

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

**IN THE MATTER OF THE PROTEST OF
CONDEV WEST, INC.
ID NO. 02-306845-00 0
ASSESSMENT NO. 2674606**

No. 02-19

DECISION AND ORDER

A formal hearing on the above-referenced protest was held August 19, 2002, before Margaret B. Alcock, Hearing Officer. Condev West, Inc. ("Taxpayer") was represented by Debbie Cornwell, its Tax Audit Manager. The Taxation and Revenue Department ("Department") was represented by Bridget A. Jacober, Special Assistant Attorney General. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The Taxpayer owns and operates retail stores in 30 states. The Taxpayer has five stores in New Mexico and 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").
2. During the audit period at issue, the Taxpayer had procedures in place to insure that compensating tax was properly reported on its purchases of tangible personal property delivered in New Mexico. In late 1998 or early 1999, the Taxpayer reviewed and enhanced these procedures.
3. When purchasing tangible personal property for its New Mexico stores, the Taxpayer first determined whether the transaction was taxable or nontaxable.
4. When a sale was taxable and the property was purchased from a New Mexico vendor, the Taxpayer checked to see whether the vendor had charged gross receipts tax on the sale. If the vendor had not charged tax, the Taxpayer asked the vendor to do so.

5. When a sale was taxable and the property was purchased from a vendor outside New Mexico, the Taxpayer consulted with the vendor to determine whether the vendor had nexus with New Mexico and should be charging gross receipts tax.

6. Once the Taxpayer determined that a vendor did not have nexus with New Mexico, the Taxpayer reported and paid compensating tax on its New Mexico purchases from that vendor.

7. When the Taxpayer discovered that a transaction had been underreported or overreported, the Taxpayer did not amend its prior return, but simply adjusted the compensating tax it reported for the current month.

8. The Taxpayer performed periodic reviews of its monthly reporting of CRS taxes. If the Taxpayer believed that inadvertent errors had led to an underreporting of tax in earlier periods, it did not go back and amend its prior returns, but added the estimated amount of the underpayment to its CRS return for the current month.

9. On November 17, 1999, the Department sent the Taxpayer written notice that it had been selected for a field audit.

10. After receiving the Department's audit notice, the Taxpayer reviewed its reporting of CRS taxes and determined that those taxes may have been underreported during the period subject to audit. On its December 1999 CRS-1 return, which was filed January 25, 2000, the Taxpayer reported an additional \$15,000 of CRS taxes to cover the suspected underpayment during earlier periods.

11. After the field audit began, the Department made a decision to limit the audit to the Taxpayer's reporting and payment of compensating tax.

12. The Department audited the Taxpayer's payment of compensating tax on the purchase of supplies, which included such items as pens, paper bags, receipts, gift wrapping, etc., by

reviewing a sample of invoices and then applying the error rate found in that sample to the entire audit period.

13. The Department audited the Taxpayer's payment of compensating tax on the purchase of capital assets by looking at each individual invoice related to these purchases.

14. The majority of underpayments found in the audit were related to the Taxpayer's purchase of capital assets.

15. Due to the Taxpayer's practice of correcting past reporting errors by adjusting its CRS reporting for the current month, rather than going back and amending its returns for the months in which the errors occurred, the Department's audit also determined that the Taxpayer had underpaid compensating taxes for certain months of the audit period and overpaid taxes for other months.

16. The Taxpayer had an outstanding compensating tax liability of \$38,820.78 for the 40-month period from January 1997 through April 2000. The Taxpayer's overpayment of compensating tax for the same period, including the \$15,000 estimated payment made after the Taxpayer received the Department's audit notice, was \$32,604.94.

17. On June 29, 2001, the Department issued Assessment No. 2674606 to the Taxpayer in the total amount of \$60,100.50, representing \$38,820.78 of compensating tax, \$17,397.63 of interest, and \$3,882.09 of penalty.

18. On September 27, 2001, pursuant to a written extension of time granted by the Department, the Taxpayer filed a written protest to the Department's assessment.

19. The Department subsequently agreed to make some minor adjustments that reduced the amount of tax principal to \$38,708.72.

20. After the Taxpayer filed a written claim for refund of the taxes it overpaid during the audit period, the Department applied the refund to the Taxpayer's outstanding liability.

21. At the administrative hearing on the Taxpayer's protest, the Taxpayer's tax audit manager stated that the Taxpayer was no longer disputing its liability for the tax principal and interest assessed by the Department and that the only matter remaining to be decided was the assessment of penalty.

DISCUSSION

The sole issue to be determined is whether the Taxpayer is liable for the penalty assessed on its underpayment of compensating tax during the period January 1997 through April 2000. The Taxpayer raises the following arguments in support of its position that penalty should be abated: (1) the amount of underreported tax is insignificant when compared to the amount of tax paid during the same period and does not provide grounds to conclude that the Taxpayer acted negligently or in disregard of the Department's rules and regulations; (2) the penalty should be based on the net amount of tax due after application of the Taxpayer's overpayments for the same period; (3) the sampling method the Department used to determine the Taxpayer's liability has a margin for error and should not be the basis for determining penalty; and (4) the Taxpayer employs three in-house CPAs to insure taxes are correctly reported and this establishes that the Taxpayer was not negligent in failing to properly report compensating tax.

Section 7-1-17 NMSA 1978 provides that any assessment of taxes made by the Department is presumed to be correct. Section 7-1-3 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 penalty at issue in this case, and it is the Taxpayer's burden to present evidence and legal arguments to support an abatement.

Section 7-1-69 NMSA 1978 governs the imposition of penalty. Subsection A imposes a penalty of two percent per month or any fraction of a month, up to a maximum of ten percent, that 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:

- 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 Taxpayer maintains that its underpayment of compensating tax during the audit period was not due to negligence or to a disregard of rules and regulations. The Taxpayer raises the following arguments in support of its position:

(1) The amount of underreported tax is insignificant when compared to the amount of tax paid during the same period and does not provide grounds for a penalty. This argument is based on a misreading of Section 7-1-69(A) NMSA 1978, which imposes a ten percent penalty whenever the failure "to pay the amount of tax required to be paid" is due to negligence or disregard of rules and regulations. The focus is on the amount of tax not paid. The statute does not provide a de minimis exception, and the fact that a taxpayer may have paid 99 percent of its tax correctly is irrelevant. If the failure to pay the remaining one percent of tax can be attributed to the taxpayer's negligence, penalty is due on that one percent. Here, the Taxpayer's underpayment of compensating

tax was due to two factors: inadvertent or “human” error and erroneous reporting of prior period adjustments. Both of these factors constitute negligence.

Inadvertent Error. At the administrative hearing, the Taxpayer’s tax audit manager acknowledged that while the Taxpayer has instituted various procedures to insure proper payment of its taxes, human errors still occur. She testified that the largest reporting errors found by the Department’s auditor were related to the Taxpayer’s failure to pay compensating tax on the purchase of fixed assets. She identified the purchase of glass display cases used in a store remodel as one of the transactions the Taxpayer failed to report. She said this was an inadvertent error and may have been due to the fact that high-dollar items require a higher level approval before tax can be paid. The audit manager gave her opinion that such errors are inevitable and do not indicate negligence on the part of the Taxpayer. New Mexico law holds differently.

In *El Centro Villa Nursing Center v. Taxation & Revenue Department*, 108 N.M. 795, 797, 779 P.2d 982, 984 (Ct. App. 1989), the New Mexico Court of Appeals rejected the argument that inadvertent or human error does not constitute negligence, stating:

It is apparent from the taped proceedings that taxpayer's advocate, its accountant, did not understand the meaning of the term "negligence," either generally or as specifically defined in Regulation 69:3. He admitted that taxpayer's accounting system failed in December 1983 and November 1984 ... but stated that this was due to "human error," which he did not characterize as negligence. Taxpayer continues the misconception about when failure to pay tax can be penalized under Section 7-1-69(A) by disregarding any accepted definition of negligence and asserting that it is unfair to penalize a taxpayer for inadvertent error.

The court concluded that “Section 7-1-69(A) is designed specifically to penalize unintentional failure to pay tax.” *Id.* See also, *Arco Materials, Inc. v. Taxation & Revenue Department*, 118 N.M. 12, 16, 878 P.2d 330, 334 (Ct. App. 1994) *rev'd on other grounds* by *Blaze Construction Co. v. Taxation & Revenue Department*, 118 N.M. 647, 884 P.2d 803 (1994). The inadvertent errors that led to the

Taxpayer's failure to pay compensating tax on certain transactions come within this definition of negligence.

Erroneous Reporting. The second factor contributing to the Taxpayer's underpayment of compensating tax was its erroneous method of reporting prior period adjustments. Section 7-9-11 NMSA 1978 requires CRS taxes to be paid "on or before the twenty-fifth day of the month following the month in which the taxable event occurs." If a taxpayer finds that compensating taxes for a particular month were underpaid, the taxpayer should file an amended return to correct its earlier reporting. If a taxpayer finds that taxes were overpaid, the taxpayer is required to file a claim for refund with the Department. *See*, Section 7-1-26 NMSA 1978.

Taxpayers are not permitted to correct reporting errors in earlier months by adjusting the compensating tax reported on the current month's return. As stated in Department Regulation 3.1.9.13 NMAC: "A taxpayer may not create a credit for a discovered overpayment of tax by understating the amount due on current tax returns to offset amounts paid on prior returns." Nor may a taxpayer guard against past underpayments by making additional estimated payments in a later reporting period. *See*, Section 7-1-10(E) NMSA 1978, limiting the use of estimated payments to taxpayers who meet specified requirements and enter into a written agreement with the Department.

As noted by the New Mexico Court of Appeals in *Amoco Production Co. v. New Mexico Taxation & Revenue Department*, 118 N.M. 72, 75, 878 P.2d 1021, 1024 (Ct. App. 1994), "a tax is not paid simply when monies are deposited with the state." Each tax payment must be properly identified to the month in which the taxable transaction occurred. This is the only way the Department can determine whether tax on that transaction was paid correctly and on time. The Taxpayer's practice of adjusting the current month's reporting to correct reports filed for prior periods was not in accordance with New Mexico law and was in disregard of the Department's rules

and regulations. Accordingly, the compensating tax liability resulting from this incorrect reporting is subject to the negligence penalty imposed by Section 7-1-69(A) NMSA 1978.

(2) The penalty should be based on the net amount of tax due after applying the Taxpayer's overpayments to the underpayments found in the audit. In *Amoco Production Co.*, *supra*, the court of appeals held that New Mexico statutes do not authorize the Department to apply overpayments of taxes for one reporting period as offsets against underpayments for another prior reporting period. The Taxpayer has accepted this ruling with regard to the tax principal and interest assessed by the Department, but argues that a different rule should apply to penalty. The Taxpayer has not provided any authority to justify such a distinction.¹ Pursuant to Section 7-1-69(A)(1) NMSA 1978, penalty is calculated as follows:

two percent per month or any fraction of a month from the date the tax was due multiplied by the amount of tax due but not paid, not to exceed ten percent of the tax due but not paid.

The “amount of tax due” for purposes of calculating penalty is the amount of tax assessed by the Department. This includes the total amount of the Taxpayer’s underpayments of compensating tax during the audit period, without regard to any overpayments made during the same period.

(3) The sampling method the Department used to determine the Taxpayer's liability has a margin for error and should not be the basis for determining penalty. At the administrative hearing, the Taxpayer’s audit manager affirmatively stated that the Taxpayer does not challenge the Department’s use of sampling to determine the Taxpayer’s liability for tax. She then argued that the sampling method used was not sufficiently accurate to justify the imposition of

¹ Effective July 1, 2001, a new Subsection F was added to Section 7-1-69 NMSA 1978, which states that no penalty shall be imposed on “tax that is deemed paid by crediting overpayments found in an audit...pursuant to Section 7-1-29 NMSA 1978.” This provision does not apply to the period at issue in this case. In addition, Section 7-1-29 NMSA 1978 requires a taxpayer to file a claim for refund before credit can be given for an overpayment and further provides that a tax is “deemed paid in the period in which the overpayment was made *or the period in which the overpayment was credited against an underpayment, whichever is later*” (emphasis added). Here, the full ten percent penalty had accrued before the Taxpayer filed its claim for refund and the

penalty. There is simply no logic to this argument. In addition, the Taxpayer failed to provide any evidence to establish why or to what extent the Department's sampling method was inaccurate.

As discussed in the previous section, the calculation of penalty is based on the amount of tax established in the Department's audit. Having withdrawn its challenge to the assessment of tax principal, the Taxpayer has no grounds to complain when this same figure is used to determine the amount of penalty due on the Taxpayer's underpayment of tax.

I also note that while the Department audited the tax paid on supplies using a sampling method, it conducted a detail audit of tax paid on capital assets. This means that the Department's auditor looked at each individual invoice to determine whether compensating tax was properly reported and paid on the assets purchased. The Taxpayer's audit manager acknowledged that most of the underpayments found in the audit were related to capital assets. Clearly, the accuracy of the Department's sampling methods does not apply to these underpayments.

(4) The Taxpayer employs three in-house CPAs to insure taxes are correctly reported and this establishes that the Taxpayer was not negligent in its failure to report compensating tax. Department 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 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." The Taxpayer argues that the fact it employs three CPAs to research tax laws and regulations establishes that the Taxpayer was not negligent in failing to properly report and pay the compensating tax assessed by the Department. There is no evidence, however, that the Taxpayer's CPAs advised the Taxpayer not to pay compensating tax on the transactions at issue in this case. Nor is there any evidence that the CPAs approved or were even aware of the Taxpayer's

Department credited the Taxpayer's overpayments to the underpayments found in the audit. Accordingly, even if the 2001

method of reporting adjustments to prior period returns. The fact that a taxpayer employs an attorney or a CPA to provide general tax advice does not establish that the taxpayer was not negligent in failing to pay tax on a particular transaction. The Department's regulation applies only when a taxpayer has consulted with its tax advisor and received erroneous advice concerning the specific liability at issue.

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest to Assessment No. 2674606, and jurisdiction lies over the parties and the subject matter of this protest.
2. The Taxpayer's underpayment of compensating tax during the audit period was due to negligence or disregard of rules and regulations, and penalty was properly imposed pursuant to Section 7-1-69 NMSA 1978.

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

DATED August 27, 2002.

legislative change were applied to this case, it would not affect the assessment of penalty to the Taxpayer.