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

IN THE MATTER OF THE PROTEST OF
ERNEST J. AND JEAN MARIE ROSE **NO. 01-14**
ID NO. 02-432209-00 1, PROTEST TO
ASSESSMENT NO. 2540943

DECISION AND ORDER

This matter came on for formal hearing on June 20, 2001 before Gerald B. Richardson, Hearing Officer. Mr. and Mrs. Rose, hereinafter, "Taxpayers", were represented by Gary D. Alsup, Esquire. The Taxation and Revenue Department, hereinafter, "Department", was represented by Bruce J. Fort, Special Assistant Attorney General. On June 27, 2001, Taxpayers filed a Motion to Supplement the record in this matter and on June 28, 2001, an order was entered granting the Taxpayers' motion, and the matter was considered submitted at that time. Based upon the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. Mr. Rose worked as a subcontractor for Rose Wood Products during 1996. His work involved the cutting, skidding, loading and delivery of logs to the sawmill in Cimarron, New Mexico as well as the brushwork or cleaning up of the logging site after the logging had been completed.

2. Mr. Rose did not own the timber which he was harvesting.

3. Taxpayers were not registered with the Department for purposes of the gross receipts tax because they believed that Mr. Rose's compensation for his work involving the severing of timber was exempt from gross receipts tax.

4. On March 7, 2000, the Department notified the Taxpayers of a limited scope audit based upon the discrepancy between the gross receipts which Taxpayers had reported on Schedule C of their 1996 federal income tax return and the fact that the Taxpayers had not reported gross receipts for purposes of reporting and paying gross receipts taxes during 1996.

5. As a result of the Department's limited scope audit, on June 14, 2000, the Department issued Assessment No. 2540943 to the Taxpayers, assessing $6,688.08 in gross receipts tax, $668.76 in penalty and $3,887.44 in interest for the January 1996 through December 1996 reporting period.

6. On July 10, 2000, the Taxpayers filed a written protest to Assessment No. 2540943.

DISCUSSION

The primary issue to be determined herein is whether Mr. Rose's activities involving the severing or harvesting of timber are subject to the gross receipts tax. The determination of this issue involves an analysis and interpretation of the interactions between the Gross Receipts and Compensating Tax Act, Sections 7-9-1 through 7-9-89 NMSA 1978, and the Resources Excise Tax Act, Sections 7-1-25 through 7-25-9 NMSA 1978.

The taxes imposed under the Resources Excise Tax Act are imposed on the privilege of severing and processing natural resources within New Mexico. Section 7-25-2. Natural resources include timber and any product thereof. Section 7-25-3(B). There are actually three different taxes which may be imposed under the Resources Excise Tax Act, depending upon who owns the natural resource and what activity is being performed. The "resources tax" is imposed

on severers of natural resources. Section 7-25-4. Severers are defined to be persons who sever natural resources that they own or owners of natural resources who have another person perform the severing of the resources. Section 7-25-3(G). The "processors tax" is imposed on processors of natural resources. Section 7-25-5. Processing is defined as "smelting, leaching, refining, reducing, compounding or otherwise preparing for sale or commercial use any natural resource so that its character or condition is materially changed in mills or plants located in New Mexico." Section 7-25-3(D). Thus, in the case of timber, processing would be what happens when the timber is taken to a mill in New Mexico and is turned into lumber. Processors are defined to be persons engaged in the business of processing natural resources owned by that person, or owners of natural resources who have others perform the processing of the natural resources. Section 7-25-3(E). Finally, there is the "service tax", which is imposed on the privilege of severing or processing New Mexico natural resources owned by others and which are not otherwise subject to the processors tax or resources tax. Section 7-25-6. There is also an exemption provided at Section 7-25-7 from resources tax if the processors tax has been paid with respect to those natural resources. As outlined above, the taxes imposed under the Resources Excise Tax Act operate in a comprehensive manner such that all natural resources severed or processed in New Mexico are subject to one of the taxes imposed under the act, but only one of the taxes will apply.

The Resources Excise Tax Act was first enacted by Laws 1966, ch. 48, § 1. Almost since its enactment, there has been an exemption in the Gross Receipts and Compensating Tax Act for activities which were subject to tax under the Resources Excise Tax Act. The exemption is presently found at Section 7-9-35 NMSA 1978, and was previously found at Section 72-16(A)-4 NMSA 1953. The rates of tax for the taxes imposed under the Resources Excise Tax Act have

always been significantly lower than the rate of tax imposed under the Gross Receipts and Compensating Tax Act. In a case involving strikingly similar facts to the instant case, the Court of Appeals found that "[T]he primary purpose of the Resources Excise Tax Act is obviously to encourage the development of the extractive industries of the state because the rates imposed are a fraction of the Gross Receipts Tax." ***Carter & Sons, Inc. v. New Mexico Bureau of Revenue,*** 92 N.M. 591, 594, 592 P.2d 191 (Ct. App. 1979). That case also involved the interaction of the two tax acts as they applied to a business which severed timber which was owned by another person, which is essentially an identical situation to the one presented for determination herein. Applying an earlier version of the exemption from gross receipts tax found at Section 7-9-35, the Court of Appeals found that the business under contract to sever the timber was exempt from the imposition of gross receipts tax on its activities. That earlier version of Section 7-9-35 had provided:

> When a privilege tax is imposed by the Resources Excise Tax Act, the provisions of the act shall apply and determine the full measure of tax liability for the privilege of engaging in the business stated in the act and no provision of the Gross Receipts and Compensating Tax Act shall apply to or create a tax liability for such privilege, except as is provided in Section 72-16A-27 NMSA 1953.

Section 72-16A-12.23 NMSA 1953.

We are now faced with determining whether the later version of that exemption applies to exempt the Taxpayers from the imposition of gross receipts tax upon the severing activities performed by Mr. Rose. Section 72-16(A)-12.23 NMSA 1953 was recodified as Section 7-9-35 in the 1978 statutory compilation. It was completely rewritten by Laws 1989, ch. 115, § 3. It now provides as follows:

> Exempted from the gross receipts tax are receipts *from the sale or processing of natural resources* the severance or processing of

> which are subject to the taxes imposed by the Resources Excise tax Act except as otherwise provided in Section 7-25-8 NMSA 1978. (emphasis added).

The Taxpayers argue that this provision must be construed broadly to cover the severing activities performed by Mr. Rose in order to effectuate the legislative intent as expressed in ***Carter & Sons*** to encourage the development of the timber extraction industry by exempting his activities from the imposition of the gross receipts tax. The Taxpayers are correct in their assertion that either the processors tax or the resources tax would be imposed on either the severing or processing of the timber Mr. Rose cut, depending upon whether Rose Wood Products or the Cimarron saw mill paid the tax. Thus, if the exemption at Section 7-9-35 is not applied, the process of getting that timber into a final saleable form as lumber would be subject to a higher cumulative tax burden than if the gross receipts tax exemption applies to Mr. Rose's activities.

The problem with the Taxpayers' argument is that Section 7-9-35 has been completely rewritten since ***Carter & Sons*** was decided and the express language of the exemption does not apply to Mr. Rose's activities. This is because Section 7-9-35 only exempts "receipts from the sale or processing of natural resources". Mr. Rose does neither of those activities. He does not own the timber, so he does not sell it. The definition of processing makes it clear that processing activities are those which occur in a mill or plant. Thus, Mr. Rose does not process the timber.

Taxpayers argue that because the definition of "selling" in Section 7-9-3(B) of the Gross Receipts and Compensating Tax Act includes both the transfer of property for consideration or any performance of service for consideration, that in order to effectuate the legislative intent of the Resources Excise Tax Act to encourage the extractive industries of New Mexico, Mr. Rose should be considered to be selling natural resources for purposes of the exemption at Section 7-

9-35. The definition of selling is written broadly in Section 7-9-3(B) because it should be obvious that a person can sell both property or services, and the Gross Receipts and Compensating Tax Act imposes gross receipts tax upon both activities. *See,* Section 7-9-3(F), the definition of "gross receipts". The fact that Mr. Rose is selling his services of cutting, skidding, loading and hauling timber, as well as doing brushwork to clean up the logging site does not transform the services he performs into the sale "*of natural resources* the severance or processing of which are subject to the taxes imposed by the Resources Excise Tax Act" as provided in Section 7-9-35. Where an exemption or deduction from tax is claimed, the statute must be strictly construed in favor of the taxing authority and the right to the exemption or deduction must be clearly established by the taxpayer. ***Security Escrow Corp., v. State of New Mexico Taxation and Revenue Department,*** 107 N.M. 540, 760 P.2d 1306 (Ct. App. 1988). The language of Section 7-9-35 is unambiguous and clear that it applies only to the sale or processing of natural resources. There is simply no way to read Section 7-9-35 to cover the services performed by Mr. Rose.

Admittedly, the operation of the Resources Excise Tax Act and the Gross Receipts and Compensating Tax Act to the activities at issue under the facts of this case results in the imposition of both taxes by the time the severed timber has been cut into lumber. That result, however, is more the result of the manner that Rose Wood Products and Mr. Rose structured their business arrangement than a failure of the statutes to ensure the competitiveness of timber extraction in New Mexico. Only one of the taxes imposed under the Resources Excise Tax Act would have been imposed had Rose Wood Products engaged Mr. Rose's services as an employee, rather than an independent contractor. Thus, the situation is really no different than that which results in other situations when a taxpayer decides to subcontract out some of the

activities which are part of their business. For example, if a plumbing business hires an independent contractor as a bookkeeper to maintain its business records, the bookkeeper would be subject to gross receipts tax upon its receipts from performing bookkeeping services for the plumbing business. Because it is common business practice for taxpayers to pass the cost of the gross receipts tax on to their customers, it would likely cost the plumbing company the additional cost of the gross receipts tax. If the plumbing business had an in-house employee keeping its books, there would be no cost associated with passed on gross receipts tax.[1] This difference in tax burden, however, is not necessarily a failure of the tax system to tax all activities equally, but is a result of the manner by which taxpayers structure their business arrangements. If, indeed, the imposition of gross receipts tax upon Mr. Rose's activities is an unintended consequence of the amendment of Section 7-9-35, Mr. Rose's remedy lies with the legislature, since the language of the exemption at present is not broad enough to encompass Mr. Rose's activities.

The final issue to be determined is whether the imposition of penalty was proper in this case. The imposition of penalty is governed by the provisions of NMSA 1978, Section 7-1-69(A) NMSA 1978 (1996), which imposes a penalty of two percent per month, up to a maximum of ten percent:

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

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

[1] There would, however, be other tax consequences, since the wages of the employee would be subject to other taxes such as income withholding tax, social security and medicare (fica) withholding, etc,

Taxpayer "negligence" for purposes of assessing penalty is defined in Regulation NMAC 3.1.11.10 (formerly TA 69:3) 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 Taxpayers were simply not aware that the gross receipts tax would apply to them even though taxes imposed under the Resources Excise Tax Act also applied to either the severing or processing of the same timber Mr. Rose was cutting and hauling. Because Mr. Rose's family has been in the logging business for a long time, I suspect that both he and Rose Wood Products were under the impression that the exemption found at Section 7-9-35 still operated in the manner it did in the ***Carter & Sons*** case. The legislature amended that provision substantially, however, and as explained above, it no longer operated in the same manner.

New Mexico has a self-reporting tax system which requires that taxpayers voluntarily report and pay their tax liabilities to the state. Because of this, the case law is well settled that every person is charged with the reasonable duty to ascertain the possible tax consequences of his actions, and the failure to do so has been held to amount to negligence for purposes of the imposition of penalty pursuant to Section 7-1-69 NMSA 1978. ***Tiffany Construction Co. v. Bureau of Revenue***, 90 N.M. 16, 558 P.2d 1155 (Ct. App. 1976), *cert. denied*, 90 N.M. 255, 561 P.2d 1348 (1977). The duty to understand how the tax laws apply to a taxpayer's activities is an ongoing duty, requiring taxpayers to keep abreast of changes in the tax laws. ***Arco Materials, Inc., v. State of New Mexico, Taxation and Revenue Department***, 118 N.M. 12, 15, 878 P.2d 330 (Ct. App. 1994) (A taxpayer has an affirmative duty to keep informed about changes in the tax law that might affect its liability). Thus, a negligence penalty is properly imposed when the failure to pay tax is based upon

a taxpayer's erroneous belief that no tax was due because there had been a change in the applicable law.

The Taxpayers also point to the fact that even a Department employee apparently was not aware of the change in law subsequent to ***Carter & Sons***, because the Taxpayers produced evidence that the Department agreed to abate the assessment at issue, but that in the review process for the abatement, a Department attorney noticed the erroneous reliance on the ***Carter & Sons*** decision and the abatement was apparently stopped before it was put into effect. While it is regrettable that even some Department employees apparently do not keep abreast of changes to the tax laws, nonetheless, it does not amount to a defense to the imposition of penalties, given the nature of the state's self-reporting tax system and the clear mandates of the court's decision in ***Arco Materials***.

CONCLUSIONS OF LAW

1. The Taxpayers filed a timely, written protest to Assessment No. 2540943 and jurisdiction lies over both the parties and the subject matter of this protest.

2. The provisions of Section 7-9-35 NMSA 1978 do not apply to exempt from gross receipts tax the timber severing activities performed by Mr. Rose because Mr. Rose is not selling natural resources or processing them.

3. The Taxpayers were negligent in failing to keep up with changes in Section 7-9-35 NMSA 1978 which had previously operated to provide an exemption from gross receipts tax for the timber severing activities of Mr. Rose and penalty was properly imposed pursuant to Section 7-1-69 NMSA 1978.

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

DONE, this 30th day of July, 2001.