

**BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT**

IN THE MATTER OF **McCLINTOCK PAPER, INC.**

Docket No. 96-09-06

Tax I.D. No. 01-793209-00 2

NO. 96-28

Assessment No. 1972612

DECISION AND ORDER

This matter came on for hearing on November 12, 1996 before Ellen Pinnes, Hearing Officer. McClintock Paper, Inc. ("the Taxpayer") was represented by Gregory DuBrock, CPA. Jim McClintock, owner of McClintock Paper, also appeared at the hearing and testified on behalf of the Taxpayer. The Taxation and Revenue Department ("the Department") was represented by Gail MacQuesten, Special Assistant Attorney General. The parties submitted their closing statements to the hearing officer in writing on November 19, 1996, and the hearing proceedings concluded at that time.

Based upon the evidence and arguments presented, IT IS HEREBY DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. Assessment No. 1972612 was issued to the Taxpayer on October 23, 1995, for \$13,983.28 in gross receipts taxes due for January 1992 through April 1995. Interest and penalties were added to the principal amount.

2. The Taxpayer filed a timely protest of the assessment by a letter from its representative dated November 3, 1995.

3. The Taxpayer, a corporation, is in the business of selling paper products. Most of its business consists of sales at wholesale to businesses and government agencies.

4. The Taxpayer has a continuing customer base, with many repeat transactions to

existing customers.

5. The Taxpayer makes approximately 100 sales in a typical business day.

6. The Taxpayer's transactions typically do not vary significantly based on the time of day at which they occur.

7. In 1995, the Department performed an audit of the Taxpayer for the period from January 1992 through April 1995. This audit was performed through a review of the Taxpayer's records.

8. The audit did not review all transactions that occurred during the audit period of three years and four months. Instead, because of the large number of transactions that had taken place during that time, the Department reviewed a sample of transactions from the period.

9. The sample consisted of certain transactions occurring in three months in each full calendar year, with those months being the high, low, and average business months for each year. For 1995, in which only four months were included in the audit period, the Department reviewed only one month, the average month.

10. For each month selected, the Department reviewed transactions occurring on two days in the month -- the fifth and fifteenth working days of each month. These days were deemed to be representative of the Taxpayer's business so as to allow the Department to extrapolate the results for these days to the Taxpayer's business as a whole. For each such day, the Department reviewed the first ten invoices on which no gross receipts tax on the sale was shown as having been collected by the Taxpayer.

11. The sample was selected according to the audit manual regularly used by the Department's auditors and according to standard Department practice.

12. The sample selected by the Department was not "statistically valid", in the sense that the margin of error applicable to the sample could be mathematically determined.

13. The sample used by the Department was selected based on the auditor's judgment

that it would provide an accurate representation of the Taxpayer's business.

14. The population of transactions from which the sample was selected was fairly homogeneous in that transactions did not vary greatly among themselves in terms of the size of the transaction, customer base involved, and types of items sold.

15. The sample has not been shown not to be representative of the Taxpayer's business.

16. In response to the Taxpayer's challenge to the validity of the sample, the Department offered to select a different sample and recalculate the error rate based on the new sample. The Taxpayer rejected this offer.

17. The Department also offered to consider the results of a self-audit performed by the Taxpayer on a sample of the latter's choosing, if the Taxpayer chose to do one. The Taxpayer declined to perform its own audit, arguing that it was the job of the Department, not the Taxpayer, to do the auditing work.

18. The Taxpayer was advised by the Department that, by statute, the Department's assessment is considered to be correct, and that the Taxpayer had the burden of showing that it was incorrect.

19. The Department's use of a "judgmental", or non-statistically valid, sample is consistent with the practice of tax departments in other states.

20. The Department's auditors determined, as to each invoice reviewed, whether receipts from the sale were properly deductible from gross receipts for gross receipts tax purposes. If the deduction was proper, no error was found. If the deduction was determined to be improper, an error was considered to have occurred.

21. Based on the findings from the audit sample, an error rate was calculated for each year in the audit period. That error rate was then applied to the full year in order to determine the amount of the assessment.

22. Of the ten months selected for review, no errors ultimately were found in four. This

included one of the three months selected in 1992, two of the three months selected in 1994, and the one month selected in 1995.

23. In the six months in which errors were identified, such errors were found in one to three invoices each month out of the twenty transactions reviewed for that month.

24. The Department removed one large transaction from the sample, for purposes of computing the error rate, because it was unusually large and therefore was considered not representative. Unpaid taxes were assessed on this sale, but it was not included in the calculation of the error rate that was applied to the full year's sales.

25. Another unusually large transaction included in the review was found not to be in error but was retained in the sample for purposes of calculating the error rate. This had the effect of reducing the overall error rate for that year, to the Taxpayer's benefit.

26. The Department disallowed deductions for sales of certain items because the Taxpayer did not have a non-taxable transaction certificate (NTTC) from the purchaser or because the transactions did not constitute sales of tangible personal property for resale. For example, deductions for sales of guest checks, garbage can liners, pan liners, and filter cones were deemed to be improper because these items typically are used by the purchaser rather than being resold as part of the product sold to the ultimate customer.

27. Following completion of the audit, the Department adjusted the error rates downward based on additional information provided by the Taxpayer which showed that it in fact had an NTTC covering the sale or that certain transactions initially deemed to be in error were in fact legitimate deductions.

28. The Taxpayer conceded that it was not entitled to deductions for sales of such items as guest checks and filter cones, but contends that some of the items disallowed are in fact resold by its customers as part of the food products sold by those customers. For example, the Taxpayer stated that garbage can liners are often used to package food for sale, and that pan liners may be used

for such purposes as wrapping tamales.

29. Although the Taxpayer presented testimony that items such as garbage can liners, pan liners and trays can be and often are used to package food for resale, it did not show that the items were so used by the purchasers in the disallowed transactions.

30. Discussions between the Taxpayer and its customers regarding the use of items purchased from the Taxpayer and whether such items are deductible from gross receipts take place between the customers and the Taxpayer's salespeople. The Taxpayer has a staff of approximately four salespeople at any given time.

31. The Taxpayer does not train its salespeople regarding the proper use of non-taxable transaction certificates. Before making a sale, the salespeople check to see whether the customer has an NTTC on file with the Taxpayer. However, they are not trained to inquire as to whether specific items purchased fall within the deduction authorized by the NTTC.

32. The Taxpayer did not maintain records, in the form of notations on the NTTCs or otherwise, on how buyers intended to use items now claimed to be deductible from gross receipts.

33. If a customer purchased both deductible and non-deductible items, the Taxpayer's practice was not to charge tax on the latter, out of concern that it would lose the sale to a competitor if it did so.

DISCUSSION

The Taxpayer challenges the assessment on two grounds: first, that the sample used by the Department's auditors to compute the assessment was invalid, and second, that some of the deductions disallowed in specific transactions included in the sample should have been allowed. *Validity of the sample used to determine the error rate and calculate the assessment*

The Department's audit of the Taxpayer covered a period of three years and four months. Because of the large number of transactions that took place during that period,¹ the Department's

¹ In a typical business day, the Taxpayer makes approximately 100 sales. On an annual basis,

auditors selected a sample for review rather than performing a detailed audit of all transactions. The deductions claimed for the reviewed transactions were determined to be either proper or improper. An error rate was computed on the basis of these findings. The error rate calculated for each year was then applied to the full year to determine the amount of tax underpaid by the Taxpayer.

The Taxpayer does not argue with use of a sample rather than a detailed audit of all transactions during the audit period. However, the Taxpayer challenges the sample used by the Department on the grounds that it is not statistically valid. The Taxpayer argues that the Department cannot use the results of such a sample to extrapolate to a full year's receipts.

The Taxpayer has cited no authority that requires the Department to use a "statistically valid" sample for the purpose of calculating and assessing underpaid taxes. The issue is not whether the sample used was statistically valid, but whether it was representative of the universe being sampled, so that its results could be extrapolated to the universe as a whole. The Taxpayer has not shown that the sample was unrepresentative or that its use resulted in an incorrect assessment.

The fact that another method might have been used does not render the Department's method invalid. The issue is not whether there is a different, or even better, method, but whether the Department's assessment is incorrect. By law, that assessment is presumed to be correct and the taxpayer has the burden of showing that it is otherwise. §7-1-17(C) NMSA 1978; TRD Regulation TA 17:4.

The Taxpayer here chose to ignore both the presumption of correctness and its burden to overcome that presumption. McClintock Paper was given repeated opportunities to present evidence to show that the Department's assessment was incorrect. In response to the Taxpayer's contentions that the sample was inadequate, the Department offered to perform a second audit based on a different sample, and to consider the results of any self-audit performed by the Taxpayer. The Taxpayer rejected the offer of a second audit and declined to perform its own audit. While a

this is some 25,000 transactions.

re-audit by the Department might have suffered from the same alleged deficiencies that the Taxpayer objected to in the initial review, any self-audit by the Taxpayer could have been structured to eliminate those objections. The Taxpayer refused to perform such an audit because it believed that the Department, not the Taxpayer, should do the work. This misconstrues the applicable law. It is the Taxpayer, not the Department, that is charged by law with showing the inaccuracy of the assessment.

Even at the hearing, the Taxpayer made no real attempt to show the incorrectness of the assessment. It repeatedly argued that the sample was not statistically valid, but offered no authority or evidence to show that it provided an inadequate basis for the assessment. General allegations of lack of statistical validity are insufficient to sustain the burden of proving the assessment to be incorrect.

In performing its audit, the Department selected a sample that it believed would be representative of the Taxpayer's business. It selected two working days in each month reviewed, precisely because they were considered to be like any other working day in the Taxpayer's business. The Taxpayer did not argue that these days were in any way unrepresentative of its business operations. The Department reviewed the first ten invoices each day on which no tax was charged; the Taxpayer conceded that its transactions did not vary according to the time of day, so that the first ten in any day were presumably representative of the full day's business. The Taxpayer made no showing that any of the transactions included in the sample was unusual or should have been excluded from the sample.

The issue is not whether a different sample might have been used, but whether the sample used by the Department was unrepresentative of the Taxpayer's business, so that the results generated from that sample were inadequate to support the assessment. While the Taxpayer has asserted that the sample was inappropriate, it has not shown the sample to be unrepresentative or otherwise demonstrated that the audit results were inaccurate.

Specific transactions

Within the sample reviewed in the Department's audit, certain transactions were found to be in error on the basis that either the Taxpayer had no NTTC to support the claimed deduction, or the product sold did not qualify for the deduction because it was not an item sold for resale by the purchaser. The items included in the latter category included guest checks, pan liners, garbage can liner bags, filter cones, trays and towels. The Taxpayer does not challenge the findings based on lack of an NTTC, but it contends that some of the disallowances in the second category were improper.²

The Gross Receipts and Compensating Tax Act provides that receipts from selling tangible personal property are deductible from gross receipts if the purchaser resells the property either by itself or in combination with other tangible personal property. §7-9-47 NMSA 1978. Nonreturnable containers which are used to package property and which become part of the product are considered property sold for resale, and receipts from sales of such items are deductible for gross receipts tax purposes. TRD Regulation GR 47:2(A). A separate regulation specifically pertaining to restaurants reiterates that materials used by restaurants and food sellers to package or wrap food for sale are deductible sales within this statutory section. Regulation GR 47:24. That regulation also enumerates certain items that are not considered items sold for resale, because they are not resold by the buyer. That list includes, *inter alia*, garbage can liners and paper towels. *Id.*

The Taxpayer argued that some of the disputed items, including can liners, pan liners, and trays, can be and are used by its customers to package foods for resale, and thus qualify for the deduction provided by §7-9-47, notwithstanding their enumeration as non-deductible items in Regulation GR 47:24. The Taxpayer is correct that receipts from sales of these items are deductible if they are in fact resold by the purchaser, even if such use is not the one for which the item may have

² As the Taxpayer's protest letter acknowledges, the majority of the assessment resulted from lack of NTTCs, with a much smaller portion resulting from "wrong category" classifications.

been designed and despite their specification in the regulation as non-deductible. However, the burden was on the Taxpayer to show that the items were in fact resold by the purchaser. This was not done here.

A contention that items such as trays and garbage can liners may be and often are used to package food for sale is not tantamount to a showing that the specific purchases on which the Taxpayer did not pay gross receipts tax were so used. The Taxpayer presented no testimony of specific uses of the items by specific purchasers involved in the disallowed transactions, to show that the errors found in the Department's audit had not occurred.³ The Taxpayer acknowledged that it had no records showing how the items were to be used by the buyers. It acknowledged further that it did not train its salespeople to ascertain the uses of various items purchased by a buyer who had presented an NTTC, to ensure that all items purchased came within the terms of the NTTC. It admitted that, where a buyer purchased both deductible and non-deductible items, it would not charge tax even on the clearly non-deductible items, for fear of antagonizing the buyer and losing the sale.

No testimony, either oral or in the form of affidavits, was presented from any of the Taxpayer's salespeople, who participated directly in the sales and who might have had greater direct knowledge of the uses to which the items purchased were put. Moreover, the Taxpayer did not supplement the knowledge of its own staff by calling any of its customers as witnesses to testify to their use of the items purchased from McClintock Paper, or by presenting affidavits from them to that effect.

³ The Department made a number of adjustments to the original audit findings before the assessment was issued. Compare Ex. 3, an earlier work paper of disallowed deductions, with Ex. H and p. C3.4 of Ex. 2, listing the errors on which the assessment was ultimately based. Certain transactions involving sales of pan liners and can liner bags, originally disallowed as products not subject to the deduction, were subsequently allowed by the Department, presumably because the Taxpayer presented evidence that the items were used by those purchasers to package items and were resold by the purchasers.

A taxpayer who accepts an NTTC continues to be responsible for ensuring that goods sold under the certificate are properly deductible within the certificate's terms. Regulation GR 43:9. The Taxpayer here was responsible for confirming that the items on which tax was not charged, by virtue of the NTTC submitted by the purchaser, were in fact deductible under the certificate. Where items are of a type that is normally subject to tax, such as garbage can liners that would ordinarily be used for a non-deductible purpose, the Taxpayer was obligated to determine that the buyer intended to use them for a deductible purpose. This the Taxpayer did not do.

Penalties and interest

Interest and penalties were imposed by the Department on the amount assessed against the Taxpayer for unpaid tax. Penalties may be imposed where failure to pay the tax results from negligence or disregard of rules and regulations. §7-1-69(A) NMSA 1978. The Taxpayer did not raise a specific objection to the penalty imposed by the Department. In any event, the evidence established that the Taxpayer acted negligently within the meaning of this section, by failing to ascertain whether items sold under the protection of an NTTC were in fact items sold for resale by the purchaser. In addition, the Taxpayer acted with disregard for applicable rules and regulations, as it admitted when it acknowledged that it would not charge the tax to a buyer purchasing both taxable and non-taxable items. Penalties were thus properly added to the amount of the assessment.

Section 7-1-67 NMSA 1978 provides that interest "shall be" paid on tax deficiencies, at the rate of fifteen percent per year. Pursuant to well settled rules of statutory construction, the word "shall" is mandatory rather than discretionary, unless a contrary legislative intent is clearly demonstrated. State v. Lujan, 90 N.M. 103, 560 P.2d 167 (1977). Section 7-1-67 requires that interest be imposed on the amount of any unpaid taxes. No exceptions to this rule are provided for. Thus, interest on the amount of the tax deficiency was properly included in the assessment.

CONCLUSIONS OF LAW

1. By its representative's letter of November 3, 1995, the Taxpayer filed a timely protest

of Assessment No. 1972612. Jurisdiction thus lies over the parties and the subject matter of this protest.

2. The Taxpayer improperly deducted certain receipts from gross receipts and failed to pay applicable gross receipts tax thereon, and the Department's assessment for such unpaid tax (as adjusted pursuant to agreement reached with the Taxpayer in the course of the hearing proceedings) is proper.

3. The Taxpayer failed to establish that the assessment was incorrect.

4. Because the Taxpayer did not pay the taxes owed at the time they were due, interest was properly imposed on the deficiency at the statutory rate.

5. The Taxpayer's failure to pay the taxes was due to negligence and/or disregard of applicable rules and regulations, and penalties were properly imposed on the unpaid amounts.

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

DONE this 16th day of December, 1996.