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

IN THE MATTER OF THE PROTEST OF
CANON DE CARNUE LAND GRANT HEIRS ASS'N 98-09
ID. NO. 01-817079-00 0
ASSESSMENT NO 2141443

DECISION AND ORDER

This matter came on for formal hearing on February 6, 1998 before Margaret B. Alcock, Hearing Officer. The Canon de Carnue Land Grant Heirs Association ("the Associa-tion") was represented by Narciso Garcia, Jr., Esq. The Taxation and Revenue Department ("the Department"), was represented by Gail MacQuesten, Special Assistant Attorney General. Based upon the evidence and the arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. In July 1974, the Canon de Carnue Grant Heirs Association was incorporated as a nonprofit corporation under the laws of the State of New Mexico.

2. Membership in the Association is limited to heirs of the original grantees of the Canon de Carnue Land Grant, located in the east mountain area near Albuquerque, New Mexico.

3. The Association charges an annual membership fee of eight dollars and has approximately 150 members and associate members;

4. The objectives and purposes of the Association, as stated in its articles of incorporation, include encouraging a closer personal acquaintance and a friendly spirit of mutual cooperation among members; promoting the general welfare and prosperity of members; protecting

the ecology and beauty existing within the Land Grant boundaries; improving public facilities and safety; and promoting educational, philanthropic, civic improvement and social uplift.

5. Article IX of the Association's bylaws prohibits activities "not permitted to be taken or carried on by an organization/exempt under Section 501(c)(3) of the Internal Revenue Code..."

6. The Association's office in Tijeras, New Mexico, is located in a building the Association leases from the Canon de Carnue Land Grant for one dollar a year.

7. The building includes a small club with an adjoining hall. There is a separate area with a refrigerator, but no cooking facilities.

8. The Association operates a social club at which liquor is sold by the Association to its members. The club is open four nights a week and is a local gathering spot for heirs of the Canon de Carnue Land Grant. The Association holds a liquor license that restricts the Association to serving liquor to members and guests.

9. The Association allows the Land Grant and other community groups to use the hall adjoining the social club. No fee is charged for use of the building, although groups must pay for security if social functions are held late at night and, except for short meetings, must pay for a janitorial service to clean up after the function. Groups usually pay the Association, which passes the payment on to the security and janitorial services.

10. In addition to being used for Land Grant meetings, the Association building is used by a senior citizens meal center for serving daily lunches to senior citizens; by a food cooperative as a drop off and distribution point; by local church parishes for summer fiestas and other benefit functions; and by groups such as acequia associations, the Girl Scouts, the East Mountain Legal

Defense Fund, and the East Mountain Neighborhood Association for meetings and social functions.

11. The Association is planning to set up a scholarship for Land Grant heirs and has collected about $1,200 to $1,500 for this purpose. No scholarship money has yet been awarded.

12. The Association does not conduct any fund raising activities although it occasionally makes small contributions of $50 or $100 to local groups.

13. In March 1975, the Association received a determination letter from the Internal Revenue Service ("IRS") stating that the Association was exempt from federal income tax because it qualified as a social welfare organization under Section 501(c)(4) of the Internal Revenue Code.

14. In 1991, the IRS notified the Association that the IRS had questions concerning the Association's status as a social welfare organization.

15. As a result of this inquiry, the Association submitted an application seeking recognition as a charitable organization under the provisions of Section 501(c)(3) of the Internal Revenue Code. The Association was subsequently notified that it did not qualify as a 501(c)(3) organization.

16. At the suggestion of the IRS, the Association submitted a second application seeking recognition as a social club under Section 501(c)(7). In January 1992, the IRS issued a determination letter stating that the Association was exempt from federal income tax because it qualified as a social club under Section 501(c)(7) of the Internal Revenue Code.

17. Prior to 1991, the Association paid New Mexico gross receipts tax on its receipts from selling liquor to its members.

18. In 1991, the Association's bookkeeper resigned for personal reasons and Pauline Lovato, who has held the office of secretary since 1988 or 1989, hired James Sanchez to help the Association with its bookkeeping and tax reporting.

19. Ms. Lovato located Mr. Sanchez from his advertisement in the yellow pages of the telephone book. Mr. Sanchez held himself out as a bookkeeper/accountant and maintained a business office in Albuquerque.

20. At the time the Association hired Mr. Sanchez, he was still attending classes at the University of Albuquerque to obtain his accounting degree, which was awarded in 1992. Mr. Sanchez became a certified public accountant in 1995.

21. Mr. Sanchez did not have any experience working with nonprofit organizations at the time he was hired by the Association, but it was his understanding that a nonprofit organization qualifying under any provision of Section 501(c) of the Internal Revenue Code did not have to pay gross receipts tax on receipts from sales to its members unless the organization made a profit on those sales.

22. Based on his understanding of the law and his knowledge that the Association originally qualified as a Section 501(c)(4) organization and was later recognized as a Section 501(c)(7) organization, Mr. Sanchez advised Pauline Lovato that the Association did not have to pay gross receipts tax on receipts from sales of liquor to its members.

23. Ms. Lovato worked with Mr. Sanchez on the applications for tax exempt status filed with the IRS in 1991, but did not understand the distinctions among 501(c) organizations.

24. Ms. Lovato found Mr. Sanchez's advice concerning payment of gross receipts tax somewhat confusing, but believed he was knowledgeable in tax matters and relied on his advice.

25. Based on Mr. Sanchez's advice, the Association stopped paying gross receipts tax on its receipts from sales of liquor to its members. The Association continued to pay gross receipts tax on receipts from activities that were open to the general public.

26. In 1993, the Association terminated Mr. Sanchez's services and hired Barela & Associates, Inc.

27. At some point after Mr. Sanchez stopped working for the Association, he became aware that the advice he had given Ms. Lovato concerning receipts from sales of liquor to members was incorrect. Mr. Sanchez did not take any action to notify the Association of his error.

28. At the time the Association replaced Mr. Sanchez, Ms. Lovato met with Celene Barela and showed her copies of the Association's articles of incorporation and bylaws. Ms. Lovato did not have any discussions with Ms. Barela concerning the Association's payment of gross receipts tax.

29. The gross receipts tax returns filed by the Association for subsequent tax periods continued to exclude receipts from sales of liquor to Association members.

30. In 1997, the Department determined that the Association had underreported its gross receipts for the period 1991 forward. On June 5, 1997, the Department issued Assessment No. 2141443 in the amount of $8,1114.76 gross receipts tax, $797.49 penalty and $3,41.35 interest for tax periods June 1991 through March 1997.

31. On June 13, 1997, the Department received the Association's written protest to the assessment.

DISCUSSION

I. Assessment of Gross Receipts Tax.

The first issue to be determined is whether the Association is entitled to the exemption from gross receipts tax provided by Section 7-9-29, NMSA 1978, which states:

> A. Exempted from the gross receipts tax are the receipts of organizations that demonstrate to the department that they have been granted exemption from the federal income tax by the United States commissioner of internal revenue as organizations described in Section 501(c)(3) of the United States Internal Revenue Code of 1954, as amended or renumbered.
>
> ...
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> C. This section does not apply to receipts derived from an unrelated trade or business as defined in Section 513 of the United States Internal Revenue Code of 1954, as amended or renumbered.

The Association argues that it is entitled to claim the exemption in Section 7-9-29 because the Association qualifies as a charitable organization under IRC Section 501(c)(3) and intends to apply to the IRS for retroactive recognition of 501(c)(3) status.

Section 7-9-29 does not provide a deduction for organizations that qualify for tax exempt status under Section 501(c)(3). The exemption is limited to organizations "*that have been granted* exemption from the federal income tax...." (emphasis added). This determination must be made by the IRS, and the exemption from gross receipts tax is contingent on a taxpayer's receipt of a written IRS determination. In this case, the taxpayer has not been granted a federal tax exemption under Section 501(c)(3) for the reporting periods at issue.

At the hearing, Pauline Lovato testified that the Association intends to submit an application for recognition as a charitable organization qualifying for tax exempt status under Section 501(c)(3) and intends to ask that this status be retroactive. Ms. Lovato did not explain why the Association believes it will qualify for 501(c)(3) status now when it was expressly denied such status in 1991. There is no indication that the Association's activities have changed since 1991.

Although the Association allows various outside groups free use of its facilities for meetings and social functions, the primary purpose of the Association as set out in its articles of incorporation is to benefit heirs of the Canon de Carnue Land Grant. The Association's primary activity in carrying out this purpose is the operation of a social club. IRS regulations make it clear that a corporation must be organized *exclusively* for charitable purposes before it will qualify for 501(c)(3) status. As stated in IRS Regulation § 1.501(c)(3)-1(b)(iii):

> an organization that is empowered by its articles..."to engage in the operation of a social club" does not meet the organizational test regardless of the fact that its articles may state that such organization is created "for charitable purposes within the meaning of section 501(c)(3) of the Code."

With regard to the operation of a 501(c)(3) organization, IRS Regulation § 1.501(c)(3)-1(d)(1)(ii) states that an organization is not operated exclusively for exempt purposes unless it serves a public rather than a private interest:

> to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Here, the Association is organized and operated for the benefit of its members. Membership is not open to the general public but is limited to individuals who are heirs of the original grantees of the Canon de Carnue Land Grant. Based on the evidence presented, the IRS's previous determination that the Association qualifies as a social club under Section 501(c)(7) but does not qualify as a charitable organization under Section 501(c)(3) is consistent with IRS statutes and regulations.

Section 7-1-13, NMSA 1978, states that taxpayers are liable for tax at the time of and after the transaction or incident giving rise to tax until payment is made. When the Association sold

liquor to its members during the period June 1991 through March 1997, it had not been granted exemption from federal income tax as an organization described in IRC Section 501(c)(3). The Association has not presented any evidence to support a conclusion that it now qualifies as a 501(c)(3) organization or that the IRS would grant such exempt status retroactive to the period covered by the Department's assessment. The Association is not entitled to claim the exemption provided in Section 7-9-29, NMSA 1978, for reporting periods June 1991 through March 1997.

II Assessment of Penalty.

The second issue to be determined is whether the Association is liable for the ten percent negligence penalty imposed by Section 7-1-69(A), NMSA 1978. The version of Section 7-1-69 in effect during the assessment period imposed 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...

The statute imposes penalty based upon negligence (as opposed to fraud) for failure to timely pay tax. There is no contention that the Association's failure to report and pay gross receipts tax was the result of bad faith or fraud. What remains to be determined is whether the Association 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.

In this case the Association's decision to stop paying gross receipts tax on its receipts from liquor sales was based on the advice of James Sanchez, who had been hired to assist the Association with its bookkeeping and tax reporting. Regulation 3 NMAC 1.11.11 (formerly TA 69:4) provides a list of situations which may indicate that a taxpayer has not been negligent for purposes of imposing penalty. Number 4 provides:

> 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; failure to make a timely filing of a tax return, however, is not excused by the taxpayer's reliance on an agent;

The first question is whether the Association was entitled to rely on the tax advice given by Mr. Sanchez during the period 1991 through 1993. At the time Pauline Lovato retained the services of Mr. Sanchez in 1991, he maintained a business office in Albuquerque and held himself out as a "bookkeeper/accountant." Although Mr. Sanchez did not have his accounting degree when he began working for the Association, he was attending classes at the University of Albuquerque and obtained his degree in 1992. Mr. Sanchez worked with Ms. Lovato on the applications for exempt status filed with the IRS and had full knowledge of the Association's status as a social club under Section 501(c)(7) of the Internal Revenue Code.

Ms. Lovato was not knowledgeable in tax matters. Recognizing that she was not qualified to make decisions concerning the Association's tax liability, she retained the services of an outside tax advisor. Based on Mr. Sanchez's advertisement and representation that he was a "bookkeeper/ accountant", Ms. Lovato believed Mr. Sanchez was knowledgeable in tax matters and relied on his

advice. Given the circumstances, Ms. Lovato's reliance on Mr. Sanchez's advice during the time he worked for the Association was not unreasonable.

The more difficult question is whether the Association's continued reliance on Mr. Sanchez's advice was reasonable during the period after Mr. Sanchez was replaced by Barela & Associates, Inc. Mr. Sanchez testified that he was "let go", indicating that the Association made the decision to terminate his services. Ms. Lovato did not explain the reasons for Mr. Sanchez's departure, nor did she explain how Barela & Associates, Inc. was selected to replace him. There is nothing in the record concerning the qualifications of Celene Barela or anyone else in the firm. Ms. Lovato testified that she provided Ms. Barela with copies of the Association's articles of incorporation and bylaws. Ms. Lovato did not discuss the Association's method of reporting gross receipts tax with Ms. Barela. Instead, Ms. Lovato continued to rely on the advice she had received from James Sanchez.

Ms. Lovato's failure to discuss the Association's gross receipts tax liability with Ms. Barela does not meet the requirements of ordinary business care and prudence. There are many situations where a taxpayer's continued reliance on advice provided by a former tax advisor would be reasonable. In this case, however, Ms. Lovato was aware of facts that should have alerted her to the need to consult with the Association's new tax advisor concerning the payment of gross receipts tax.

Ms. Lovato began serving as secretary of the Association in 1988 or 1989. At that time, the Association's bookkeeper was reporting and paying gross receipts tax on all of the Association's receipts, including its sales of liquor to members. After James Sanchez assumed the duties of bookkeeper in 1991, the Association changed its method of reporting gross receipts tax on those

sales. When the Association terminated Mr. Sanchez's services in 1993 and hired Barela & Associates, Inc., Ms. Lovato knew that the Association's two former bookkeepers had disagreed concerning the proper gross receipts tax treatment of the Association's liquor sales. In addition, Ms. Lovato did not have a clear understanding of the basis for Mr. Sanchez's advice concerning the exemption from gross receipts tax and testified that she found the distinction between sales to members and sales to nonmembers confusing. Under these circumstances, a reasonable taxpayer would have discussed the Association's inconsistent gross receipts tax reporting with its new tax advisor and sought advice as to whether the Association should continue to exclude liquor sales to members when reporting gross receipts tax. Given the specific facts of this case, Ms. Lovato's failure to consult with Barela & Associates, Inc. concerning the Association's liability for gross receipts tax was negligent under Section 7-1-69(A).[1]

CONCLUSIONS OF LAW

1. The Association filed a timely written protest to Assessment No. 2141443 pursuant to Section 7-1-24, NMSA 1978, and jurisdiction lies over the parties and the subject matter of this protest.

2. The Association does not qualify for the exemption from gross receipts tax provided in Section 7-9-29, NMSA 1978, to taxpayers that have been granted exemption from federal income tax as organizations described in Section 501(c)(3) of the Internal Revenue Code.

[1] The Association's 1993, 1994 and 1995 federal tax returns were prepared by Barela & Associates, Inc. (Taxpayer Exhibits 7, 8 and 9). The Association's 1996 federal tax return was prepared by Jackson Hewitt Tax Service (Taxpayer Exhibit 10). There is nothing in the record to explain whether Jackson Hewitt replaced Barela & Associates, Inc. or whether Ms. Lovato had any discussions with Jackson Hewitt concerning the Association's gross receipts taxes.

3. The Association reasonably relied on the advice of its bookkeeper/accountant James Sanchez during the years 1991-1993 and was not negligent in failing to report gross receipts tax during this period.

4. The Association was negligent in continuing to rely on the advice of James Sanchez after his services were terminated, rather than discussing its gross receipts tax liability with the firm hired to replace Mr. Sanchez.

For the foregoing reasons, the Association's protest IS DENIED IN PART AND GRANTED IN PART and the Department is ordered to abate the penalty assessed against the Association for underreporting of gross receipts tax during the period 1991-1993.

DONE this 16th day of February 1998.