

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

**IN THE MATTER OF THE PROTEST OF
PAT CAMPBELL INSURANCE, INC.
ID NO. 01-507916-00-3**

No. 02-03

ASSESSMENT NOS. 2700898-2700921 & 2703246-2703247

DECISION AND ORDER

A formal hearing on the above-referenced protest was held January 7, 2002, before Margaret B. Alcock, Hearing Officer. Pat Campbell Insurance, Inc. ("Taxpayer") was represented by Kerry D. Hixon, its president. The Taxation and Revenue Department ("Department") was represented by Javier L. Lopez, Special Assistant Attorney General. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. Since 1946, the Taxpayer has been engaged in the insurance business in Las Cruces, New Mexico.
2. The Taxpayer is registered with the Department for payment of gross receipts, compensating and withholding taxes, which are required to be paid monthly under the Department's combined reporting system ("CRS"). Given the nature of the Taxpayer's business, the only CRS taxes due on a regular basis are withholding taxes.
3. Sometime in the mid-1980s, the Taxpayer hired an office manager.
4. At the time Kerry Hixon joined the firm as an owner and corporate officer in 1991, the office manager had been with the firm for about six years and was responsible for all of the Taxpayer's accounting procedures. This included preparing tax returns, making out the checks to

pay taxes and other bills, and entering information into the Taxpayer's computerized cash management system, which she then used to prepare monthly and year-end financial statements.

5. The office manager was not authorized to sign tax returns or checks on behalf of the Taxpayer. Once the returns and checks were prepared, she brought them to Mr. Hixon or the other corporate officer for review. Once the returns and checks were signed, the office manager was responsible for making sure they were mailed in a timely manner.

6. Beginning in December 1998 and continuing for a period of more than two years, the office manager stopped mailing tax returns and payments to the Department, the Internal Revenue Service, and the New Mexico Department of Labor. She continued to bring the prepared returns and checks to Mr. Hixon for signature and entered information into the Taxpayer's computer system to make it look as though the taxes had been paid.

7. During the period the office manager failed to file tax payments, she was diverting many of the Taxpayer's cash receipts to her own use.

8. It was not unusual for some of the Taxpayer's customers to pay their insurance premiums in cash. Such cash payments, which could be as much as \$3,000, were accepted by a customer service representative. The cash was then turned over to the office manager for deposit.

9. The office manager entered the correct information in the Taxpayer's computer system and credited the customer with the payment. It appears she then kept some or all of the cash and substituted other checks received by the Taxpayer to make up the difference on the deposit slip.

10. There was no procedure requiring an employee other than the office manager to reconcile daily cash received with daily cash deposited in the Taxpayer's bank account.

11. Because the diverted cash deposits were offset by the amount of unpaid taxes that remained in the Taxpayer's bank account, and because the Taxpayer had large sums of money

flowing through its bank account each month, the nonpayment of taxes did not result in noticeably incorrect bank balances.

12. Although the Taxpayer's corporate officers recognized that it would be advisable to assign another employee to reconcile the Taxpayer's monthly bank statements, this task often fell to the office manager when no one else was available. During the period at issue, the office manager was the only person to reconcile the bank statements on a regular basis.

13. For this reason, no one discovered that none of the checks made out to state and federal tax agencies were clearing the Taxpayer's bank account or noticed the discrepancy between the cash deposits shown in the Taxpayer's computer system and the cash deposits shown on the bank deposit slips.

14. When past due tax notices were mailed to the Taxpayer, the office manager intercepted the notices, preventing them from going to the corporate officers. Most of the employees opening and distributing the mail were college students who might not have understood the significance of the tax notices and would have been unlikely to question the office manager concerning the notices.

15. Although the Taxpayer consulted with a certified public accountant concerning tax matters, the CPA relied on the tax forms and financial statements prepared by the office manager. The CPA did not review the Taxpayer's original bank statements or conduct an audit of the Taxpayer's records.

16. In July 2000, one of the Taxpayer's customer service representatives discovered a notice from the New Mexico Department of Labor stating that it had not received the Taxpayer's March 31, 2000 and December 31, 2000 quarterly reports. The customer service representative gave the notice to Mr. Hixon.

17. When Mr. Hixon asked the office manager about the notice, she said she had mailed the reports and tax payments on time. Mr. Hixon subsequently learned this was not true and personally saw to it that the required forms and payments were filed.

18. After this incident, Mr. Hixon began to look into other areas of potential problems. He discovered that the Taxpayer's checking account had not been reconciled for more than two years and that checks issued to state and federal tax agencies were very old and had never cleared the Taxpayer's bank account.

19. Mr. Hixon notified the Taxpayer's CPA of the situation and immediately contacted the various tax agencies to determine the extent of the Taxpayer's outstanding liabilities.

20. On August 29, 2001, after being contacted by Mr. Hixon, the Department issued Assessment Nos. 2700898-2700921 & 2703246-2703247 to the Taxpayer for reporting periods December 1998 and May 1998 through May 2001 in the amount of \$33,574.80 of tax principal, \$6,292.71 of interest and \$3,282.76 of penalty.

21. On September 28, 2001, the Taxpayer filed a written protest to the interest and penalty portions of the assessments.

DISCUSSION

The issue to be determined is whether the Taxpayer is liable for interest and penalty on the late payment of withholding taxes due for reporting periods December 1998 and May 1999 through May 2000. 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(V) 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." *See also, El Centro Villa Nursing Center v. Taxation and Revenue Department*, 108 N.M. 795, 779 P.2d 982 (Ct. App. 1989). Accordingly, the

presumption of correctness applies to the assessment of interest and penalty at issue in this case, and it is the Taxpayer's burden to present evidence and legal arguments to support an abatement.

Assessment of 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.... (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, 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. 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. Here, the Taxpayer failed to pay withholding tax due for a period of more than two years. Accordingly, interest was properly assessed against the Taxpayer and there is no basis for abatement.

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 ten percent when a taxpayer fails "due to negligence or disregard of rules and regulations" to pay taxes or file required tax reports in a timely manner. Taxpayer negligence for purposes of assessing penalty 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.

In this case, the Taxpayer's failure to timely report and pay its monthly CRS taxes was attributable to two factors: (1) the office manager's failure to pay the Taxpayer's withholding taxes; and (2) the lack of safeguards in the Taxpayer's accounting system.

Inaction of the Office Manager. During the period December 1999 through May 2001, the Taxpayer's office manager stopped mailing required CRS returns and payments to the Department. Under the doctrine of *respondeat superior*, an employer may be liable for the acts of its employee if the wrongful acts are committed in the course and scope of employment. As a general rule, an employee's act is within the course of employment if: (1) it is something fairly and naturally incidental to the employer's business assigned to the employee, and (2) it is done while the employee is engaged in the employer's business with the view of furthering the employer's interest and does not arise entirely from some external, independent and personal motive on the part of the employee. *See*, UJI 13-407; *Los Ranchitos v. Tierra Grande, Inc.*, 116 N.M. 222, 227, 861 P.2d 263, 268 (Ct. App. 1993). There are numerous cases holding that an employee who steals or embezzles is not acting in the interests of his or her employer, but is acting from some independent, personal motive. *Id.* In this case, the Taxpayer's officer manager was not acting in the scope of her employment when she withheld payment of the Taxpayer's tax payments as a means of covering up her ongoing diversion of cash deposits. Accordingly, these acts cannot be attributed to the Taxpayer under the doctrine of *respondeat superior*.

Lack of Safeguards in Accounting System. While the most direct cause of the Taxpayer's failure to file tax returns was the illegal acts of its office manager, the failure was also attributable to the

lack of accounting safeguards maintained by the Taxpayer. The evidence establishes that the corporate officers delegated responsibility for many key aspects of the business to the office manager.

Although the corporate officers recognized the importance of assigning other employees to reconcile the Taxpayer's monthly bank statements and to open and distribute the mail, no steps were taken to implement an adequate system of checks and balances. As a result, the office manager had complete and unsupervised control over the deposit of large amounts of cash, the reconciliation of the Taxpayer's bank statements, and the entry of data into the computer system used to generate the Taxpayer's financial statements. Because mail duties were assigned to inexperienced college students, who were unlikely to question the authority of the office manager or recognize the significance of past due tax notices, the office manager was also able to intercept any notices that would have alerted the corporate officers to her activities.

It is understandable that a small business may not have the resources to assign more than one employee to perform the company's routine bookkeeping and office duties. When that is the case, however, it is incumbent on the business to arrange for a regular audit of the company's records. This could be done by an outside accountant or by someone within the company, provided that person was both qualified and independent of the daily financial operations of the business. At the administrative hearing, Mr. Hixon testified that he did not think an outside audit was necessary because the monthly and year-end financial statements did not indicate any problems. He failed to appreciate the fact that the financial statements were based entirely on information entered into the computer system by the office manager—the same person who had control over the Taxpayer's cash deposits and the reconciliation of the Taxpayer's bank statements.

In this case, the Taxpayer was the victim of an unscrupulous employee and had no intention of cheating the state or federal government of taxes due. The fact remains, however, that the

employee could not have carried out her scheme (and probably would not have tried) if procedures had been in place to detect her manipulation of the Taxpayer's accounting system. Given the large sums of money that routinely flowed through the Taxpayer's business—at least some of it in cash—the Taxpayer was negligent in giving such complete and unsupervised control over its accounting system to a single employee.

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest to Assessment Nos. 2700898-2700921 & 2703246-2703247, and jurisdiction lies over the parties and the subject matter of this protest.

2. Pursuant to Section 7-1-67 NMSA 1978, interest is due on the Taxpayer's late payment of withholding taxes.

3. The Taxpayer was negligent in failing to properly supervise its office manager's activities over a period of more than two years, and penalty is due under Section 7-1-69 NMSA 1978.

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

DATED January 9, 2002.