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

IN THE MATTER OF THE PROTEST OF
SAVE A SHIELD, NM **No. 02-01**
ID NOS. 02-427868-00-8 & 02-317607-00-5
ASSESSMENT NOS. 2576316 & 2602872

DECISION AND ORDER

A formal hearing on the above-referenced protest was held November 27, 2001, before Margaret B. Alcock, Hearing Officer. Save A Shield, NM ("Taxpayer") was represented by Robert M. Fiser, its attorney. The Taxation and Revenue Department ("Department") was represented by Bruce J. Fort, Special Assistant Attorney General. Following the submission of written closing arguments, the matter was submitted for decision. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The Taxpayer is engaged in the business of repairing and reconditioning automobile windshields for car rental agencies.

2. The Taxpayer operates its business in Arizona, New Mexico, Colorado and California.

3. The Taxpayer began business in New Mexico in 1996. At that time, the Taxpayer was operating as a sole proprietorship. In 1999, the business was restructured as an S corporation.

4. The Taxpayer performs two types of services for car rental agencies: (1) repairing small cracks and chips in windshields, which makes up 40 percent of the Taxpayer's business, and (2) reconditioning windshields, which makes up 60 percent of the Taxpayer's business.

5. The Taxpayer has developed a unique resin that it uses in repairing and reconditioning windshields. The Taxpayer pays a chemist to blend and package the resin, usually in batches costing $2,000 to $3,000.

6. The Taxpayer has not patented its resin formula, but considers it to be proprietary information.

7. The Taxpayer does not sell the resin used in its business. If an outside party asked to purchase the resin, the Taxpayer would refuse the request.

8. The Taxpayer's repair services are performed on windshields with small cracks or chips no larger than the size of a quarter. These services involve injecting resin into the damaged area of the windshield, waiting 5 to 10 minutes while the resin "cures" or bonds to the windshield, scraping off the excess resin, and polishing the repaired area.

9. The Taxpayer's reconditioning services are performed on windshields that are badly pitted across all or a portion of the surface. These services involve treating the pits, applying resin to the entire surface of the windshield, allowing the resin to cure, scraping off the excess resin, and polishing the windshield

10. The Taxpayer's reconditioning services are usually performed on vehicles the car rental agency has leased from the manufacturer and is returning to the manufacturer at the expiration of the lease term. When the vehicle's windshield is pitted and the agency knows it will not pass the manufacturer's inspection, the agency has the Taxpayer recondition the windshield in order to avoid a surcharge on the lease.

11. The Taxpayer performs repair and reconditioning services for its customers on-site at each car rental agency's facility.

12. The Taxpayer does not takes title to the vehicles or windshields on which the Taxpayer performs its services.

13. As reflected on Schedule C of the Taxpayer's 1996, 1997 and 1998 federal income tax returns, the Taxpayer's cost of labor was substantially higher than the cost of materials used in its windshield repair and reconditioning business.

14. When the Taxpayer began business in New Mexico in 1996, its customers told the Taxpayer not to charge them the New Mexico gross receipts tax because they were "exempt". The car rental agencies also told the Taxpayer they could provide the Taxpayer with nontaxable transaction certificates (NTTC) if necessary.

15. The Taxpayer did not require the car rental agencies to provide NTTCs to establish their nontaxable status, nor did the Taxpayer question the tax information received from the agencies or make any effort to verify this information with the Department.

16. The 1996 and 1997 gross receipts tax returns filed by the Taxpayer reported and deducted the Taxpayer's receipts from performing services for its car rental customers. Beginning in 1998, the Taxpayer stopped reporting these receipts altogether.

17. In February 2000, the Department began a field audit of the Taxpayer.

18. On February 24, 2000, the auditor gave the Taxpayer what is known as a "60-day letter." The letter advised the Taxpayer that, pursuant to Section 7-9-43 NMSA 1978, the Taxpayer must be in possession of all required NTTCs within 60 days or deductions claimed relating to the NTTCs would be disallowed.

19. After receiving the 60-day letter, the Taxpayer contacted its car rental customers and asked them to send the Taxpayer the NTTCs needed to support the Taxpayer's deductions.

20. Four car rental agencies provided the Taxpayer with a Type 4 NTTC (sale of tangible personal property for lease); one agency provided the Taxpayer with a Type 2 NTTC (sale of tangible personal property for resale); one agency provided the Taxpayer with a Uniform Sales and Use Tax Certificate; and one agency provided the Taxpayer with a letter.

21. A description of the proper use of each type of NTTC issued by the Department is set out on the back of the NTTC form itself, as well as in the Department's CRS Filer's Kit, which is mailed to all taxpayers registered for payment of gross receipts taxes.

22. The Taxpayer did not examine or question the documents it received to determine whether they met the statutory requirements for the deductions claimed, but simply turned the documents over to the Department's auditor.

23. The auditor disallowed the Type 2 and Type 4 NTTCs because those NTTCs apply to the sale of tangibles, not to the sale services. The auditor disallowed the Uniform Sales and Use Tax Certificate and the letter because they did not meet the statutory requirements for NTTCs.

24. On September 13, 2000, the Department issued Assessment No. 2576316 to the Taxpayer in the amount of $5,346.54, representing gross receipts tax, interest and penalty for reporting periods January through December 1999.

25. On October 11, 2000, the Taxpayer filed a written protest to Assessment No. 2576316.

26. On November 22, 2000, the Department issued Assessment No. 2602872 to the Taxpayer in the amount of $21,674.37, representing gross receipts tax, interest and penalty for reporting periods September 1996 through December 1998.

27. On December 18, 2000, the Taxpayer filed a written protest to Assessment No. 2602872.

DISCUSSION

The Taxpayer raises the following arguments in support of its protest: (1) the Taxpayer is engaged in selling tangible personal property, not services, and is entitled to accept Type 2 and Type 4 NTTCs from its customers; (2) the Taxpayer is entitled to the deductions claimed because it accepted the NTTCs in good faith; and (3) the Taxpayer is not liable for the negligence penalty because the Taxpayer relied on the advice of its accountant. The Taxpayer has not challenged the Department's disallowance of deductions based on the Uniform Sales & Use Tax Certificate and the letter provided by the Taxpayer's customers.

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).

(1) Sale of Services v. Sale of Tangible Personal Property. In support of the deductions and exemptions claimed during the audit period, the Taxpayer provided the Department with Type 2 and Type 4 NTTCs, both of which apply to transactions involving the sale of tangible personal property. The Department refused to accept the NTTCs based on its position that the Taxpayer is engaged in the sale of services. The Taxpayer argues that under the test set out in Section 7-9-3(K) NMSA 1978, it is selling a tangible product—not services—and is entitled to accept the NTTCs provided by its customers.

Section 7-9-3(K) NMSA 1978 defines the term "service" as follows:

> K. "service" means 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.... In determining what is a service, the intended use, principal objective or ultimate objective of the contracting parties shall not be controlling....

This language was first enacted in a 1976 amendment to current Section 7-9-3(K) (formerly Section 72-16A-3K). *See*, 1976 N.M. Laws, ch. 25, § 1. In *EG & G, Inc. v. Director, Revenue Division, Taxation & Revenue Department,* 94 N.M. 143, 607 P.2d 1161, (Ct. App.), *cert. denied*, 94 N.M. 628, 614 P.2d 545 (1979), the court of appeals noted that the 1976 amendment changed the test for determining whether a transaction constitutes a sale of services or a sale of tangibles from one focusing on the end product's value to the purchaser to one focusing on the nature of the seller's activity, *i.e*., on the seller's investment of skills and materials. The court concluded that the "only material issue of fact under the test adopted by the Legislature relates to the relative inputs of services and tangible property." *Id*., 94 N.M. at 146, 607 P.2d at 1164.[1]

In this case, the Taxpayer maintains that it is selling a tangible product because the cost of materials used in its windshield repair and reconditioning business exceeds the cost of labor involved. In support of this contention, the Taxpayer presented the testimony of Ed Fields, one of its shareholders and corporate officers. Mr. Fields is also the father of Barton Fields, who was the sole proprietor of the Taxpayer during the period 1996-1998. Ed Fields testified that 40 to 50 percent of the cost of repairing a windshield is attributable to the special resin injected into the windshield and 60 to 70 percent of the cost of reconditioning a windshield is attributable to the cost of the resin. This testimony conflicts with the federal income tax returns filed by Barton Fields for tax years

[1] The Department also relies on Regulation 3.2.1.29 NMAC, which sets out a number of factors to be considered in determining whether a taxpayer is selling services or tangibles. Because this version of the regulation was not enacted until the very end of the audit period, it has limited application to this protest. *See*, *Kewanee Industries, Inc. v. Reese*, 114 N.M. 784, 790, 845 P.2d 1238, 1244 (1993), where the court refused to apply regulations not in effect

1996, 1997 and 1998. Schedule C of those returns lists Barton Fields as the proprietor of the Taxpayer, which is described as a "Windshield Repair" business. For each year, the cost of labor deducted on Schedule C far exceeds the cost of materials and supplies:

Tax Year	Cost of Labor Sch. C, Line 37	Materials and Supplies Sch. C, Line 38
1996	$103,818	$ 3,343
1997	$214,368	$ --0--
1998	$416,091	$65,111

See, Department Exhibits A, B and C.

Ed Fields was unable to explain the discrepancy between his estimate of the cost of materials and the amounts reported on the Taxpayer's federal income tax returns, admitting that those figures were "difficult to dispute". Mr. Fields said his review of the federal tax returns had been "sketchy" and that he relied on the Taxpayer's CPA to insure everything was properly reported. Mr. Fields suggested that the cost of resin for 1996 and 1997 may have been reported on Line 36 of Schedule C ("Purchases less cost of items withdrawn for personal use") rather than on Line 38, but this still results in a cost of materials that is less than one-third the cost of labor reported for each of those years. Mr. Fields also testified that the cost of labor reported on the returns overstated the cost of performing the repair and reconditioning work because it included the salaries of the owner and other managerial employees. Mr. Fields failed, however, to provide any breakdown of those salaries. Nor did he explain why he thought the cost of labor reported on Line 37 of Schedule C included the salary of the owner when the instructions for that line specifically state that the owner's salary should not be included.

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during the tax years at issue, stating: "A regulation promulgated by an administrative agency shall be construed to have retroactive effect only if it is clearly and manifestly intended."

On cross-examination, Mr. Fields was asked to describe the number of people employed by the Taxpayer during the audit period, as well as their duties and salaries. He was also questioned concerning the amount and cost of resin purchased during each tax year at issue. Mr. Fields was either unable to answer the questions or gave conflicting information. He testified that he did not know how much the Taxpayer spent on resin each year. Mr. Fields knew the resin was packaged in different sized vials, and knew the number of vials used for each job, but he did not know how much the vials cost, stating that his son and his CPA were more familiar with this aspect of the business.

Based on the evidence presented, Mr. Fields' assertion that the cost of materials used in the Taxpayer's business exceeds the cost of labor is unconvincing. Mr. Fields was unable to provide any documents or credible testimony to substantiate his position or to dispute the correctness of the figures reported on the Taxpayer's federal tax returns. Those returns establish that the cost of labor far exceeded the cost of materials during 1996, 1997 and 1998, three of the four years under audit. There is no evidence to indicate that this cost ratio changed during 1999, the final year of the audit. Under the test set out in *EG&G, supra*, the Taxpayer was not engaged in the sale of resin—or any other tangible product—during the tax periods at issue. Accordingly, the Type 2 and Type 4 NTTCs were properly disallowed by the Department.

(2) Good Faith Acceptance of NTTCs. The Taxpayer argues that it is entitled to the deductions claimed even if Type 2 and Type 4 NTTCs do not apply to the transactions at issue because the Taxpayer accepted the NTTCs in good faith. The good faith provision at issue appears in Section 7-9-43 NMSA 1978, which provides, in pertinent part:

> When the seller or lessor accepts a nontaxable transaction certificate within the required time and in good faith that the buyer or lessee will employ the property or service transferred in a nontaxable manner, the properly executed nontaxable transaction certificate shall be conclusive evidence, and the only

> material evidence, that the proceeds from the transaction are deductible from the seller's or lessor's gross receipts.

In support of its contention that even the wrong NTTC can support a deduction, the Taxpayer cites to *Leaco Rural Telephone Cooperative, Inc. v. Bureau of Revenue*, 86 N.M. 629, 526 P.2d 426 (Ct. App. 1974), which upheld a telephone company's right to claim a deduction based on an improperly issued NTTC. In *Leaco*, however, the court specifically stated that its decision was not based on a finding of good faith on the part of the taxpayer:

> [N]either good faith nor bad faith is an issue in this appeal. The Commissioner made no finding concerning good faith. The Commissioner did not reject the applicability of the NTTCs on the basis that Leaco did not accept them in good faith.

86 N.M. at 632, 526 P.2d at 429. In contrast to *Leaco*, the primary issue in this case is whether the Taxpayer accepted NTTCs in good faith that its customers would employ the Taxpayer's services in a nontaxable manner. The *Leaco* decision provides no guidance on this issue.

The purpose of the good faith provision is to protect a seller who has no way of verifying whether its customer's subsequent use of goods or services complies with the requirements for issuance of a particular NTTC. In *Arco Materials, Inc. v. State, Taxation & Revenue Department*, 118 N.M. 12, 15, 878 P.2d 330, 333 (Ct. App.), *rev'd on other grounds*, 118 N.M. 647, 884 P.2d 803 (1994), the court noted that it would create a tremendous burden to require a taxpayer to monitor its purchaser's activities. The good faith provision is designed to relieve the taxpayer of this burden. For example, a seller of tools is entitled to accept a Type 2 NTTC (sale of tangible personal property for resale) from a hardware store in good faith that the hardware store will use the tools in a nontaxable manner, *i.e.,* will resell the tools in the ordinary course of business. The seller is not required to check up on its customer the following month to be sure the tools were actually resold. The seller is

entitled to deduct its receipts in reliance on the NTTC, even if it is later discovered that the owner of the hardware store took the tools home for his personal use.

A different scenario is presented, however, when the NTTC proffered by the customer bears no relation to the transaction at issue. New Mexico case law holds that the good faith provision in Section 7-9-43 NMSA 1978 does not cover situations where the NTTC accepted by the seller is inapplicable to the goods or services being sold. In *McKinley Ambulance Service v. Bureau of Revenue*, 92 N.M. 599, 601-602, 592 P.2d 515, 517-518 (Ct. App. 1979), the court rejected the ambulance company's claim that the NTTC it accepted from its customer served as conclusive evidence of the company's right to a deduction:

> The taxpayer claims he accepted a nontaxable transaction certificate in good faith, and the certificate is conclusive evidence that proceeds from intrastate transportation of ambulance passengers were deductible. The "conclusive evidence" provision of § 7-9-43(A), N.M.S.A. 1978 does not apply unless the certificate covered the receipts in question....
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> The certificate in this case was for the "PURCHASE OF SERVICES FOR EXPORT".... This certificate did not apply to receipts from the taxpayer's in-state ambulance service....
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> There being no certificate applicable to the taxpayer's in-state services, the failure to approve a deduction on the basis of receipts from in-state services was not error.

More recently, in *Arco Materials, supra,* the court held that taxpayers have a continuing duty to assess the validity of deductions taken in reliance on NTTCs, including the duty to insure that the NTTC is of the type needed to cover the transaction at issue. In its decision, the court quoted the following language from Department Regulation GR 43:9 (now renumbered as 3.2.201.14 NMAC):

> Acceptance of nontaxable transaction certificates (NTTCs) in good faith that the property or service sold thereunder will be employed by the purchaser in a nontaxable manner is determined at the time the certificates are initially accepted. *The taxpayer claiming the protection of a certificate continues to be*

> *responsible that the goods delivered thereafter are of the type covered by the certificate* (emphasis the court's).

Id., 118 N.M. at 16, 878 P.2d at 334.

In this case, the Taxpayer made no effort to assess the validity of the deductions it claimed during the audit period. When the Taxpayer began business in New Mexico in 1996, its car rental customers told the Taxpayer not to charge them tax because they were "exempt." The Taxpayer did not question this information or ask its customers to explain which provision of New Mexico law exempted them from the gross receipts tax. Nor did the Taxpayer check with the Department to verify whether the Taxpayer was, in fact, entitled to deduct its receipts from performing windshield repair and reconditioning services. Instead, the Taxpayer simply started deducting its receipts from the car rental companies. In 1998, the Taxpayer stopped reporting those receipts altogether.

The first time the Taxpayer asked its customers for the NTTCs required to support its deductions was when it received the Department's 60-day letter in February 2000. At that time, four car rental agencies provided the Taxpayer with Type 4 NTTCs (sale of tangible personal property for lease) and one agency provided the Taxpayer with a Type 2 NTTC (sale of tangible personal property for resale). Although there is a description of the proper use of each type of NTTC on the back of the form itself, as well as in the Department's CRS Filer's Kit, the Taxpayer made no effort to examine the NTTCs it received to ascertain whether they covered the transactions at issue. Only after the Department's audit did the Taxpayer contact the tax departments of the various car rental companies to discuss the advice they had given the Taxpayer four years earlier.

The facts establish that the Taxpayer blindly accepted whatever NTTCs—and whatever tax advice—its customers provided. Blind acceptance is not equivalent to good faith acceptance. Although taxpayers are not expected to monitor the activities of their customers, taxpayers are

required to make some effort to determine whether they are entitled to the deductions they claim. There is no dispute that the NTTCs accepted by the Taxpayer applied to the sale of tangible personal property. Pursuant to the holdings in *McKinley Ambulance, supra,* and *Arco Materials, supra*, these NTTCs do not support the Taxpayer's deduction of receipts from performing windshield repair and reconditioning services.

(3) Assessment of 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 10 percent, "in the case of failure due to negligence or disregard of rules and regulations...to pay when due any amount of tax required to be paid." Taxpayer "negligence" is defined in Regulation 3.1.11.10 NMAC 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.

Regulation 3.1.11.11 NMAC sets out several situations that may indicate a taxpayer has not been negligent, including proof that the failure to pay tax "was caused by reasonable reliance on the advice of competent tax counsel or accountant as to the taxpayer's liability after full disclosure of all relevant facts".

The Taxpayer argues that it comes within the nonnegligence provisions of Regulation 3.1.11.11 NMAC because it relied on its CPA to take care of all tax matters relating to the business. The Taxpayer appears to believe that hiring an accountant served to relieve the Taxpayer of any further responsibility to insure that its taxes were properly paid. This is not the case. As the New Mexico Court of Appeals stated in *El Centro Villa Nursing Center v. Taxation and Revenue Department*, 108 N.M. 795, 799, 779 P.2d 982, 986 (Ct. App. 1989):

> this court has held that "[e]very person is charged with the reasonable duty to ascertain the possible tax consequences of his action [or inaction]." *Tiffany Constr. Co. v. Bureau of Revenue*, 90 N.M. at 17, 558 P.2d at 1156. We are not inclined to hold that the taxpayer can abdicate this responsibility merely by appointing an accountant as its agent in tax matters.

In *El Centro Villa*, the taxpayer failed to report gross receipts tax on certain Medicaid payments. The court rejected the taxpayer's contention that it should be excused from the negligence penalty because it relied on the gross receipts tax reports prepared by its accountant. Instead, the court held that the taxpayer had a responsibility to question the accountant concerning the tax treatment of the payments at issue:

> Beyond taxpayer's mere failure to inquire as to these particular payments, we find substantial evidence exists to support the finding that it was not reasonable for taxpayer to rely on the December 1983 and November 1984 reports. According to the accountant's testimony, taxpayer reviewed the monthly reports and failed to inquire about the reporting of the payments as cost reimbursements. Taxpayer should have known that it had received large payments, especially in November 1984, no different in character than the Medicaid income received monthly throughout the year and reported monthly as gross receipts, and that the same readjustment payments were reported in 1982 as gross receipts. Given taxpayer's knowledge of the character and size of the income payments in question, taxpayer cannot be said to have reasonably relied on the incorrect reports as advice of its accountant.

Id., 108 N.M. at 796-797, 779 P.2d at 983-984. In this case, Ed Fields testified that the Taxpayer deducted its receipts based on advice received from its customers. There is no evidence that Mr. Fields, his son, or any other employee of the Taxpayer discussed this advice with the Taxpayer's CPA. Nor is there any evidence that the CPA advised the Taxpayer to deduct its receipts "after full disclosure of all relevant facts" concerning the nature of the services being performed for the car rental agencies. *See*, Regulation 3.1.11.11 NMAC. The Taxpayer did not reasonably rely on the advice of its accountant—it simply delegated all of its tax responsibilities to him. At the November 27, 2001 hearing, Ed Fields testified that he did not know whether the Taxpayer's CPA actually filed gross receipts tax returns with

the Department. Although Mr. Fields was aware that no tax was paid on the Taxpayer's receipts, when Department counsel asked him why no tax was paid, Mr. Fields again stated that he did not know. Such a complete abdication of responsibility does not meet the standard of nonnegligence set out in the Department's regulation or in the court's decision in *El Centro Villa, supra*.

As additional evidence that it was not negligent, the Taxpayer points to the fact that Ed Fields sought advice concerning the Taxpayer's deductions from the tax departments of its car rental customers. This did not occur, however, until after the Department's audit was complete. As confirmed in a recent decision of the court of appeals, negligence is determined as of the time that taxes are due:

> Where the taxpayer ignores its tax obligations and consults with an attorney or accountant about its tax obligations only *after* an audit and assessment by the Department, such conduct is not evidence of a diligent protest and does not provide a basis for avoiding a penalty. (emphasis the court's)

Sonic Industries, Inc. v. Chavez, Secretary of Taxation & Revenue, 2000-NMCA-087, P38, 129 N.M. 657, 666, 11 P.3d 1219, 1228, *cert. granted and pending*, 10 P.3d 843 (2000). Here, as in *Sonic*, the Taxpayer's after-the-fact decision to seek advice concerning its gross receipts tax liability does not support abatement of the negligence penalty.

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest to Assessment Nos. 2576316 and 2602872, and jurisdiction lies over the parties and the subject matter of this protest.

2. During the tax years at issue, the Taxpayer was engaged in selling services, not tangible personal property.

3. Type 2 and Type 4 NTTCs apply to the sale of tangible personal property and do not support the Taxpayer's deduction of receipts from selling services.

4. The Taxpayer did not accept Type 2 and Type 4 NTTCs in good faith that its customers would use the Taxpayer's services in a nontaxable manner.

5. The Taxpayer was negligent in failing to pay gross receipts tax on receipts from performing services for car rental agencies, and penalty was properly imposed pursuant to Section 7-1-69(A) NMSA 1978.

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

DATED January 3, 2002.