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

IN THE MATTER OF THE PROTEST OF
DLORAH, INC.
d/b/a NATIONAL AMERICAN UNIVERSITY **No. 02-31**
ID NO. 02-180159-00 2
ASSESSMENT NO. 2260069

DECISION AND ORDER

On November 19, 2002, Dlorah, Inc. ("Dlorah") filed a motion for partial summary judgment on its protest to the Taxation and Revenue Department's ("Department") assessment of a $12,398.15 penalty on Dlorah's underpayment of gross receipts tax for the period June 1991 through November 1997. On November 26, 2002, the Department filed its response. On December 9, 2002, a hearing on Dlorah's motion was held before Margaret B. Alcock, Hearing Officer. Dlorah was represented by its attorney, Benjamin A. Roybal, Esq., Betzer, Roybal & Eisenberg, P.C. The Department was represented by Bridget A. Jacober, Special Assistant Attorney General.

At the December 9, 2002 hearing, the parties agreed that there were no material facts in dispute and that the Hearing Officer's ruling on Dlorah's motion for summary judgment would be dispositive of the issues raised in the protest. Based on the undisputed facts and the arguments presented by the parties, IT IS DECIDED AND ORDERED AS FOLLOWS:

STATEMENT OF FACTS

Following are the undisputed facts set out in Dlorah's motion for summary judgment and accompanying exhibits, as modified by agreement of the parties at the December 9, 2002 hearing.

1. Dlorah is a South Dakota corporation, engaged in the business of operating for-profit educational institutions.

2. Dlorah is registered with the Department under CRS No. 02-180159-00-2.

3. The Department is an agency of the State of New Mexico charged by law with the duty, authority and responsibility to administer the Gross Receipts and Compensating Tax Act.

4. In January 1998, the Department commenced an audit of Dlorah covering the period June 1991 through November 1997 ("Audit Period").

5. The Department completed the audit in March 1998.

6. On May 29, 1998, the Department issued Assessment No. 2260069 to Dlorah in the total amount of $229,046.08, representing $123,981.28 gross receipts tax, $12,398.15 penalty, and $92,666.65 interest due for the Audit Period.

7. On July 23, 1998, after obtaining an extension of time from the Department, Dlorah filed a protest of the tax, penalties, and interest assessed pursuant to Assessment No. 2260069.

8. On July 24, 1998, pursuant to Department Regulation 3.1.7.9 NMAC, Dlorah paid the gross receipts tax due under Assessment No. 2260069.

9. Dlorah does not contest the assessment of gross receipts tax (or related interest) assessed pursuant to Assessment No. 2260069.

10. Dlorah operates business schools in six states and twelve cities.

11. Each of those states and cities has different state and local tax systems.

12. Dlorah does not have (and during the Audit Period did not have) the expertise or staff in house to evaluate tax and other legal obligations of every state or jurisdiction in which it conducts business.

13. Because of the lack of in-house expertise, Dlorah relies (and historically has relied) on outside experts, including its accountants and lawyers, to advise Dlorah on those issues.

14. Dlorah has a longstanding relationship with Ketel Thortenson, LLP ("Ketel"), an accounting and consulting firm based in Rapid City, South Dakota.

15. Ketel is very familiar with Dlorah's business operations, including revenue sources and expenses.

16. Ketel routinely advises Dlorah on financial and other issues, including tax reporting and compliance issues.

17. From time to time during the years covered by the Audit Period, Dlorah sought Ketel's advice on various state tax issues.

18. From time to time during the years covered by the Audit Period, Ketel advised Dlorah on various state tax issues.

19. Prior to and at all times during the Audit Period, Dlorah engaged Ketel to audit Dlorah's books and records and financial statements and to advise Dlorah on financial, tax and other business issues.

20. Prior to and at all times during the Audit Period, Dlorah engaged Ketel to prepare Dlorah's federal and state income tax returns, including its New Mexico Corporate Income Tax returns.

21. Ketel's standard practice and procedure in the course of each audit is to identify issues requiring the attention of Dlorah's senior management and its owner, including, without limitation, financial reporting issues, reserve levels and reserves for income and other taxes.

22. Ketel's standard practice and procedure is to prepare and send a management letter identifying issues related to the financial statements to ensure that those items are brought to the attention of Dlorah's senior management and its owner.

23. If Ketel identifies an issue that needs to be brought to the attention of Dlorah's senior management and its owner, Ketel will include that item in the management letter sent to senior management at the close of an audit.

24. Dlorah's senior management relies on Ketel's management letters to apprise them of undisclosed or unknown liabilities, including tax liabilities.

25. Ketel audited Dlorah's books and records and financial statements for the years covered by the Audit Period.

26. In conjunction with the preparation of the audit of its books and records and financial statements, Dlorah supplied Ketel with information pertaining to its New Mexico operations, including revenue sources and expense information.

27. Ketel produced and delivered management letters and audit reports with respect to Dlorah's books and records and financial statements for the years covered by the Audit Period.

28. The Independent Auditors' Report for the year ending May 31, 1992 states that Ketel "audited the accompanying balance sheet...and the related statements of operations and retained earnings and cash flows for the year then ended. These financial statements are the responsibility of National College's management. Our responsibility is to express an opinion on these financial statements based on our audit."

29. The Independent Auditors' Report for the year ending May 31, 1992 describes the scope of Ketel's review as follows: "we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation."

30. The Independent Auditors' Reports for the years ending May 31, 1993, 1994, 1995, 1996 and 1997 describe the purpose and scope of Ketel's audit in the same terms as the 1992 report.

31. The Independent Auditors' Report for the year ended May 31, 1997 contains the following disclaimer: "Compliance with laws, regulations, contracts and grants applicable to the University is the responsibility of the University's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the University's compliance with certain provisions of laws, regulations, contracts and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion."

32. Dlorah's senior management reviewed each management letter produced by Ketel for each year covered by the Audit Period.

33. The management letters for the years covered by the Audit Period did not identify New Mexico gross receipts or compensating tax as an undisclosed liability or issue requiring the attention of senior management of Dlorah.

34. Dlorah's senior management relied on Ketel's management letters to apprise them of undisclosed or unknown liabilities, including tax liabilities, for the years covered by the Audit Period.

35. Ketel also prepared Dlorah's federal and state income tax returns for the years covered by the Audit Period, including Dlorah's New Mexico Corporate Income Tax returns.

36. In conjunction with the preparation of its New Mexico Corporate Income Tax returns, Dlorah supplied Ketel with information pertaining to its New Mexico operations, including revenue sources and expense information.

37. As it did in most other states, Dlorah paid tax on textbooks, but was not aware that New Mexico's gross receipts tax applied to tuition receipts as well.

38. Information provided by Dlorah to Ketel in connection with the preparation of its New Mexico Corporate Income Tax returns identifies expenditures for New Mexico gross receipts tax on sales of textbooks, but not on tuition receipts.

39. Ketel reviewed the information supplied by Dlorah in connection with Ketel's preparation of Dlorah's Corporation Income Tax Returns.

40. Ketel did not identify Dlorah's failure to pay New Mexico gross receipts tax on tuition receipts as an issue to be addressed by Dlorah's senior management for the years covered by the Audit Period.

41. Ketel did not inform Dlorah's senior management or owner of the need to pay New Mexico gross receipts tax on tuition receipts orally or in the management letters issued for the years covered by the Audit Period.

42. Because Ketel did not identify it, Dlorah was not aware of the obligation to pay New Mexico gross receipts tax on tuition receipts.

43. Dlorah relied on Ketel to identify and apprise Dlorah of unpaid tax liabilities, including New Mexico gross receipts tax liability on tuition receipts.

DISCUSSION

The sole issue to be determined is whether Dlorah is liable for the $12,398.15 negligence penalty assessed in connection with its underpayment of gross receipts tax for the period June 1991 through November 1997. 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." Accordingly, the presumption of correctness applies to the assessment of penalty at issue in this case, and it is Dlorah's burden to present evidence and legal arguments to justify an abatement. *See, El Centro Villa Nursing Center v. Taxation and Revenue Department*, 108 N.M. 795, 779 P.2d 982 (Ct. App. 1989).

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.

Regulation 3.1.11.11 NMAC sets out several situations that may indicate a taxpayer has not been negligent, including instances where the taxpayer proves that the failure to pay tax "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."

In this case, Dlorah concedes that its failure to pay New Mexico gross receipts tax on its tuition receipts was caused by its lack of knowledge of New Mexico law. Dlorah argues, however, that this lack of knowledge did not constitute negligence because it reasonably relied on the advice of its accounting firm to insure that all of its state and federal taxes were properly paid. In response, the Department argues that a general delegation of tax matters to an agent is not sufficient to meet the requirements of Regulation 3.1.11.11 NMAC. The Department maintains that Dlorah's reliance on its accounting firm to discover errors in Dlorah's gross receipts tax reporting was not reasonable because Dlorah never consulted its accountants on this issue.

As the primary support for its protest, Dlorah cites to *Kidz Karousel, Inc.*, an administrative decision issued by the Department's Hearing Officer in August 2001.[1] In that case, the owners of Kidz Karousel, which operated a retail clothing store in New Mexico, consulted with a New Mexico attorney and a New Mexico CPA at the time the corporation was formed. The owners specifically asked their attorney and CPA to advise to them on business procedures and to insure that the corporation filed all legal forms, including tax forms, required by New Mexico law. Neither the attorney nor the CPA ever advised the owners that the corporation was required to file gross receipts tax returns to report its receipts from retail sales.

[1] Pursuant to the exception to confidentiality set out in Section 7-1-8(Z) NMSA 1978 (2001 Repl. Pamp), administrative decisions issued by the Department's hearing officers are public records open to inspection by the public. Although these decisions are posted on the Department's web site and provide general guidance concerning positions taken in past cases, they do not serve as legal precedent for future cases.

The facts in this case are quite different. Here, Dlorah operates business schools in six states and twelve cities, each of which has different state and local tax systems. Dlorah has retained Ketel, an accounting and consulting firm based in Rapid City, South Dakota, to provide Dlorah with accounting advice. The scope of Ketel's work for Dlorah includes preparing its state and federal income tax returns and auditing its annual financial statements to insure there are no material misstatements. From time to time during the Audit Period, Dlorah also sought and received Ketel's advice on various state tax issues. There is no indication, however, that those discussions related to Dlorah's payment of New Mexico gross receipts tax. Nor is there any indication that Ketel, a South Dakota accounting firm, had any expertise on New Mexico's tax laws or had been engaged to determine whether Dlorah was in compliance with those laws. To the contrary, the Independent Auditors' Report Ketel prepared for the year ended May 31, 1997 specifically disclaims such responsibility:

> Compliance with laws, regulations, contracts and grants applicable to the University is the responsibility of the University's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the University's compliance with certain provisions of laws, regulations, contracts and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Based on this disclaimer, and the clear language in Ketel's audit reports setting out the limited scope of its review of Dlorah's financial statements, it was not reasonable for Dlorah to have relied on Ketel to determine whether Dlorah was correctly reporting New Mexico gross receipts tax.

The facts presented in Dlorah's motion for summary judgment are closer to the facts in *Vivigen, Inc. v. Minzner*, 117 N.M. 224, 870 P.2d 1382 (Ct. App. 1994) and *Arco Materials, Inc. v. Taxation & Revenue Department*, 118 N.M. 12, 878 P.2d 330 (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), than they

are to the facts in *Kidz Karousel*. In *Vivigen*, the taxpayer raised virtually the same defense to the assessment of penalty as Dlorah raises here, arguing that:

> At all times during the audit period, Vivigen was a public corporation, subject to the reporting rules of the United States Securities and Exchange Commission. As a consequence, its financial affairs were annually audited by KPMG Peat Marwick, and that company certified the accuracy of the financial statements contained in the annual reports to shareholders. There is no explanation for the failure of Vivigen's bookkeeping system to account for New Mexico compensating tax liability, or for that failure escaping the attention of the auditors.

The Court of Appeals was unconvinced, stating:

> This response is not persuasive. Apparently, Vivigen's sole excuse is that the failure to pay compensating use tax was not uncovered by the accountants who certified the accuracy of Vivigen's financial statements for the annual reports to shareholders required by federal securities law. Vivigen offered no evidence that the outside auditors reviewed Vivigen's monthly state tax returns and does not explain why the audit for the annual reports should have uncovered failure to pay compensating tax, nor does it explain why the failure of the auditors to discover the error would excuse Vivigen's failure to comply with clear state law. We therefore reverse the district court's determination that the penalty assessment was improper.

117 N.M. at 231-232, 870 P.2d at 1389-1390. In *Arco Materials*, the Court of Appeals again dismissed the taxpayer's general reliance on its outside auditors as a basis for abating penalty:

> There was also evidence that the office manager believed the audits performed by an accounting firm would uncover potential tax problems, although there did not appear to have been any evidence concerning discussions with the firm's auditors about these issues. Taxpayer's general manager and secretary-treasurer testified that he believed materials sold for repair and maintenance were not taxable. We believe that his testimony was substantial evidence that Taxpayer's failure to pay the gross receipts tax due was based on its erroneous beliefs, inattention, inaction where action would be reasonably required, or a failure to exercise the degree of ordinary business care that similarly situated businesses would exercise. *See* Reg. TA 69:3; *El Centro Villa Nursing Ctr.*, 108 N.M. at 798, 779 P.2d at 985.

118 N.M. at 16-17, 878 P.2d at 334-335.

A taxpayer's reliance on a tax professional must be active and informed—not passive and unaware—in order to support a finding that the taxpayer's failure to pay tax was not negligent for purposes of Section 7-1-69(A) NMSA 1978. A taxpayer's responsibility for payment of taxes due to

the state cannot be delegated to a third party and then forgotten. As the Court of Appeals held in *El Centro Villa Nursing Center v. Taxation and Revenue Department*, 108 N.M. 795, 799, 779 P.2d 982, 986 (Ct. App. 1989):

> "[e]very person is charged with the reasonable duty to ascertain the possible tax consequences of his action [or inaction]." *Tiffany Constr. Co. v. Bureau of Revenue*, 90 N.M. at 17, 558 P.2d at 1156. We are not inclined to hold that the taxpayer can abdicate this responsibility merely by appointing an accountant as its agent in tax matters.

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. A finding of nonnegligence requires proof that the taxpayer engaged in "informed consultation" concerning the specific liability at issue. *See, e.g., C&D Trailer Sales v. Taxation and Revenue Department*, 93 N.M. 697, 700, 604 P.2d 835, 838 (Ct. App. 1979) (penalty upheld where there was no evidence that the taxpayer "relied on any informed consultation" in deciding not to pay tax); *Phillips Mercantile v. New Mexico Taxation and Revenue Department*, 109 N.M. 487, 491, 786 P.2d 1221, 1225 (Ct. App. 1990) (penalty upheld where there was no evidence that the failure to pay tax was the result of diligent protest "based on informed consultation and advice").

In this case, Dlorah retained a South Dakota accounting firm to prepare its corporate income tax returns and audit its annual financial statements. There is no evidence that the accounting firm was asked to prepare or audit Dlorah's New Mexico gross receipts tax returns. Nor is there any evidence that Dlorah consulted with or sought the advice of its accountants concerning Dlorah's liability for New Mexico gross receipts tax. Dlorah's failure to pay gross receipts tax on its tuition receipts was not caused by its reasonable reliance on the advice of its accountants after full disclosure of all relevant facts, but by its lack of knowledge of New Mexico law and its erroneous belief that tax was not due on certain transactions. This constitutes negligence for purposes of Section 7-1-69(A) NMSA 1978, and penalty was properly assessed by the Department.

CONCLUSIONS OF LAW

1. Dlorah filed a timely, written protest to Assessment No. 2260069, and jurisdiction lies over the parties and the subject matter of this protest.

2. Dlorah was negligent in failing to pay gross receipts tax due on its New Mexico receipts, and penalty was properly imposed pursuant to Section 7-1-69(A) NMSA 1978.

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

DATED December 20, 2002.