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

IN THE MATTER OF THE PROTEST OF
KIDZ KAROUSEL, INC. d/b/a **No. 01-15**
CHILREN'S ORCHARD
ID NO. 02-361614-00 8
ASSESSMENT NOS. 2532927 through 2532933

DECISION AND ORDER

A formal hearing on the above-referenced protest was held July 25, 2001, before Margaret B. Alcock, Hearing Officer. Children's Orchard was represented by Mary Lou Lopez and Margaret Mulvey, its owners (referred to as "Taxpayers"). The Taxation and Revenue Department (referred to as "Department") was represented by Javier Lopez, Special Assistant Attorney General. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. "Children's Orchard" is a franchise of retail clothing stores.

2. In May 1998, the Taxpayers formed the corporation Kidz Karousel, Inc. for the purpose of opening a store under the Children's Orchard franchise.

3. The Taxpayers did not have any business background or knowledge of tax or financial matters. For this reason, they hired an attorney and a certified public accountant ("CPA") to advise them.

4. The Taxpayers explained their lack of business experience to the attorney and CPA and said they were relying on their advisers to educate the Taxpayers on business procedures and to insure the Taxpayers filed all required legal forms, including tax forms.

5. The Taxpayers had considered hiring a bookkeeper for the business, but decided to spend the extra money for a CPA to insure that all taxes were properly reported and paid.

6. The CPA gave them a list of the documents he would need to prepare the business's income tax returns. Neither the CPA nor the attorney ever discussed gross receipts tax with the Taxpayers.

7. In addition to hiring an attorney and CPA, the Taxpayers consulted with the New Mexico Business Resource Center, and it was someone at the Center who told the Taxpayers they needed to obtain a tax identification number from the Department.

8. The Taxpayers registered the business with the Department and were given a tax identification number to be used for payment of gross receipts, compensating and withholding taxes under the Department's combined reporting system ("CRS").

9. The Taxpayers were also given a CRS packet that contained the CRS-1 forms used to report gross receipts, compensating and withholding taxes each month.

10. The Taxpayers hired a payroll service to handle their payroll taxes. When they received the CRS packet from the Department, Ms. Lopez called the payroll company and asked whether the company would be filing CRS-1 returns for the Taxpayers' business.

11. The payroll service said they would file the CRS-1 returns and told Ms. Lopez to forward the CRS packet to them. Thereafter, Ms. Lopez sent the CRS packets the Taxpayers received from the Department to the payroll service.

12. In January 1999, the Taxpayers met with their CPA to go over the information needed to file the business's 1998 corporate income tax returns. Although gross receipts taxes may be taken as an expense against business income, the CPA did not ask for copies of the Taxpayers' gross receipts tax reports.

13. In January 2000, the Taxpayers met with their CPA to go over the information needed to file the business's 1999 corporate income tax returns. This time, the CPA asked for copies of the monthly gross receipts tax reports.

14. The Taxpayers told the CPA that the payroll service was filing their monthly CRS-1 returns, but subsequently discovered that the CRS-1 returns filed by the payroll service included only withholding tax and did not report the Taxpayer's gross receipts tax liability.

15. The Taxpayers did not understand why the CPA had not discussed the gross receipts tax with them during prior meetings and asked the CPA why the issue had not come up when he prepared the business's 1998 income tax returns the year before. The CPA gave a somewhat evasive answer, saying that the appropriate adjustments had been made on the Taxpayer's 1998 income tax return. From this, the Taxpayers concluded that the CPA had simply estimated the previous year's gross receipts tax deduction.

16. After the Taxpayers' filing problems came to light, their CPA offered to have someone on his staff walk the Taxpayers through the steps needed to complete the CRS-1 returns.

17. The Taxpayers made an appointment to meet with someone in the Department's Albuquerque office. After the meeting, the Taxpayers filed all back gross receipts tax returns and began making monthly payments on their outstanding tax liability.

18. On May 23, 2000, the Department issued assessments to the Taxpayers' business for unpaid gross receipts tax, plus interest and penalty.

19. On May 23, 2000, the Taxpayers filed a protest to the interest and penalty assessed.

20. After the assessments were issued, Ms. Lopez told the Taxpayers' attorney about the business's tax problems. The attorney indicated to Ms. Lopez that he should have discussed the gross receipts tax with the Taxpayers when they first set up the corporation.

DISCUSSION

The issue to be decided to whether the Taxpayers' corporation is liable for the interest and penalty assessed by the Department. The Taxpayers do not dispute their liability for the tax principal, but maintain it is unfair to assess them interest and penalty because they took all reasonable steps to insure compliance with the state's tax laws and should not be penalized for the failure of their attorney and CPA to properly advise them.

Section 7-1-17(C) NMSA 1978 provides that any assessment of taxes made by the Department is presumed to be correct. Section 7-1-3(X) NMSA 1978 defines tax to include not only the amount of tax principal imposed but also, unless the context otherwise requires, "the amount of any interest or civil penalty relating thereto." Thus, the presumption of correctness of an assessment of taxes also applies to the assessment of interest and penalty. *El Centro Villa Nursing Center v. Taxation and Revenue Department*, 108 N.M. 795, 779 P.2d 982 (Ct. App. 1989).

Interest. Section 7-1-67 NMSA 1978 governs the imposition of interest on late payments of tax and provides, 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...

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, 560 P.2d 167 (1977). The legislature has directed the Department to assess interest whenever taxes are not timely paid and has provided no exceptions to the mandate of the statute. The assessment of interest is not designed to punish taxpayers, but to compensate the state for the time value of unpaid revenues.

In this case, the Taxpayers failed to pay gross receipts tax during the first eighteen months they were in business. Although the Taxpayers' failure to pay tax was not intentional, the fact remains that the Taxpayers had the use of the state's money during this period. Even now, a portion of the gross receipts tax is still outstanding and is being paid on an installment basis. Section 7-1-67 NMSA 1978 specifically provides that interest accrues on unpaid tax "without regard to any extension of time or installment agreement". As this illustrates, the reason for a late payment of tax is irrelevant. Interest must be paid for any period of time during which the state is denied the use of the funds to which it is 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. 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 Taxpayers maintain that by consulting with both an attorney and a CPA concerning their business and tax filing obligations, they exercised a sufficient degree of ordinary business care and prudence to establish nonnegligence under Regulation 3.1.11.10(A) NMAC. The Department disputes that the Taxpayers' actions met the nonnegligence requirements of Regulation 3.1.11.11(D) NMAC, which provides that a taxpayer will not be considered negligent where:

> D. the taxpayer proves that the failure to pay tax or to file a return 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; failure to make a timely filing of a tax return, however, is not excused by the taxpayer's reliance on an agent.

Relying on the last sentence of the regulation, the Department maintains that the Taxpayers' failure to file gross receipts tax returns cannot be excused by their reliance on the payroll service to file their CRS-1 returns.

The Department is correct in its position that merely delegating tax responsibilities to an accountant or other agent is not sufficient for a taxpayer to escape the imposition of penalty when the agent is negligent in performing his duties. The negligent acts of an agent are attributable to the taxpayer. This was the holding of the Court of Appeals in *El Centro Villa Nursing Center v. Taxation and Revenue Department*, 108 N.M. 795, 779 P.2d 982 (Ct. App. 1989), which upheld the imposition of penalty on a taxpayer who delegated its obligation to prepare and file tax returns to an accountant. In that case, the taxpayer received unusually large Medicaid payments as a result of reimbursement adjustments made by the Human Services Department. Although the taxpayer reported gross receipts tax on its normal Medicaid payments, it failed to report and pay tax on the adjustment payments. The court found negligence on the part of both the taxpayer and its accountant. The finding of negligence by the taxpayer was based on the taxpayer's failure to alert its accountant to the unusual payments and the nature of those payments. The court found that the accountant was negligent in failing to implement an accounting system in such a way that checks and balances in the system would have alerted the accountant to the unusual income items so they could be examined and reported properly for tax purposes.

The facts of this case are quite different than those in *El Centro Villa*. Here, the Taxpayers' failure to pay gross receipts tax was not attributable to their delegation of authority to the payroll

service. The payroll service had been hired as the Taxpayer's agent to prepare and file returns relating to the Taxpayers' payroll, which included withholding and employment taxes. The payroll service performed these duties correctly, and there was no negligence on its part that could be attributed to the Taxpayers. The Taxpayers' failure to file gross receipts tax returns resulted from the Taxpayers' lack of knowledge concerning the gross receipts tax and the mechanics of the Department's combined reporting system, which uses the same form to report both withholding and gross receipts tax. The Taxpayers did not understand that even though the payroll service was filing monthly CRS-1 returns to report withholding tax, the Taxpayers had to file separate CRS-1 returns to report their gross receipts tax.

Although lack of knowledge is one of the indications of negligence set out in Regulation 3.1.11.10 NMAC, a taxpayer's ignorance of the law may be excused when the taxpayer has taken reasonable steps to educate himself concerning his tax liabilities. In this case, the Taxpayers were well aware they lacked the knowledge and experience needed to run a business and attempted to remedy the situation by engaging the professional services of an attorney and an accountant. The Taxpayers considered hiring a bookkeeper to advise them, but ultimately decided to incur the extra expense of hiring a CPA to insure their taxes were properly reported. Unfortunately, neither the attorney nor the CPA ever discussed the gross receipts tax with the Taxpayers or explained their reporting obligations. Particularly troubling is the failure of the CPA to ask for copies of gross receipts tax returns when preparing the Taxpayers' 1998 income tax returns. Gross sales reported for income tax purposes may not be an accurate basis for determining the amount of gross receipts tax paid since a business is often entitled to claim deductions and exemptions that serve to reduce taxable receipts. Also troubling is the fact that the CPA waited until after the Taxpayers' filing problems came to light before offering to have someone on his staff walk the Taxpayers through the steps needed to complete the CRS-1 returns. If

this had been done when the Taxpayers first opened their business, none of the current problems would have arisen.

The Taxpayers' experience is very similar to the situation set out in Regulation 3.1.11.11(D) NMAC, which supports a finding of nonnegligence based on a taxpayer's "reasonable reliance on the advice of competent tax counsel or accountant as to the taxpayer's liability after full disclosure of all relevant facts." In dealing with their attorney and accountant, the Taxpayers made no secret of their lack of business knowledge. They made it clear they were relying on their advisors to walk them through the procedures to be followed in operating the business and to advise them on their legal obligations, including tax obligations. Although these facts are slightly different than those in the Department's regulation, the eight scenarios set out in 3.1.11.11 NMAC are only examples. There are many situations that will support a finding of nonnegligence. The ultimate question is whether a taxpayer has exercised ordinary business care and prudence with respect to its obligation to timely report and pay taxes, not whether the situation exactly mirrors the hypothetical fact patterns described in the Department's regulations.

Based on the facts presented, the Taxpayers exercised the degree of ordinary business care and prudence which reasonable taxpayers would exercise under like circumstances and the assessment of penalty should be abated.

CONCLUSIONS OF LAW

1. The Taxpayers filed a timely, written protest to Assessment Nos. 2532927 through 2532933, and jurisdiction lies over the parties and the subject matter of this protest.

2. Pursuant to Section 7-1-67 NMSA 1978, interest was properly assessed against the Taxpayers on the late payment of gross receipts taxes.

3. Pursuant to Section 7-1-69 NMSA 1978 and the Department's regulations, the Taxpayers were not negligent in failing to report gross receipts tax during the period at issue.

For the foregoing reasons, the Taxpayer's protest IS DENIED IN PART AND GRANTED IN PART. The Department is hereby ordered to abate the penalty portion of Assessment Nos. 2532927 through 2532933.

DATED August 1, 2001.