

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

**IN THE MATTER OF THE PROTEST OF
RAUL M. AND ANTONIETA M. ARIZPE
TO DENIAL OF REQUEST FOR REFUND
OF 2004 PERSONAL INCOME TAX ISSUED
UNDER LETTER ID NO. L0642431488**

NO. 05-14

DECISION AND ORDER

A formal hearing on the above-referenced protest was held on July 13, 2005, before Margaret B. Alcock, Hearing Officer. The Taxation and Revenue Department ("the Department") was represented by Peter Breen, Special Assistant Attorney General. The taxpayers, Raul and Antonieta Arizpe, were represented by Antonieta Arizpe. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The taxpayers were full-year residents of Texas in tax year 2004.
2. During 2004, Ms. Arizpe spent a substantial amount of time playing the slot machines at Sunland Park Racetrack/Casino ("the Casino") in Sunland Park, New Mexico.
3. The Casino issues patrons a rewards card that enables them to enter various drawings and obtain a small percentage of cash back on money spent at the casino.
4. To participate in the rewards program, the patron must insert the card, which keeps track of the patron's wins and losses, into the slot machine before starting to play.
5. Ms. Arizpe used her rewards card during some, but not all, of her visits to the Casino.

6. The Casino issued Forms W-2G for tax year 2004 showing that Ms. Arizpe won \$187,535 playing the slot machines, from which the casino withheld New Mexico income tax in the amount of \$11,252.

7. Ms. Arizpe believes she lost as much as she won during 2004, but was able to document only \$90,506.75 of her gambling losses. This is the amount shown on a “Win/Loss Statement” the Casino issued based on Ms. Arizpe’s use of her rewards card. There is no record of losses that might have been incurred when Ms. Arizpe played without using the card.

8. In February 2005, the Arizpes had their 2004 personal income tax returns prepared by an H & R Block office in El Paso, Texas.

9. The income reported on the Arizpes’ 2004 federal income tax return consisted of wages, taxable interest, taxable refunds, and “other income,” which included \$186,535 of Ms. Arizpe’s gambling winnings from the Casino.

10. Offsetting the Arizpe’s income was a \$22,215 loss from Ms. Arizpe’s sole proprietorship (a sales business located in El Paso, Texas) and a number of itemized deductions reported on Schedule A, including \$186,535 of gambling losses.

11. The Arizpes’ 2004 New Mexico personal income tax return (“PIT-1”), which was also prepared by H & R Block, contained two errors: first, it failed to allocate Ms. Arizpe’s gambling winnings to New Mexico as required by NMSA 1978, § 7-2-11(A)(5); second, the return apportioned the entire \$22,215 loss from Ms. Arizpe’s Texas business to New Mexico.

12. As a result of the erroneous allocation and apportionment of income, the Arizpes reported zero personal income tax to New Mexico and requested a refund of the entire \$11,252 of tax withheld from Ms. Arizpe’s gambling winnings by the Casino.

13. On April 23, 2005, the Department sent the Arizpes notice that their claim for refund was being denied “because you have provided insufficient substantiation of claimed gambling income and loss.”

14. On May 2, 2005, the Arizpes filed a written protest to the Department’s denial of their claim for refund.

DISCUSSION

The issue to be decided is whether the Arizpes are entitled to the \$11,252 refund claimed on their 2004 New Mexico personal income tax return. The Department stated the following reasons for denying the refund: (1) the Arizpes failed to properly allocate and apportion their income on Schedule PIT-B to their New Mexico return; and (2) they failed to document the gambling losses taken as an itemized deduction on their federal income tax return, which served to reduce the federal adjusted gross income used as the starting point for calculating New Mexico tax. In addition, the Department maintains that Ms. Arizpe had additional winnings that were not reported by the Casino and argues that this justifies denying any refund of taxes due to the Arizpes.

Allocation and Apportionment of New Mexico Income. Payment of New Mexico personal income tax is governed by NMSA 1978, §§ 7-2-1, *et seq.* New Mexico is among the majority of states that use the federal income tax system as the basis for calculating state income taxes. As reflected on the Department’s 2004 PIT-1, New Mexico taxable income is calculated by starting with the taxpayer's federal adjusted gross income, deducting the taxpayer's itemized deductions and federal personal exemption, and making certain adjustments reflected on Schedule PIT-ADJ. The amount of tax is then drawn from the tax rate table or tax schedule. When a taxpayer has income that is taxable both within and without New Mexico, NMSA 1978, § 7-2-11

allows the taxpayer to file Schedule PIT-B to allocate and apportion certain categories of income between New Mexico and non-New Mexico sources. The percentage of total income allocated or apportioned to New Mexico is then applied to the tax previously calculated to determine the tax due.

Gambling Income. Subsection (A)(5) of § 7-2-11 states as follows: “gambling winnings of a nonresident shall be allocated to this state if the gambling winnings arose from a source within this state.” There is no dispute that all of Ms. Arizpe’s gambling winnings came from a casino located in New Mexico. For this reason, the entire \$187,535 the Casino reported to the Department as Ms. Arizpe’s 2004 winnings must be allocated to New Mexico on Schedule PIT-B of the Arizpes’ 2004 New Mexico income tax return.¹

Business Losses. Ms. Arizpe is engaged in the business of selling vitamins and fashion jewelry. Although she sells her products nationwide, the business is operated out of her home in El Paso, Texas. Because the 2004 expenses for the business exceeded its receipts, the Arizpes’ 2004 federal income tax return reported a \$22,215 loss. The entire loss was then apportioned to New Mexico on Schedule PIT-B to their New Mexico return. At the administrative hearing, Ms. Arizpe had no explanation for why losses attributable to her Texas business were apportioned to New Mexico. Accordingly, the Arizpes’ 2004 Schedule PIT-B should be corrected to remove the \$22,215 loss from the New Mexico column.

Gambling Losses. 26 U.S.C. § 165(d) allows taxpayers to deduct their gambling losses as an itemized deduction on Schedule A to their federal Form 1040, up to the amount of any gambling

¹ In the absence of any explanation for the \$1,000 discrepancy between the \$186,535 of gambling winnings reported on the Arizpe’s 2004 return and the \$187,535 of gambling winnings reported by the Casino, the amount reported by the Casino will control for purposes of this protest.

winnings reported. Taxpayers must be prepared, however, to provide documentation to support the winnings and losses reported. In Publication 529 (“Miscellaneous Deductions”), the Internal Revenue Service sets out the types of documentation needed, which may include a diary of winnings and losses, wagering tickets, canceled checks, credit records, bank statements, or statements provided directly by the gambling establishment.

New Mexico law also requires taxpayers to keep documentation to support the amounts reported on their tax returns. NMSA 1978, § 7-1-10(A) requires every person to "maintain books of account or other records in a manner that will permit the accurate computation of state taxes...." NMSA 1978, § 7-1-11(C) states that taxpayers “shall upon request make their records and books of account available for inspection at reasonable hours to the secretary or the secretary's delegate.” After reviewing the Arizpes’ 2004 New Mexico income tax return, the Department asked them to provide documentation to support the \$186,535 of gambling losses included in their itemized deductions. No documentation was provided, and the Arizpes’ requested refund of \$11,252 was denied.

At the July 13, 2005 administrative hearing, Ms. Arizpe produced a 2004 “Win/Loss Statement” that she had obtained from the Casino. The statement shows gambling winnings of \$60,751.00 and losses of \$90,506.75. The statement was limited to wins and losses recorded when Ms. Arizpe used the rewards card issued by the Casino. Ms. Arizpe did not present any evidence to substantiate losses she may have incurred without using the card. When called as a witness, the Department’s protest auditor stated that he was familiar with the Win/Loss Statements issued by the Casino and believed the statement produced by Ms. Arizpe was reliable evidence of the losses shown.

Right of Offset. Based on the evidence presented at the administrative hearing, the Arizpes are entitled to a refund of approximately \$6,400 of the New Mexico income tax withheld by the Casino. This figure is arrived at by adjusting their 2004 PIT-1 as follows:

Line 5	Reported Federal AGI	\$235,770
Line 7	Itemized Deductions (reduced by \$96,028 of unsubstantiated gambling losses)	(126,334)
Line 8	Federal Exemption	(5,084)
Line 11	New Mexico Taxable Income	104,352
Line 12	Tax on Line 11, from PIT-B	4,855*
Line 17	NM Income Tax Withheld	11,252
Line 22	Overpayment	6,397

*The tax on \$104,352, determined from the 2004 tax schedule, is \$6,104. This is then multiplied by 79.541% (NM percentage from PIT-B after allocating \$187,535 of gambling winnings to NM and excluding the \$22,215 business loss) to arrive at a tax due of \$4,855.

Despite evidence that Ms. Arizpe suffered gambling losses of \$90,507 during 2004, the Department maintains that it is entitled to retain any refund due to the Arizpes as an offset against unreported income. The Department argues that the Casino only withheld tax from winnings over a certain dollar amount and theorizes that Ms. Arizpe must have had additional winnings below that threshold. The Department must do more than theorize, however. The method used by the Casino to withhold New Mexico income taxes is far from clear. Ms. Arizpe stated her belief that the Casino withheld tax from jackpots of \$1,000 or more. Federal law requires casinos to issue a Form W-2G to *report* gambling winnings of \$1,200 or more from slot machines, but 26 U.S.C. § 3402(q)(5) specifically exempts slot machine winnings from the general duty to *withhold* taxes. *See also, Lyszkowski v. Commissioner*, Tax Court Memo 1995-602, *aff'd without opinion*, 79 F.3d 1138 (3d Cir. 1996). New Mexico law limits its withholding requirement to every person

“who is required by the provisions of the Internal Revenue Code to deduct and withhold federal tax from payment of winnings that are subject to withholding....” NMSA 1978, § 7-3-3(D).

In this case, the Department did not present evidence to establish the actual threshold Sunland Park Casino used to withhold New Mexico income taxes from slot machine winnings. The Department did not present expert testimony or other evidence to establish how much a person who gambled as frequently as Ms. Arizpe gambled during 2004 was likely to win in jackpots below the withholding threshold. Nor did the Department audit the taxpayers to examine bank statements and other records that might indicate whether Ms. Arizpe had an additional \$94,000 of income from such jackpots.²

NMSA 1978, § 7-1-29(C) gives the secretary of the Department discretion to offset any amount of tax to be refunded “against any amount of tax for which the person due to receive the refund is liable.” Based on the evidence presented at the administrative hearing, the Arizpes are liable for tax in the amount of \$4,855. If the Department believes there is income that the Arizpes failed to report, the Department has the right to initiate an audit in accordance with the procedures set out in the Tax Administration Act. The Department does not have the right to withhold the Arizpes’ refund based solely on its unsubstantiated hunch that additional taxes may be due.

CONCLUSIONS OF LAW

A. The taxpayers filed a timely, written protest to the denial of their claim for refund, and jurisdiction lies over the parties and the subject matter of this protest.

² At New Mexico’s top 2004 tax rate of 6.8 percent, this is the approximate amount of unreported income needed to fully offset the \$6,400 refund otherwise due to the Arizpes.

B. The Arizpes substantiated gambling losses in the amount of \$90,507; they failed to substantiate the \$96,028 of remaining losses claimed as a deduction on their 2004 PIT-1, and the deduction for those losses must be disallowed.

C. The Arizpes are required to allocate the \$187,535 that Ms. Arizpe won at the Sunland Park Racetrack/Casino to New Mexico on Schedule PIT-B to their 2004 PIT-1.

D. The Arizpes may not apportion the \$22,215 loss from Ms. Arizpe's Texas business to New Mexico on Schedule PIT-B to their 2004 PIT-1.

E. Based on the adjustments set out in Conclusions B, C, and D, above, the Arizpes are entitled to a refund of \$6,397.

For the foregoing reasons, the Taxpayers' protest IS GRANTED IN PART AND DENIED IN PART. The Department is ordered to refund the Arizpes \$6,397, plus applicable interest. The balance of the refund requested on the Arizpes' 2004 New Mexico income tax return is denied.

DATED July 19, 2005.