

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

IN THE MATTER OF THE PROTEST OF
BOOKBINDERS OF NEW MEXICO, INC.,
ID. NO. 02-024378-00 2, PROTEST TO
ASSESSMENT NOS. 1884844 and 1937973.

No. 96-17

DECISION AND ORDER

This matter came on for formal hearing on June 5, 1996 before Gerald B. Richardson, Hearing Officer. Bookbinders of New Mexico, Inc. (hereinafter "Taxpayer") was represented by Matthew Urrea, Esq. The Taxation and Revenue Department (hereinafter "Department") was represented by Frank D. Katz, Chief Counsel.

Based upon the evidence and the arguments presented, IT IS DECIDED AND ORDERED as follows:

FINDINGS OF FACT

1. The Taxpayer is a corporation located in Albuquerque, New Mexico which has been wholly owned by Mr. James J. Salazar since 1985.
2. The Taxpayer is engaged in the business of bookbinding and selling custom three ring binders.
3. The Taxpayer's bookbinding business falls into three categories. The first category consists of binding loose pages provided by a customer into a bound book. The second category consists of binding magazines provided by a customer into a bound book. The third category consists of removing an old and worn out binding from a book and replacing it with a new binding.
4. About ninety to ninety-five percent of the Taxpayer's bookbinding work is done

for governmental agencies, such as University libraries, public libraries, the legislative council service, public schools and other state and federal agencies. The Taxpayer's custom three ring binding work is done for private entities.

5. The bookbinding process involves sewing the pages together, creating what is known as a bookblock. The Taxpayer's customers supply either loose pages, magazines or old bookblocks to the Taxpayer for binding into books. End sheets are added to the book block and are glued so as to make a hinge. A spine is then glued to the bookblock and end pages to reinforce the binding. Then a cover is made. The cover consists of binder's board, a heavy paperboard, which is cut to size and a cloth cover is glued onto it. The cover is then glued onto the bookblock and end sheets. Then the title of the book is embossed in gold lettering onto the end of the book.

6. The Taxpayer estimates that on average, the cost of materials it provides for the bookbinding process is approximately \$1.60, which can vary slightly, depending upon the size of the book bound. On average, the Taxpayer charges its customers \$8.60 to bind magazines and loose pages and \$5.85 to rebind old books.

7. After an audit by the Department, the Department issued two assessments to the Taxpayer. Assessment No. 1884844 was mailed to the Taxpayer on June 15, 1995 and assessed \$15,264.62 gross receipts tax, \$190 compensating tax, \$15,962.29 interest and \$1,545.47 penalty for the reporting periods of January, 1988 through December, 1988. Assessment No. 1937973 was also mailed to the Taxpayer on June 15, 1995 and assessed \$42,409.63 gross receipts tax, \$4,830.52 compensating tax, \$4,724.01 penalty and \$35,869.29 interest for the reporting periods of January, 1989 through March, 1994.

8. On July 13, 1995, the Taxpayer filed a written protest to Assessment Nos.

1884844 and 1937973.

9. Prior to 1991 the Taxpayer did not report and pay gross receipts tax upon its receipts from bookbinding for its governmental clients and it did not charge those clients gross receipts tax. This practice was based upon the practice which had been in place since before Mr. Salazar acquired the company in 1985. The Taxpayer did charge, report and pay gross receipts tax upon its other gross receipts from non-governmental clients.

10. The Department's audit determined that gross receipts taxes were owing upon the Taxpayer's receipts from its governmental clients.

DISCUSSION

The primary issue to be determined herein is whether the Taxpayer is liable for gross receipts tax upon its receipts from its governmental customers for whom it bound books. Key to this determination is whether the Taxpayer's activities amount to the performance of a service for the governmental customers or whether the Taxpayer is selling tangible personal property to its governmental customers in the form of a bookbinding. This is because there is a deduction from gross receipts tax, found at Section 7-9-54(A) NMSA 1978, for receipts from selling tangible personal property to the United States, New Mexico, or any governmental unit, subdivision, agency department or instrumentality thereof. There is, however, no corresponding deduction or exemption for receipts from the sale of services to such governmental entities.

The Taxpayer contends that it is selling tangible personal property in the form of the bookbinding¹ to its governmental customers. The Department argues that the Taxpayer is

¹ Since the Taxpayer's customers provide the materials which, when sewn together, constitute the bookblock, the Taxpayer argues that only the bookbinding it manufactures is the tangible personal property which it is selling to governmental entities.

performing bookbinding services to its governmental customers, rendering its receipts from its governmental customers subject to gross receipts tax.

"Service" is defined at Section 7-9-3(K) NMSA 1978² in pertinent part as follows:

"service" means all activities engaged in for other persons for a consideration, which activities involve *predominantly* the performance of a service as distinguished from selling or leasing property. "Service" includes activities performed by a person for its members or shareholders. In determining what is a service, the intended use, principal objective or ultimate objective of the contracting parties shall not be controlling. (emphasis added).

This definition was adopted by the 1976 legislature in order to modify the body of caselaw which had developed prior to the enactment of the 1976 amendments. *EG&G, Inc. v. Director, Revenue Division*, 94 N.M. 143, 607 P.2d 1161 (Ct. App.), *cert. denied*, 94 N.M. 628, 614 P.2d 545 (1979). This definition requires that rather than focusing on the end product's value to the purchaser, the focus is on the nature of the seller's activity, requiring an inquiry into the seller's relative investment of skills and materials to determine which predominates, the services or the tangibles. *Id.* at 146. In this case, that inquiry leads to the conclusion that the Taxpayer is performing a service rather than selling bookbindings. Comparing the relative values of the materials to the amount charged its customers, the materials represent only approximately one quarter to one fifth of the total amount charged. This indicates that the materials are incidental to the service being provided.

In this regard, the Taxpayer argues that since it charges more to bind larger books than smaller ones, this is indicative of the fact that it is selling a tangible, since more materials are used

² The definition of "service" has remained unchanged during all periods pertinent to the assessments at issue, so

to bind larger books but the relative amount of labor remains the same. This argument might be persuasive in an instance where the relative values of the of materials and the labor are very close. That is not the case in this matter, however, where the value of the labor is almost four or five times that of the materials involved and the value of the labor clearly predominates.

The Department's regulation GR 47:3 (example 3) is instructive with respect to the facts of this case and supports the Department's position that the Taxpayer is predominately performing a service. The Department's regulations are presumed to be a proper implementation of the provisions of the laws that are charged to the Department to apply. Section 9-11-6.2(G) NMSA 1978 (1995 Supp.). The regulation provides in pertinent part:

When a taxpayer uses tangible personal property in the performance of an activity which is predominately the sale of a service, the taxpayer must compute the tax liability based on total receipts. Such receipts include the charge for the performance of the service plus any other amounts such as the charge for material used in the performance of the service. Where separate billing of material and labor is the trade practice, and the taxpayer bills separately, the taxpayer may give a nontaxable transaction certificate (NTTC) for the purchases of the material.

Example 3: X, a dry cleaner, mends clothing that is brought to X for cleaning. X uses thread, material and buttons to mend the clothing. X maintains that they are selling these products. X does not sell thread, buttons or material: rather X is engaged in performing a service and uses the materials in the performance of the service. Therefore, the sale of these products to X is not a sale for resale.

Although this regulation is directed at determining whether the deduction from gross receipts for selling tangible personal property for resale pursuant to Section 7-9-47 is available to a seller of tangible personal property who receives a nontaxable transaction certificate from the purchaser, it remains instructive on the issue of whether the purchaser is reselling a tangible or is using a

no particular supplement of pamphlet of the statutes is included in the statutory citation.

tangible in the performance of a service.

Because the facts of this case indicate that the Taxpayer is predominately performing a service for its governmental customers and there is no deduction available in such a case, the Taxpayer's receipts from performing bookbinding services are subject to gross receipts tax and the Department's assessments with respect to that issue are proper.

A secondary issue remains. The Taxpayer contends that both assessments, to the extent that they assess taxes beyond the normal three year statute of limitations found at Section 7-1-18(A) NMSA 1978 should be abated. Although Section 7-1-18(A) does limit assessment of taxes to three years from the end of the calendar year in which payment of the tax was due, it recognizes certain exceptions to this limitation on the assessment of tax. Specifically, Subsection D of Section 7-1-18 provides as follows:

If a taxpayer in a return understates by more than twenty-five percent of the amount of his liability for any tax for the period to which the return relates, appropriate assessments may be made by the department at any time within six years from the end of the calendar year in which payment was due.

The Taxpayer argues that Section 7-1-18 is modelled on Section 6501(e) of the Internal Revenue Code which also provides for a six year limitation on assessment of tax when there has been an understatement in excess of twenty-five percent of a taxpayers gross income. The Taxpayer argues that "understatement" has been interpreted under this section to not include situations where the Internal Revenue Service could determine that a tax liability was understated by an examination of the taxpayer's return because the basis for the tax calculation was disclosed on the face of the taxpayer's return. The Taxpayer argues that Section 7-1-18(D) should be interpreted similarly and that this would prohibit the assessment of tax beyond the three year

limitation of Section 7-1-18(A) because the Taxpayer's returns disclosed its total receipts but then claimed a deduction for its receipts from its governmental customers.

I have not examined the authority interpreting IRC Section 6501(e), but I would note a significant difference in the wording of the state and federal provisions. While the federal provision refers to the omission from gross income of amounts in excess of twenty-five percent of gross income, Subsection D makes no reference to the underreporting of gross receipts. Rather, it refers to the understatement by more than twenty-five percent of the amount of a taxpayer's *liability*. In this case, while the Taxpayer reported the full amount of its gross receipts prior to claiming the deduction for the sale of tangible personal property to governmental entities, nonetheless, the Taxpayer's returns still underreported the Taxpayer's gross receipts tax liability by more than twenty-five percent. Thus, I find that the Department's assessments were authorized by Section 7-1-18(D).

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest, pursuant to Section 7-1-24 NMSA 1978 to Assessment Nos. 1884844 and 1937973 and jurisdiction lies over both the parties and the subject matter of the Taxpayer's protest.

2. The Taxpayer activities in binding books for governmental entities involved predominately the performance of a service rather than the sale of tangible personal property and thus the Taxpayer was not entitled to claim the deduction found at Section 7-9-54 NMSA 1978 for its receipts from its governmental customers.

3. Assessment Nos. 1884844 and 1937973 assess taxes within the limitations of Section 7-1-18(D) NMSA 1978 and are therefore proper assessments of tax.

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

DONE, this 3rd day of July, 1996.