the state for the time value of unpaid revenues. The reason for a late payment of tax is irrelevant to the imposition of interest. Even taxpayers who obtain a formal extension of time to file or pay tax, or enter into an installment agreement, are liable for interest from the original due date of the tax until the date payment is made.

Here, the Taxpayer failed to pay gross receipts tax due to the state. Although this failure was based on an honest mistake and was not intentional, the fact remains that the Taxpayer—not the state—had use of those tax funds during the six-year period at issue. Section 7-1-67 NMSA 1978 requires interest to be paid for any period of time during which the state is denied the use of the funds to which it is legally entitled. Accordingly, interest was properly assessed against the Taxpayers and there is no basis for abatement.

*Penalty***.** Section 7-1-69 NMSA 1978 governs the imposition of penalty. Subsection A imposes a penalty of two percent per month, up to a maximum of ten percent, when a taxpayer fails "due to negligence or disregard of rules and regulations" to pay taxes in a timely manner.[1] Taxpayer negligence for purposes of assessing penalty is defined in Regulation 3.1.11.10 NMAC as:

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

In this case, the Taxpayer's failure to pay gross receipts tax was due to her lack of knowledge and her erroneous belief that tax was not due on certain transactions. This comes within the definition of negligence set out in the Department's regulations, and penalty was properly imposed.

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest to Assessment No. 2611399, and jurisdiction lies over the parties and the subject matter of this protest.

2. The Taxpayer's receipts from her buydown contracts with cigarette manufacturers come within the definition of gross receipts and are subject to tax.

3. The Taxpayer's receipts from her shelf-display contracts with cigarette manufacturers are not receipts from the lease of real property, and the Taxpayer is not entitled to the deduction provided in Section 7-9-53 NMSA 1978.

4. Pursuant to Section 7-1-67 NMSA 1978, the Taxpayer is liable for interest on unpaid gross receipts tax from the date the tax was originally due until the date it is paid.

[1] Taxpayers who *intentionally* fail to pay tax in order to defraud the state or evade the payment of tax they know to be due are subject to a 50 percent fraud penalty instead of the 10 percent negligence penalty. Section 7-1-69(C).

5. Pursuant to Section 7-1-69 NMSA 1978 and the Department's regulations, the Taxpayer was negligent in failing to report gross receipts tax during the period at issue and penalty was properly assessed.

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

DATED August 16, 2001.