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

IN THE MATTER OF THE PROTEST OF
SYBASE, INC.
ID. NO. 02-235041-00 1 NO. 98-06
PROTEST TO ASSESSMENT NO. 2052732

DECISION AND ORDER

THIS MATTER came on for formal hearing before Gerald B. Richardson, Hearing Officer, on January 16, 1998. Sybase, Inc., hereinafter, "Taxpayer", was represented by Ms. Kathy Kobayashi, Tax Manager for the Taxpayer. The Taxation and Revenue Department, hereinafter, "Department", was represented by Bruce J. Fort, Special Assistant Attorney General. Based upon the evidence and the arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The Taxpayer is a Delaware corporation with its headquarters located in Emeryville, California.

2. In approximately March of 1994, the Taxpayer entered into a software licensing agreement with Presbyterian Healthcare Services of Albuquerque, New Mexico. Under the terms of this agreement, the Taxpayer grants a perpetual, non-exclusive, non-transferable, fully paid license to use the Taxpayer's software at its business site. The agreement also provides that the software remains the exclusive property of the Taxpayer.

3. On March 30, 1994, the Taxpayer invoiced Presbyterian Healthcare Services a total of $1,953.937.22 for the software license. The invoice broke down the charges as $1,639,595 for the site license, $122,969 for software updates, $85,000 for support and technical services for a year, $3,700 for shipping and $102,673.22 for New Mexico gross receipts taxes.

4. After receiving the invoice, Presbyterian Healthcare Services contacted the Taxpayer's sales office, which handled the transaction, and disputed that the transaction was subject to New Mexico gross receipts tax. Presbyterian Healthcare Services provided the Taxpayer with a Type 9 nontaxable transaction certificate in support of their contention that the transaction should not be subject to New Mexico gross receipts tax.

5. As a result of the discussions between the Taxpayer's sales office and Presbyterian Healthcare Services, and the acceptance by the Taxpayer of the nontaxable transaction certificate from Presbyterian Healthcare Services, the Taxpayer's sales office issued a credit memo with respect to the invoice to Presbyterian Healthcare Services for the gross receipts tax invoiced and the Taxpayer claimed a deduction from gross receipts tax upon its receipts from its software licensing agreement with Presbyterian Healthcare Services when it filed its monthly tax report with the Department.

6. The nontaxable transaction certificates issued by the Department have information on the back with respect to the types of certificates and the transactions to which they apply. With regard to Type 9 certificates, the certificate states as follows:

> **TYPE 9** certificates may be executed by **GOVERNMENTAL AGENCIES** and **501(c)(3) ORGANIZATIONS** for the purchase of **TANGIBLE PERSONAL PROPERTY ONLY.** These certificates may not be used for the purchase of services or for the lease of property. (emphasis and capitalization in original.)

7. The Taxpayer did not consult with the Department to determine whether it considered the sale of software pursuant to a software licensing agreement the sale of tangible personal property or the sale of a license.

8. Subsequent to the transaction with Presbyterian Healthcare Services, the Taxpayer was audited by the Department. The only audit exception picked up by the Department's auditors was the sale of the software license to Presbyterian Healthcare Services for which the Taxpayer had claimed a deduction from tax.

9. As a result of the Department's audit, on July 25, 1996 the Department mailed Assessment No. 2052732 to the Taxpayer, assessing $108,897.88 in gross receipts tax, $10,889.79 in penalty, and $36,753.03 in interest.

10. On August 23, 1996, the Taxpayer made a written request for a sixty day extension of time in which to file a protest to Assessment No. 2052732.

11. The Department granted the Taxpayer's request for an extension of time, and granted the Taxpayer until October 23, 1996 to file its protest.

12. On October 20, 1996, the Taxpayer filed a written protest to the penalty portion only of Assessment No. 2052732 and paid the remaining portion of the assessment.

DISCUSSION

The sole issue to be determined herein is whether the Department properly assessed the Taxpayer penalty based upon its claim of an improper[1] deduction in calculating the amount of gross receipts tax it paid to the Department.

[1] Because the Taxpayer chose not to dispute the amount of gross receipts tax assessed upon the transaction at issue, it is proper to conclude that the Taxpayer has agreed that the transaction did not qualify for the deduction claimed pursuant to Section 7-9-54 NMSA 1978 for the sale of tangible personal property to a 501(C)(3) organization.

The imposition of penalty is governed by the provisions of NMSA 1978, Section 7-1-69(A)(1995 Repl. Pamp.), which imposes a penalty of two percent per month, up to a maximum of ten percent:

> In the case of failure, due to negligence or disregard of rules and regulations, but without intent to defraud, to pay when due any amount of tax required to be paid or to file by the date required a return regardless of whether any tax is due,....

This statute imposes penalty based upon negligence (as opposed to fraud) for failure to timely pay tax. Thus, there is no contention that the failure to report and pay taxes was based upon any conscious attempt by the Taxpayer to underreport taxes. What remains to be determined is whether the Taxpayer was negligent in failing to report its taxes properly. Taxpayer "negligence" for purposes of assessing penalty is defined in Regulation 3 NMAC 1.11.10 (formerly TA 69:3) 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.

The Taxpayer argues that it was not negligent in claiming the erroneous deduction at issue and posits several grounds in support of its argument. First, the Taxpayer argues that other than the transaction at issue, it has had an excellent record of compliance with the tax laws of New Mexico, the transaction at issue being its first and only instance of failure to comply with the tax laws. Second, the Taxpayer argues it exercised ordinary business care with respect to its handling of this transaction. This is especially so because the law is confusing with regards to whether selling packaged software is the sale of tangible personal property or the sale of a license to use property, and the availability of the deduction claimed in this case turns upon the nature of what the Taxpayer sold its customer. Finally, the Taxpayer argues that it was not negligent because it relied upon advice of legal counsel, in this case, an employee of Presbyterian Healthcare Services. These arguments will be addressed individually, below.

With respect to the first argument, I have found no statutory language or case law which supports the theory that taxpayers get one "free bite of the apple", in the form of one opportunity to incorrectly report taxes. At most, it may be indicative that a taxpayer exercises ordinary business care, when viewed with the totality of circumstances surrounding a transaction, including the procedures a taxpayer may have in place to ensure proper reporting and payment of taxes.

In addition to there being no statutory or case law support for this argument, the argument overlooks the purpose behind the enactment of a penalty provision for negligent failure to properly report taxes. There are sound policy reasons for the legislature to have provided for the imposition of penalty. A self-reporting tax system relies upon taxpayers accurately reporting their tax liabilities to the government. There are insufficient government resources to audit every taxpayer periodically to otherwise assure tax compliance. The imposition of penalty provides taxpayers with an incentive to understand the tax consequences of their actions and to implement procedures to assure that taxes are accurately reported. Otherwise, if the only consequence of an audit and determination of underpayment of tax was the payment of the tax which was owed, it would always advantage a taxpayer who underreports taxes, whether due to a failure to understand the law or due to failure to have sufficient procedures in place to assure the proper payment of taxes, to regard its obligation to properly report and pay taxes casually, and to simply pay the taxes if the underreporting is discovered upon audit.

The Taxpayer argues that it was not negligent because it exercised the degree of ordinary business care and prudence a reasonable taxpayer would exercise under like circumstances. One of the circumstances the Taxpayer believes is significant with respect to this argument is that it was selling packaged software and whether such a sale is treated as a sale of tangible personal property or as the sale of a license is a complicated legal issue which affected the determination of taxability with respect to the transaction at issue.

While the Department agreed that the characterization of what was being sold may be considered a confusing or difficult issue, it argues that the Taxpayer had the obligation to investigate these legal issues and to investigate how the Department treats such transactions prior to claiming the deduction at issue. The Taxpayer response to the Department's position is that as a taxpayer doing business in many different states with different tax statutes and requirements, it would be unreasonable to expect the Taxpayer to know how each state would characterize the product it sells in order to assure compliance with the tax laws of the various taxing jurisdictions.

Although the issue of whether the sale of pre-packaged software programs are the sale of a tangible or the sale of a license may be the subject of disparate treatment among taxing jurisdictions, New Mexico provides rather clear guidance on this issue through its regulations, which have been in effect since 1991. Regulation 3(F):64 provided as follows:

> When a computer company sells a pre-packaged software program where:
> 1) no extraordinary services are performed in order to furnish the program;
> 2) the buyer pays a fixed amount for the software package and the license to use the software; and
> 3) the buyer is allowed to resell the license to use the program with the software package itself;
>
> such a transaction constitutes a sale of tangible personal property. Sale of such property for resale is subject to the deduction provided in Section 7-9-47.

This regulation sets out three conditions to be met for the sale of software to be the sale of tangible personal property. The terms of the agreement at issue herein, titled a "software license agreement" characterize the license as nontransferable. Specifically, paragraph 2.2 of the agreement provides that:

> The Program and all copies (in whole or part) shall remain the exclusive property of Sybase and its licensors and may not be used except as expressly authorized by this Agreement. Customer shall not modify, reverse engineer, reverse assemble or reverse compile any Program or part thereof, except Customer may modify date file portions of the program as described in the user manuals. Customer shall not Use the Program in a service bureau or time sharing arrangement nor distribute, rent, lease or transfer the Program to any third party. (capitalization in original).

The agreement clearly prohibits the resale of the license to use the program, thereby contravening one of the listed requirements for the sale to be considered the sale of a tangible.

The Department had another regulation which largely mirrored the above regulation which was also in effect at the time of the transaction at issue. Regulation GR 3(I):5 provided as follows:

> The definition of property includes licenses. The sale of a license to use software constitutes a sale of property and comes within the definition of gross receipts.
>
> The transaction constitutes a sale of a license to use the software program when a computer software company sells an already developed software program where:
>
> 1) no extraordinary services are performed in order to furnish the program,
> 2) the buyer pays a fixed amount for the license to use the program and use is generally limited to a specific computer, and
> 3) the buyer may not resell to any other person a license to use the program and may not transfer the software package itself to any other person.

Application of this regulation to the transaction at issue would also result in the conclusion that the Taxpayer was selling a license to use a software program, which, although constituting the sale of property for gross receipts tax purposes, is different than the sale of tangible personal property.

With these regulations in place, had the Taxpayer consulted the Department's regulations, it could have readily determined that its receipts from Presbyterian Healthcare Services did not meet the requirements for the use of a Type 9 nontaxable transaction certificate, which are explicitly stated on the back of the certificate, which provides:

> **TYPE 9** certificates may be executed by **GOVERNMENTAL AGENCIES and 501(c)(3) ORGANIZATIONS** for the purchase of **TANGIBLE PERSONAL PROPERTY ONLY.** These certificates may not be used for the purchase of services or for the lease of property. (emphasis and capitalization in original).

It should have also been obvious to the Taxpayer that a portion of the sale was not the sale of any type of property, tangible or intangible. The invoice broke down the components of the sale, and one of the line items was $85,000 for "alliance support contacts". The invoice further stated that the "software support period" was March 29, 1994 to March 28, 1995. Paragraph 3.2 of the software license agreement requires that the customer purchase technical support for the first year for all licenses and paragraph 5 characterizes technical support as "support and technical services". Thus, the Taxpayer was clearly selling services to Presbyterian Healthcare Services in addition to the software. This should have further alerted the Taxpayer to the inapplicability of the Type 9 nontaxable transaction certificate to the sale at issue. With such obvious discrepancies between the nontaxable certificate tendered and the type of transaction involved, a person exercising ordinary business care should not have accepted the certificate to shield the transaction from the application of tax.

This leads us to the Taxpayer's argument that it is unreasonable to expect a taxpayer engaging in business in many states to know and understand the tax laws of every taxing jurisdiction. While I do not purport to know how other taxing jurisdictions address this issue, the law in New Mexico with respect to taxpayers doing business in New Mexico is well established. New Mexico has a self-reporting tax system which requires that taxpayers voluntarily report and pay their tax liabilities to the state. Because of this, the case law is well settled that every person is charged with the reasonable duty to ascertain the possible tax consequences of his actions, and the failure to do so has been held to amount to negligence for purposes of the imposition of penalty pursuant to Section 7-1-69 NMSA 1978. ***Tiffany Construction Co. v. Bureau of Revenue***, 90 NM 16, 558 P.2d 1155 (Ct. App. 1976), *cert. denied*, 90 N.M. 255, 561 P.2d 1348 (1977). It is also noteworthy that the transaction at issue was not a small and insignificant transaction. This was a $2 million sale. Considering the significant tax consequences attaching to a transaction of this size, it does not seem unreasonable to require that taxpayers be diligent in ascertaining how such a transaction is taxed.

This leads us to the third defense raised by the Taxpayer. The Department recognizes that it is an indication that a taxpayer has not been negligent for purposes of the imposition of penalty where they have made a sufficient effort to determine tax consequences, even if it should later be determined that the answer given was wrong. Thus, Department Regulation TA 69:4 provides as example four, that lack of negligence is indicated where:

> the taxpayer proves 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 this provision applies to them because Presbyterian Healthcare Services' Vice-President of Legal Services, Mr. Gene Walton, is an attorney, and the Taxpayer alleged that he was aware of the transaction at issue.

There are several problems with this argument. In the first place, there was a failure of proof on this issue because the Taxpayer's representative at the hearing, Ms. Kobayashi, testified that the determination of taxability with respect to the transaction at issue was made by the people in the Taxpayer's sales office, rather than its tax office, and Ms. Kobayashi could provide no details of any discussions between the sales office and representatives of Presbyterian. Not only could no details be provided, there was no evidence that Mr. Walton was even brought into any discussions about this transaction until after the Department's audit. Additionally, although not explicitly stated in the regulation, I believe it is implicit in the regulations that to avail oneself of the protection of the regulation, the attorney or accountant consulted must be the taxpayer's attorney or accountant. This is because only one's own accountant or attorney would have a professional responsibility to his or her client to provide competent advice on the issue. Obviously, there would be no attorney-client relationship between Mr. Walton and the Taxpayer. In fact, because Mr. Walton's professional responsibility would be to his own client, Presbyterian, he would be in a potential conflict of interest in offering legal advice to the Taxpayer under the circumstances in this case because of the conflict of interest between Presbyterian's interest in the economic benefit of a lower purchase price if it did not include gross receipts tax and the Taxpayer's own interest in paying the correct amount of tax. Because there was no evidence that the Taxpayer made the determination that the transaction at issue was not taxable based upon consultation with their own tax professional, nor did they prove that professional tax advice was actually received with respect to this transaction prior to their determination that the transaction was not subject to tax, the Taxpayer has failed to establish reliance on a tax professional as a basis for disputing the assessment of penalty.

Looking at the totality of the circumstances surrounding the transaction at issue, there is ample evidence of taxpayer negligence. The Taxpayer sells and services one product, computer software. It is not unreasonable to expect that a taxpayer engaging in a type of business know and understand how that business is taxed in the jurisdictions in which it does business. Although the Taxpayer argues that the characterization of what it is selling is a complicated and confusing legal issue, the Taxpayer took no steps to resolve its confusion when its customer requested to make its purchase tax free. The Taxpayer did not consult the Department's regulations, nor did it consult the Department, itself. Even the manner in which it handled the determination of taxability internally raises questions as to the sufficiency of its procedures with respect to resolving the issue of taxability. Apparently, the determination was made by personnel in the Taxpayer's sales office. The Taxpayer does have a tax office, presumably staffed with personnel with more expertise in knowing and applying the tax laws of the jurisdictions in which it engages in business. Those people were not consulted, however, prior to determining not to charge tax on the transaction at issue. Instead, a certificate which, on its face would not apply to at least a portion of the transaction at issue, was accepted as evidence that tax need not be charged or remitted on the transaction. This amounts to the type of inadvertent error caused by inattention or erroneous belief because of the Taxpayer's own failure to investigate and understand how the Department imposes tax on the product and services it sells which amounts to negligence for purposes of imposition of penalty.

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest to assessment No. 2052732 and jurisdiction lies over both the parties and the subject matter of this protest.

2. The Taxpayer was negligent in failing to pay gross receipts tax upon its sale of a license to use software and related support services to Presbyterian Healthcare Services and penalty was properly imposed pursuant to Section 7-1-69 NMSA 1978.

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

DONE, this 29th day of January, 1998.