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

IN THE MATTER OF THE PROTEST OF
LOUIS AND CAROLYN BORTOT, **NO. 98-52**
ID. NO. 02-324191-00 8, PROTEST
TO ASSESSMENT NO. 2092481

DECISION AND ORDER

This matter came on for formal hearing on August 31, 1998 before Gerald B. Richardson, Hearing Officer. Louis and Carolyn Bortot, hereinafter, "Taxpayers", were represented by James Jay Mason, Esq. The Taxation and Revenue Department, hereinafter, "Department", was represented by Jana C. Werner, Special Assistant Attorney General. Based upon the evidence and the arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. For the 1993 calendar and tax year, the Taxpayers did not report any wages, salaries or tips on their federal income tax return. The Taxpayers did report on the Schedule C-EZ form for reporting net profit from business (sole proprietorship) that Mr. Bortot received $2,950 in net profit and Mrs. Bortot received $43,925 in net profit.

2. The Department has an information sharing agreement with the Internal Revenue Service ("IRS") whereby the IRS provides information to the Department with respect to New Mexico residents' federal income tax returns.

3. Based upon the information contained in the Taxpayers' 1993 Schedule C-EZ forms, on December 14, 1996, the Department issued Assessment No. 2092481 to the Taxpayers

assessing $2,737.22 in gross receipts tax, $273.72 in penalty and $1,300.18 in interest for the January through December, 1993 reporting periods.

4. On February 11, 1997, the Taxpayers requested a sixty-day extension of time in which to file a protest to Assessment No. 2092481.

5. On February 20, 1997 the Department granted a retroactive extension of time to file a protest and acknowledged the Taxpayers' letter, postmarked January 14, 1997, as a timely protest.

6. Lumic, Inc. is a small, closely held family corporation in which the Taxpayers own 51% of the stock, with the other 49% owned by their children. Lumic, Inc. owns a commercial building in Gallup, New Mexico, which generates rental income. The Taxpayers did everything required to run the corporation, including collecting rents and maintaining the property.

7. Lumic, Inc. filed a federal corporation income tax return, federal form 1120, which reported no deductions for compensation of officers or for salaries or wages paid to employees for periods relevant to the 1993 tax year. Lumic, Inc., however, paid Mr. Bortot $3,000 during the 1993 tax year. It reported that amount on a federal form 1099 as nonemployee compensation. It also reflected this amount as "commissions" on its statement of other deductions on its federal form 1120. Because of a difference in the corporate fiscal year and the calendar year used as the tax year by the Taxpayers, the amounts reported as commissions on the form 1120 and the amounts reported as nonemployee compensation on form 1099 do not match.

8. Nizhoni Self Storage, Inc. is a small, closely held family corporation in which the Taxpayers own 50% of the stock, with the other 50% being owned by a cousin. Nizhoni Self Storage, Inc. owns self-storage units which generate rental income. The Taxpayers' did

everything required to manage the corporation, including collecting rents and maintaining the property.

9. Nizhoni Self Storage, Inc. filed a federal corporation income tax return, federal form 1120, which reported no deductions for compensation of officers or for salaries and wages paid employees for periods relevant to the 1993 tax year. Nizhoni Self Storage, Inc., however, paid Mrs. Bortot $28,100 during the 1993 tax year. It reported that amount on a federal form 1099 as nonemployee compensation. It also reflected that amount as "management commissions" on its statement of other deductions on its federal form 1120. Because of a difference in the corporate fiscal year and the calendar year used as the tax year by the Taxpayers, the amounts reported as management commissions on the form 1120 and the amounts reported as nonemployee compensation on form 1099 do not match.

10. Mr. Steve Petranovich, the accountant for the Taxpayers, Lumic, Inc. and Nizhoni Self Storage, Inc., treated the amounts paid the Taxpayers by the two corporations as commissions rather than wages in order to simplify tax reporting by avoiding the necessity of filing reports with the Department and the IRS reporting income tax withholding. Because the Taxpayers reported and paid self-employment tax to the IRS on these amounts, and because these amounts were included in the Taxpayers' income as reported to both federal and state tax authorities, Mr. Petranovich's method of reporting the amounts paid to the Taxpayers was not intended to result in any tax avoidance by the Taxpayers or their closely held corporations.

11. Neither Lumic, Inc. or Nizhoni Self Storage, Inc. purchased worker's compensation insurance or paid unemployment insurance on behalf of the Taxpayers.

12. The compensation paid to the Taxpayers by Lumic, Inc. and Nizhoni Self Storage, Inc. was not based upon the keeping of time records of the time the Taxpayers spent managing

the businesses or upon any set periodic schedule for compensating the Taxpayers. The Taxpayers paid themselves based upon when they felt that the corporations could afford to pay them compensation and in amounts they felt the corporations could afford to pay.

13. The Taxpayers performed management services for the corporations based upon the corporations' needs and not upon an established schedule.

14. The Taxpayers received no paid vacation and accumulated no sick leave from the corporations of which they were shareholders.

15. The Taxpayers have conceded that the compensation they received from their closely held corporations could have been reported more accurately as wages paid to them as employees of the corporations they manage, but the corporations and the Taxpayers do not wish to file amended returns to more accurately report this compensation for the tax year at issue.

16. Commencing with the 1997 tax year, the compensation paid to the Taxpayers by their closely held corporations has been reported as wages paid to employees for both state and federal purposes.

DISCUSSION

The Taxpayers have protested the assessment of gross receipts tax based upon their claim that the compensation they received from their closely held corporations was actually wages they were paid as employees of the corporations. Wages received by employees are exempt from gross receipts tax pursuant to § 7-9-17 NMSA 1978, which provides:

> Exempted from the gross receipts tax are the receipts of employees from wages, salaries, commissions or from any other form of remuneration for personal services.

Because the statute exempts any form of remuneration paid to "employees", it does not matter whether the compensation is classified as wages, salary or commissions. The determinative factor is whether an employer-employee relationship exists between the payor and the recipient of the compensation.

The Department argues that the Taxpayer is bound by the manner it elected to report the compensation at issue, and without an amendment to the federal returns filed by both the Taxpayers and the corporations they manage, that they are not entitled to claim the exemption provided at § 7-9-17.

Because the corporations which paid the compensation at issue are closely held corporations managed by the Taxpayers, this case presents a highly unusual situation which has not heretofore been addressed. What should the interface be between the standards for determining the existence of an employment relationship and the common law requirements that taxpayers file consistently for both state and federal purposes?

An employee is not defined in the Gross Receipts and Compensating Tax Act, Chapter 7, Article 9 NMSA 1978, so we will look to the common law definition of employee. In determining whether a person is an employee or an independent contractor, the rule in New Mexico and in general is that the principal consideration is the right to control. Thus, the relationship of employer and employee usually results where there is control over the manner and method of performance of the work to be performed. Where there is only control over the results, however, and not the details of the performance, the worker is usually considered to be an independent contractor. ***Buruss v. B.M.C. Logging Co.***, 38 N.M. 254, 31 P.2d 263 (1934). The

most recent pronouncement of this rule can be found in ***Harger v. Structural Services, Inc.***, 121 N.M. 657, 663, 916 P.2d 1324, 1330 (1996). In that case the New Mexico Supreme Court adopted the approach set out in the Restatement (Second) of Agency § 220(1) to determine a worker's status as an employee or an independent contractor:

> The important distinction is between service in which the actor's physical activities and his time are surrendered to the control of the master, as service under an agreement to accomplish results or to use care and skill in accomplishing results. Those rendering service but retaining control over the manner of doing it are not servants.

Among the factors to be considered are: whether the party employed engages in a distinct occupation or business; whether the work is part of the employer's regular business; the skill required in the particular occupation; whether the employer supplies the instrumentalities, tools or the place of work; the duration of a person's employment and whether that person works full-time or regular hours; whether the parties believe they have created the relationship of employer and employee and the manner and method of payment. The totality of all of the circumstances must be considered in determining whether the employer has the right to exercise that degree of control over a worker so as to make the worker an employee.

The Department has adopted a regulation under Section 7-9-17 to provide criteria by which the status of a worker may be determined. Regulation 3 NMAC 2.12.7. provides as follows:

> In determining whether a person is an employee, the department will consider the following indicia:
> 1. is the person paid a wage or salary;
> 2. is the "employer" required to withhold income tax from the person's wage or salary;
> 3. is F.I.C.A. tax required to be paid by the "employer";
> 4. is the person covered by workmen's compensation insurance;

5. is the "employer" required to make unemployment insurance contributions on behalf of the person;

6. does the person's "employer" consider the person to be an employee;

7. does the person's "employer" have a right to exercise control over the means of accomplishing a result or only over the result (control does not mean "mere suggestion').

If all of the indicia mentioned are present, the department will presume that the person is an employee. However, a person may be an employee even if one or more of the indicia are not present.

In this case, because the alleged "employer" is a closely held corporation managed by the Taxpayers, it is difficult to dispute that sufficient control over the acts of the "employees" does not exist, since the Taxpayers, as officers, managers and shareholders of the corporations, control their own activities. Thus, the question, ultimately, is whether those same individuals are bound by their own actions as to how they treated their compensation for federal tax reporting purposes.

Although the issue has not arisen in this unique context, the law in New Mexico has been unequivocal on the issue of whether consistency is required in how taxes are reported for both state and federal purposes. The first case to address this issue was ***Co-Con, Inc. v. Bureau of Revenue***, 87 N.M. 118, 529 P.2d 1239 (Ct App., 1974), ***cert. denied***, 87 N.M. 111, 529 P.2d 1232 (1974). Co-Con, Inc. was a wholly owned subsidiary of Universal Constructors, Inc. During the audit period, pieces of construction equipment common to the operations of both corporations were utilized by both on their construction projects without regard to which corporation held legal title to the equipment. Each corporation owning the equipment attributed a value to the use of its equipment and reflected that value as "gross rentals" for federal income tax purposes. The Department assessed gross receipts tax on those gross rental amounts reflected on the federal returns of Co-Con, Inc. and Universal Constructors, Inc. as gross receipts from leasing property in New Mexico. The corporations argued that they did not have gross receipts

from equipment rental. The Court of Appeals upheld the assessments, finding that the treatment by the corporations of the transactions as gross rentals for federal income tax purposes indicated that the intent of the taxpayers was to treat the arrangement as rentals or leases. The court went on to state:

> Taxpayers must treat transactions uniformly for all purposes within the tax scheme and not attempt to show, first, a lease for federal purposes and second, a non-taxable event for state tax purposes. We find ample evidence in the record to indicate that taxpayers engaged in leasing, both by intent and within the scope of the statutory definition.

Id., 87 N.M. at 121-122.

In ***Stohr v. New Mexico Bureau of Revenue***, 90 N.M. 43, 559 P.2d 420(Ct. App. 1976), ***cert. denied***, 90 N.M. 254, 561 P.2d 1347 (1977), the Court of Appeals upheld an assessment of gross receipts tax against Mr. Stohr on the compensation he was paid by various individuals for doing carpentry. Mr. Stohr argued that these amounts were wages exempt from gross receipts tax under § 72-16A-12.5 NMSA 1953, the predecessor to § 7-9-17 NMSA 1978. The court noted that Mr. Stohr had filed self employment tax returns for social security purposes with the IRS for the compensation he received from the customers who did not withhold FICA tax and had filed a federal Schedule C during the audit years reporting his compensation as being from a business or profession. In determining Mr. Stohr liable for gross receipts tax, the court examined the indicia of employment found in the Department's regulation, which are the same ones contained in the current regulation, 3 NMAC 2.12.7. However, the court stated:

> The ***controlling*** factor, however, is that the taxpayer must treat transactions uniformly for all purposes within the tax laws. The taxpayer must not attempt to show one scheme for federal tax purposes and a nontaxable event for purposes of state gross receipts taxes. (citations omitted, emphasis added).

Thus, the court found that the manner by which Mr. Stohr reported his compensation for federal purposes controlled the determination of whether that compensation could be considered wages exempt from gross receipts taxes.

The most recent case to address the issue of whether consistency is required in filing state and federal returns is ***Sutin, Thayer & Browne v. Revenue Division of the Taxation and Revenue Department,*** 104 N.M. 633, 725 P.2d 833 (Ct. App. 1985), ***cert. denied.*** 102 N.M. 293, 694 P.2d 1358 (1986). That case concerned whether the Sutin firm could claim a wage deduction for state corporate income tax reporting purposes that exceeded the wage deduction claimed for federal corporate income tax purposes. Under the Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, a new jobs tax credit was enacted to provide employers with a tax incentive to create new jobs. Under the act, a corporation could either claim a federal tax deduction for the wages paid to its employees or elect a jobs credit for wages paid to certain new employees. New Mexico did not have a similar jobs credit. The Sutin firm had claimed the jobs credit with the IRS, foregoing a deduction for wages paid to those employees for whom the credit was claimed. Because New Mexico did not have a similar jobs credit, the Sutin firm claimed a deduction for those wages on its New Mexico return that it had not claimed on its federal return, arguing that to deny it the wage deduction would be unfair and result in overstating its taxable income for state tax purposes. The court denied the Sutin firm's claim of deduction, stating that, "[A] taxpayer who makes an election for federal purposes is bound by that election in calculating the amount of its state taxes." ***Id.,*** 104 N.M. at 636.

As all of the above cases make clear, when there is a conflict in how a taxpayer has reported a transaction for federal purposes and how they are requesting that it be treated for state purposes, they are bound by the manner in which they reported for federal purposes. It should

also be noted that if, as Taxpayers argue, their method of reporting does not reflect the true nature of a transaction or taxable activity, the Taxpayer has the option, if not the obligation[1] to file amended federal returns. Unless that is done, the Taxpayers are bound by their method of reporting their compensation with the IRS and are not entitled to claim the exemption provided at § 7-9-17 NMSA 1978.

CONCLUSIONS OF LAW

1. The Taxpayers filed a timely, written protest to Assessment No. 2092481 pursuant to § 7-1-24 NMSA 1978 and jurisdiction lies over both the parties and the subject matter of this protest.

2. Because the Taxpayers reported the compensation they received as nonemployee compensation and as commissions from operating a business, they are not entitled to claim it as wages, salary or commissions from employment for purposes of claiming an exemption from gross receipts tax pursuant to Section 7-9-17 NMSA 1978.

For the foregoing reasons, the Taxpayers' protest IS HEREBY DENIED.

DONE, this 28th day of September, 1998.

[1] Tax reporting, even when it does not distort income or result in tax savings, is not a matter of convenience or selecting a manner which simplifies reporting requirements. Tax returns are supposed to accurately reflect the transactions being reported.