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

IN THE MATTER OF THE PROTEST OF
CLARENCE F. GARRETT TO ASSESSMENT **No. 07-03**
ISSUED UNDER LETTER ID L0385558016

DECISION AND ORDER

A formal hearing on the above-referenced protest was held on March 21, 2007, before Margaret B. Alcock, Hearing Officer. The Taxation and Revenue Department ("Department") was represented by Elizabeth K. Korsmo, Special Assistant Attorney General. Clarence F. Garrett ("the Taxpayer") represented himself. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The Taxpayer and his wife moved to New Mexico in July 2004 after the Taxpayer retired from his job in Illinois.

2. For the 2004 tax year, the Taxpayer's income included wages, interest and dividends earned while he was a resident of Illinois; capital gain on Pennsylvania real estate he sold prior to moving to New Mexico; and pension distributions, interest and dividends received while he was a resident of New Mexico.

3. In completing his 2004 New Mexico personal income tax return, the Taxpayer first calculated the amount of tax that would be due on his total federal adjusted gross income (less deductions and exemptions) and then multiplied that amount by the percentage of income allocated to New Mexico on Form PIT-B of his 2004 return.

4. After determining the amount of tax due on his New Mexico income, the Taxpayer claimed a credit for taxes paid to Pennsylvania on the capital gain income he received from the sale of Pennsylvania real estate. None of this income had been allocated to New Mexico on Form PIT-B.

5. The Department disallowed the credit the Taxpayer claimed for taxes paid to Pennsylvania and, on June 23, 2005, assessed him for $662 of additional personal income tax, plus interest and penalty.

6. On June 27, 2005, the Taxpayer filed a written protest to the assessment. As authorized by Department Regulation 3.1.7.9 NMAC, he subsequently paid the assessment in order to stop the accrual of additional penalty and interest.

7. As part of his protest, the Taxpayer devised his own method of allocating income, deductions, and exemptions between New Mexico and non-New Mexico sources and filed an amended 2004 personal income tax return based on this methodology.

8. Although New Mexico's 2004 Form PIT-1 requires federal adjusted gross income to be reported on Line 5 of the return, the Taxpayer's amended return reflected only the income he received after moving to New Mexico in July 2004. The Taxpayer then reduced this amount by one-half of his federal deductions and exemptions and calculated New Mexico tax on the resulting figure.

9. Based on the Taxpayer's personal method of computing New Mexico income tax, his amended return showed a refund due in the amount of $400.

DISCUSSION

The issues to be determined are: (1) whether the Taxpayer is required to follow New Mexico's statutory method of calculating personal income tax on his 2004 income and is therefore liable for the additional tax assessed by the Department; and (2) if additional tax is due, whether the Department properly assessed penalty and interest on the underreported tax.

Burden of Proof. NMSA 1978, § 7-1-17(C) states that any assessment of taxes made by the Department is presumed to be correct. *Holt v. New Mexico Department of Taxation & Revenue*, 2002 NMSC 34, ¶ 4, 133 N.M. 11, 59 P.3d 491. NMSA 1978, § 7-1-3 defines tax to include not only the amount of tax principal imposed but also, unless the context otherwise requires, the amount of any interest or civil penalty relating thereto. *El Centro Villa Nursing Center v. Taxation and Revenue Department*, 108 N.M. 795, 779 P.2d 982 (Ct. App. 1989). Accordingly, it is the Taxpayer's burden to come forward with evidence and legal argument to establish that he is entitled to an abatement of the assessment, in full or in part.

Calculation of Personal Income Tax. 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 Form PIT-1, New Mexico taxable income is calculated by starting with the taxpayer's federal adjusted gross income, deducting the taxpayer's federal personal exemption and deductions, and making certain adjustments reflected on Form PIT-ADJ. The amount of tax is then drawn from the tax rate table or tax schedule.

When a taxpayer has income from sources within and without New Mexico, NMSA 1978, § 7-2-11(A) directs the taxpayer to allocate and apportion this income between New Mexico and

non-New Mexico sources. This is done by completing the Department's Form PIT-B. Pursuant to § 7-2-11(C), the amount of tax previously calculated on federal adjusted gross income is then reduced by a credit computed by multiplying the tax by the percentage of income allocated or apportioned outside New Mexico.[1]

In this case, the Taxpayer completed Forms PIT-1 and PIT-B in accordance with the Department's instructions and determined the amount of tax due on the income he received after moving to New Mexico in July 2004. The Taxpayer then claimed a credit for taxes paid to Pennsylvania on the income from his sale of Pennsylvania real estate in May 2004. This credit was disallowed by the Department, resulting in the assessment at issue in this protest.

Credit for Taxes Paid to Another State. Pursuant to NMSA 1978, § 7-1-13, a New Mexico resident may claim a credit for taxes paid to another state "*with respect to income that is required to be either allocated or apportioned to New Mexico*." (emphasis added). The purpose of this provision is to prevent two states from taxing the same income. Here, however, none of the income the Taxpayer received from the sale of Pennsylvania real estate was allocated to New Mexico on his Form PIT-B and that income was not included in the New Mexico percentage used to calculate the Taxpayer's New Mexico tax liability. For this reason, the Taxpayer was not entitled to claim a credit for the tax he paid to Pennsylvania.

Taxpayer's Objections to New Mexico's Income Tax Laws. The Taxpayer believes that requiring him to calculate tax on his total federal adjusted gross income before determining

[1] As a shortcut, New Mexico's Form PIT-B determines the tax due New Mexico by multiplying the tax calculated on total income by the percentage of income allocated or apportioned to New Mexico. The result of this calculation is the same as that reached by the statutory method of multiplying the tax by the non-New Mexico percentage and then taking a tax credit in this amount.

the percentage of tax attributable to New Mexico unfairly inflates his New Mexico tax liability. Accordingly, he devised his own method of calculating his tax liability by including only New Mexico income on his amended tax return, reduced by one-half of the federal deduction and exemption amounts. Whatever logic there may be to the Taxpayer' methodology, it is not the methodology adopted by the New Mexico Legislature. The Taxpayer is required to follow the state's tax laws as written and is not entitled to make up his own rules based on his personal circumstances and beliefs.

New Mexico's income tax laws are not unique, nor do they result in the taxation of out-of-state income. In *Maxwell v. Bugbee,* 250 U.S. 525 (1919), decided almost ninety years ago, the United States Supreme Court upheld a New Jersey inheritance tax that required the inclusion of the decedent's entire estate, wherever located, to determine the rate at which the estate's property in New Jersey would be taxed. Similar to the income tax scheme at issue here, the inheritance tax was calculated by first determining the amount of tax that would be due on the entire estate and then reducing the tax to reflect only the percentage of estate assets located in New Jersey. The Supreme Court upheld the constitutionality of this approach:

> When the state levies taxes within its authority, property not in itself taxable by the state may be used as a measure of the tax imposed.... In the present case the state imposes a privilege tax, clearly within its authority, and it has adopted as a measure of that tax the proportion which the specified local property bears to the entire estate of the decedent.... The transfer of certain property within the state is taxed by a rule which considers the entire estate in arriving at the amount of the tax. It is in no just sense a tax upon the foreign property, real or personal.

250 U.S. at 539. Since *Maxwell*, courts in a number of states have upheld the calculation of tax on in-state income as a percentage of the tax that would be due on total income. *See, e.g*., *Walters v. State ex rel. Oklahoma Tax Commission*, 935 P.2d 398 (Okl.App. 1996), *cert. denied*,

522 U.S. 908 (1997); *Brady v. State of New York,* 607 N.E.2d 1060 (N.Y. 1992), *cert. denied,* 509 U.S. 905 (1993); *Stevens v. State Tax Assessor,* 571 A.2d 1195 (Me.), *cert. denied,* 498 U.S. 819 (1990); *Wheeler v. State,* 249 A.2d 887 (Vt.), *appeal dismissed*, 396 U.S. 4 (1969); *United States v. Kansas,* 810 F.2d 935 (10th Cir.1987).

Courts have also held that a credit for taxes paid to another state does not apply simply because a taxpayer's entire gross income is used to calculate the rate of tax applied to the other state's income. *See, e.g*., *Peet v. Commi*ssioner, 705 A.2d 497 (Pa. Cmwlth 1998), where the court disallowed the taxpayer's claim to a credit for tax paid to Delaware, finding that the taxpayers' Pennsylvania income was not subject to tax in Delaware. As the court explained:

> [T]he Peets posit that their entire income is taxed by the State of Delaware because the Peets' entire income, from both inside and outside of Delaware, is used to compute their Delaware *tax rate.* Therefore, the Peets argue, they are entitled to a credit for the entire amount of taxes paid to Delaware. We must disagree. We believe that the Delaware system, like those systems in other graduated income tax states, uses out-of-state income merely as a measure of the tax rate, rather than actually taxing that income. The Peets' Pennsylvania income, therefore, was not subject to tax by Delaware. (emphasis in the original).

Id., 705 A.2d at 501. *See also*, *Comptroller of the Treasury v. Hickey*, 689 A.2d 1316 (Md. App. 1997) (disallowing credit claimed by Maryland residents for tax paid to New York); *Torpy v. Department of Revenue*, 2004 WL 3119002 (Ore. Tax Court 2004) (disallowing credit claimed by Oregon resident for tax paid to Colorado); *Chin v. Director, Division of Taxation,* 14 N.J. Tax 304 (N.J. Tax Ct.1994), *aff'd sub nom., Carroll v. Director, Division of Taxation,* 15 N.J. Tax 177 (N.J. Super.Ct.App.Div. 1995) (disallowing credit claimed by New Jersey residents for tax paid to New York). In this case, the capital gain the Taxpayer recognized from the sale of his Pennsylvania real estate was not allocated to New Mexico on Form PIT-B. As established in the court cases cited above, the fact that New Mexico took this income into account when calculating

the rate of tax applied to other income that *was* allocated to New Mexico does not constitute a tax on the capital gain derived from Pennsylvania. Because there was no double taxation, the credit for taxes paid to Pennsylvania was properly disallowed.

Rationale for New Mexico's Taxation of First-Year Residents. Although the Taxpayer perceives New Mexico's tax system as unfair, it is intended to insure that taxpayers with the same income pay tax at the same graduated tax rate, regardless of the source of their income.[2] For example, a single taxpayer who was a full-year resident of New Mexico in 2004 and had taxable income (*i.e.*, federal adjusted gross income less applicable deductions and exemptions) of $50,000, would be in the 5.4% marginal tax bracket. A first-year resident who had the same income—one-half earned in New Mexico and one-half earned in another state—would also be in the 5.4% tax bracket. The difference is that the full-year resident would pay the full amount of tax computed on his income while the first-year resident would pay only 50 percent of the tax, which is the percentage of his income allocated to New Mexico. For states with a graduated tax system, which apportions liability based on a taxpayer's ability to pay, this methodology insures that similarly situated taxpayers pay tax at the same marginal rate. As both state and federal courts have consistently held, this methodology does not result in the taxation of income earned outside the state.

Assessment of Interest. NMSA 1978, § 7-1-67 governs the imposition of interest on late payments of tax and provides, in pertinent part:

[2] The Taxpayer believes that Illinois' method of calculating tax based solely on the income earned in that state is more equitable than New Mexico's system. Unlike New Mexico, however, Illinois has a flat tax system. Under those circumstances, a taxpayer with income from another state would pay tax at the same rate whether the tax is calculated on the income earned in Illinois or is first applied to total income and then adjusted to reflect the percentage of income earned in Illinois.

> A. If a tax imposed is not paid on or before the day on which it becomes due, interest *shall be paid* to the state on that amount from the first day following the day on which the tax becomes due, without regard to any extension of time or installment agreement, until it is paid.... (emphasis added).

The Legislature's use of the word "shall" indicates that the provisions of the statute are mandatory rather than discretionary. *State v. Lujan*, 90 N.M. 103, 105, 560 P.2d 167, 169 (1977). *See also*, NMSA 1978, § 12-2A-4(A) of the Uniform Statute and Rule Construction Act (the words "shall" and "must" express a duty, obligation, requirement or condition precedent). With limited exceptions that do not apply here, § 7-1-67 directs the Department to assess interest whenever taxes are not timely paid. Even taxpayers who obtain a formal extension of time to pay tax are liable for interest from the original due date of the tax to the date payment is made. *See*, NMSA 1978, § 7-1-13(E).

The assessment of interest is designed to compensate the state for the time value of unpaid revenues. In this case, the Taxpayer made an error in completing his 2004 income tax return. As a result of this error, the Taxpayer—rather than the state—had the use of his $662 of underreported tax for the period between April 15, 2005, the original due date of the tax, and June 27, 2005, the postmark date of the Taxpayer's payment. Although the Taxpayer questioned whether the state's 15 percent interest rate is excessive, that is a matter within the discretion of the Legislature. *See*, *State ex rel. Taylor v. Johnson*, 1998-NMSC-015, ¶ 22, 125 N.M. 343, 961 P.2d 768 (an administrative agency may not alter, modify or extend the reach of a law created by the Legislature).

Assessment of Penalty. NMSA 1978, § 7-1-69(A) provides that when a taxpayer fails to pay taxes due to the state as a result of negligence or disregard of rules and regulations, a penalty

"shall be added" to the amount of the underpayment. The term negligence as used in § 7-1-69(A) is defined in Regulation 3.1.11.10 NMAC as:

> A. failure to exercise that degree of ordinary business care and prudence which reasonable taxpayers would exercise under like circumstances;
>
> B. inaction by taxpayers where action is required;
>
> C. inadvertence, indifference, thoughtlessness, carelessness, erroneous belief or inattention.

In this case, the Taxpayer maintains that he did not act negligently or in disregard of the Department's rules and regulations, but made a good faith mistake of law that qualifies for the exception provided in NMSA 1978, § 7-1-69(B), which states:

> No penalty shall be assessed against a taxpayer if the failure to pay an amount of tax when due results from a mistake of law made in good faith and on reasonable grounds.

The facts indicate, however, that while the Taxpayer may have made a mistake concerning his right to claim a credit for taxes paid to Pennsylvania, that mistake was not made "on reasonable grounds."

In determining that he qualified for the credit for taxes paid to another state, the Taxpayer relied on the following paragraph on page 26 of the Department's instructions to Form PIT-ADJ (Taxpayer Exhibit A):

> A resident of New Mexico who must pay tax to another state on income that is also taxable in New Mexico may take a credit against New Mexico tax for tax owed to the other state.

The Taxpayer argues that because his Pennsylvania income was used in preliminary calculations of his New Mexico tax, he reasonably believed that this income was "taxable in New Mexico" and

qualified for the credit provided in NMSA 1978, § 7-1-13. The problem with this argument is that the same page of the Department's instructions specifically advise taxpayers that:

> Income that is allocated or apportioned outside New Mexico on Schedule PIT-B, does not qualify for credit for taxes paid to another state on that same income.

As the Taxpayer acknowledged at the administrative hearing, and as clearly shown on the Form PIT-B attached to his original 2004 return (Department Exhibit 2), all of his Pennsylvania income was allocated *outside* New Mexico. Based on the Department's instructions, quoted above, this income "does not qualify for credit for taxes paid to another state on that same income."

The Taxpayer's error in completing his 2004 New Mexico income tax return was the result of his failure to carefully read the Department's instructions or to seek help from the Department or a professional tax advisor to assist him in understanding New Mexico's tax laws. Instead, the Taxpayer completed his return based on his understanding of the tax laws of Illinois (where he formerly lived) and his own personal belief as to what was "fair." This constitutes negligence as defined in the Department's regulations and in New Mexico case law. *See*, *Arco Materials, Inc. v. Taxation & Revenue Department*, 118 N.M. 12, 17, 878 P.2d 330, 335 (Ct. App.) *rev'd on other grounds by Blaze Const. Co. v. Taxation & Revenue Department*, 118 N.M. 647, 647-48, 884 P.2d 803, 803-804 (1994) (New Mexico case law is clear that penalties may properly be assessed even when the failure to pay is based on inadvertent error or unintentional failure to pay the tax due); *see also*, *El Centro Villa Nursing Center v. Taxation & Revenue Department*, 108 N.M. 795, 797, 779 P.2d 982, 984 (Ct. App. 1989); *Phillips Mercantile Co. v. New Mexico Taxation & Revenue Department*, 109 N.M. 487, 490-91, 786 P.2d 1221, 1224-25 (Ct. App. 1990). For this reason, penalty was properly imposed.

CONCLUSIONS OF LAW

A. The Taxpayer filed a timely, written protest to the assessment issued under Letter ID L0385558016**,** and jurisdiction lies over the parties and the subject matter of this protest.

B. The Taxpayer was not entitled to claim a credit against his 2004 New Mexico income taxes for taxes paid to Pennsylvania, and he is liable for the $662 of tax principal assessed by the Department.

C. The Taxpayer did not pay his 2004 New Mexico tax liability by the statutory due date, and he is liable for the interest assessed by the Department.

D. The Taxpayer was negligent in underreporting his 2004 New Mexico income taxes, and he is liable for the penalty assessed by the Department.

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

DATED March 26, 2007.