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THE DEDUCTIBILITY FOR FEDERAL INCOME TAX PURPOSES OF THE NEW MEXICO GROSS RECEIPTS TAX PAID ON THE PURCHASE OF A NEWLY CONSTRUCTED HOME

SCOTT A. TAYLOR*

INTRODUCTION

In October 1982, the Internal Revenue Service (the "Service") issued a revenue ruling[1] that outlined the circumstances under which the buyer of a newly constructed home can deduct the New Mexico gross receipts tax imposed on the sale.[2] By the terms of the ruling, an individual who purchases a personal residence from a builder or developer is not entitled to a federal income tax deduction for the New Mexico gross receipts tax imposed on the sale.[3] The ruling allows a deduction, however, if the purchaser contracts with the builder to construct the home and if the agreement between the parties provides that the builder will act as the purchaser's agent and will purchase the home building materials so that the purchaser is billed directly by the seller of the materials.

Before the issuance of this revenue ruling, the Service in New Mexico followed the administrative practice of allowing the gross receipts tax as a deduction, even if the builder did not construct the home as the purchaser's agent. Such a deduction usually amounted to $2000 to $6000, depending on the price of the home.[4] A deduction of $4000 for a taxpayer in a marginal tax bracket of forty percent translated into a reduction of $1600 in federal income taxes. A deduction of $2000 for a taxpayer in a marginal tax bracket of twenty percent provided a tax savings of $400. Now that the Internal Revenue Service has adopted a position denying the gross receipts tax deduction, the state's housing industry has one less

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1. Rev. Rul. 82-173, 1982-42 I.R.B. 5.

2. Sales of private residences by individuals are not usually subject to the New Mexico gross receipts tax because of the exemption for isolated or occasional sales of property. N.M. Stat. Ann. § 7-9-28 (Repl. Pamp. 1980).

3. The gross receipts tax is computed on the sales price paid by the purchaser with a deduction allowed for the value of the real property not attributable to the builder's improvements. For example, a builder purchases a lot for $10,000 and constructs a home on that lot. The entire property (lot and home) sells for $110,000. The gross receipts tax is applied only to $100,000, the amount that is attributable to the builder's improvements. *See* N.M. Stat. Ann. § 7-9-3(F) (Cum. Supp. 1982); § 7-9-53 (Repl. Pamp. 1980).

4. I.R.C. § 164(a)(4) allows a deduction for state and local sales taxes paid during the taxable year. All references and citations to sections in this article are to sections of the Internal Revenue Code of 1954, as amended to the date of publication, unless otherwise indicated. All references and citations to regulations are to Treasury regulations under the Internal Revenue Code of 1954, as amended to the date of publication, unless otherwise indicated.

financial incentive to use in encouraging the prospective home buyer to purchase a new home.

The validity of the ruling, however, is questionable. The regulation[5] on which the Service based its decision is probably invalid as applied to the New Mexico gross receipts tax. Even if the regulation is valid, the ruling may have incorrectly applied it. The ruling may also have incorrectly interpreted the legal application of the New Mexico gross receipts tax.[6]

In judging the soundness of the Service's recent revenue ruling on the deductibility of the New Mexico gross receipts tax, the author first considers the relevant statutory provisions of the gross receipts tax and the applicable portions of the Internal Revenue Code and regulations. The author next discusses the factual and legal bases for the revenue ruling, then analyzes its soundness, and concludes that the ruling is erroneous.

STATUTORY BACKGROUND

New Mexico Gross Receipts Tax

The New Mexico gross receipts tax[7] and compensating use tax[8] apply to those persons doing business in the state. A uniform rate of three and one-half percent applies in the case of both taxes.[9] The gross receipts tax is a tax imposed on the privilege of doing business in New Mexico. The compensating use tax is imposed for the privilege of using property in the state if such property is acquired out-of-state in a transaction that would have been subject to the gross receipts tax had the transaction occurred in New Mexico.[10]

Gross receipts are determined by adding up the total amount of receipts collected from the sale of property or for the performance of services in New Mexico.[11] Property is defined broadly by the statute and includes "real property, tangible personal property, licenses, franchises, patents, trademarks and copyrights."[12] As a result, the gross receipts tax will

5. Treas. Reg. § 1.164-3(e).

6. See G.C.M. 38902 (Oct. 6, 1982), *reprinted in* Federal Taxes: Internal Memoranda of the IRS (P-H) ¶278(82) (1982), in which the Service indicated that whether a deduction for a gross receipts tax is precluded when the sale involves real property is a legal issue yet to be resolved.

7. N.M. Stat. Ann. § 7-9-4 (Cum. Supp. 1982). The statute provides: "A. For the privilege of engaging in business, an excise tax equal to three and one-half percent of gross receipts is imposed on any person engaging in business in New Mexico. B. The tax imposed by this section shall be referred to as the 'gross receipts tax.' "

8. N.M. Stat. Ann. § 7-9-7 (Cum. Supp. 1982).

9. N.M. Stat. Ann. §§ 7-9-4(A); 7-9-7(A) (Cum. Supp. 1982).

10. N.M. Stat. Ann. § 7-9-7 (Cum. Supp. 1982).

11. N.M. Stat. Ann. § 7-9-3(F) (Cum. Supp. 1982).

12. N.M. Stat. Ann. § 7-9-3(I) (Cum. Supp. 1982). The statute provides: " 'property' means real property, tangible personal property, licenses, franchises, patents, trademarks and copyrights. Tangible personal property includes electricity and mobile homes. . . ."

apply to the sale of almost any property, whether real or personal, tangible or intangible. Where a person is engaged in the business of selling real property, the statute provides for a deduction. The seller deducts from his gross receipts the value of the real property except to the extent such value is attributable to improvements the seller has added to the property.[13] In the case of newly constructed homes, the builder can deduct only the value of the raw land. The house, whose value is attributable to the building materials and labor the builder has added, is subject to the tax. If the builder makes any improvements to the land (e.g., landscaping), the value of such improvements would also be subject to the gross receipts tax.

To eliminate the pyramiding of taxes that would otherwise result, the New Mexico statute allows a seller who sells materials to a construction business to deduct such sales from the seller's gross receipts.[14] The deduction will be allowable only if the buyer (builder) delivers a nontaxable transaction certificate to the seller. In order to qualify for the certificate, the buyer must incorporate the materials as an ingredient or component part of a construction project that will be subject to the gross receipts tax upon its completion.[15] The same rules apply to the seller of construction services.[16] These provisions operate to shift the incidence of the gross receipts tax on such materials and services to the sale of the completed home.

Normally, the builder will benefit from the deferral of the gross receipts tax until someone buys the completed home. Such a result, which the New Mexico gross receipts statute expressly permits, reduces the amount of cash or credit the builder may need to purchase materials from suppliers or construction services from subcontractors. When the home purchaser

13. N.M. Stat. Ann. § 7-9-53(A) (Repl. Pamp. 1980).

14. N.M. Stat. Ann. § 7-9-51(A) (Repl. Pamp. 1980). The statute provides: "Receipts from selling tangible personal property may be deducted from gross receipts if the sale is made to a person engaged in the construction business who delivers a nontaxable transaction certificate to the seller. . . ."

15. N.M. Stat. Ann. § 7-9-51(B) (Repl. Pamp. 1980).

16. N.M. Stat. Ann. § 7-9-52 (Repl. Pamp. 1980). The statute provides as follows:

A. Receipts from selling a construction service may be deducted from gross receipts if the sale is made to a person engaged in the construction business who delivers a nontaxable transaction certificate to the person performing the construction service.

B. The buyer delivering the nontaxable transaction certificate must have the construction services performed upon:

(1) a construction project which is subject to the gross receipts tax upon its completion or upon the completion of the overall construction project of which it is a part; or

(2) a construction project which is subject to the gross receipts tax upon the sale in the ordinary course of business of the real property upon which it was constructed.

buys a newly constructed house, the builder collects the gross receipts tax[17] and pays it over to the state on his next monthly return.[18]

I.R.C. § 164(a)(4) and the Regulation

As a general rule, a cash-basis taxpayer who pays real property,[19] personal property,[20] or general sales taxes[21] imposed by a state or local government may deduct such taxes in the year paid.[22] The person upon whom the tax is imposed is the taxpayer entitled to the deduction.[23] In the case of general sales taxes, determining whether the seller or buyer gets the deduction under section 164(a)(4) may sometimes be difficult if one refers only to local law to decide the legal incidence of the tax.[24] To minimize the inevitable complexity and resulting inconsistency caused by the number and variety of state general sales tax statutes, Congress adopted a rule of convenience that allows the incidence of a general sales tax to shift from the seller to the buyer for purposes of section 164(a)(4), even though the state taxing statute may actually impose the tax on the seller.[25] Under section 164(b)(5), the general sales tax is deemed to be

17. N.M. Stat. Ann. § 7-9-4(A) (Cum. Supp. 1982).
18. N.M. Stat. Ann. § 7-9-11 (Repl. Pamp. 1980).
19. I.R.C. § 164(a)(1).
20. I.R.C. § 164(a)(2).
21. I.R.C. § 164(a)(4).
22. *Id.*
23. *See* Magruder v. Supplee, 316 U.S. 394, 396 (1942) (a case involving the proper person entitled to deduct a Maryland real property tax).
24. Cases involving the New Mexico gross receipts tax have arisen in areas outside the narrow deductibility question raised in § 164(a)(4). *See* Ramah Navajo School Bd. v. Bureau of Revenue, ___ U.S. ___, 102 S. Ct. 3394 (1982) (New Mexico gross receipts tax invalidly imposed on non-Indian contractors who built high school for Indian tribe; federal common law on Indian sovereignty preempted state statute); United States v. New Mexico, ___ U.S. ___, 102 S. Ct. 1373 (1982) (New Mexico gross receipts tax imposed on federal contractors was valid; contractors were not agencies or instrumentalities of federal government); Mescalero Apache Tribe v. O'Cheskey, 625 F.2d 967 (10th Cir. 1980), *cert. denied*, 450 U.S. 959 (1981) (New Mexico gross receipts tax validly imposed on non-Indian contractors building resort-hotel on reservation; tax did not impair right to tribal self-government because incidence of tax fell on contractor, not tribe). For further discussion of these cases, see Dumas, *Tax Law, Survey of New Mexico Law: 1981–1982*, 13 N.M. L. Rev. 459 (1983).
25. In 1942, Congress enacted the predecessor to I.R.C. § 164(b)(5). Revenue Act of 1942, Pub. L. No. 77-753, § 122, 56 Stat. 820. The Senate Finance Report explained the reason for the provision:

> Some State and local sales taxes are upon the purchaser at the retail sale. The purchaser thus becomes the taxpayer and is allowed the amounts of such taxes as a deduction in computing net income for Federal income-tax purposes. In the case of other State and local sales taxes, the tax is upon the seller, usually in the form of a privilege or franchise tax, but is measured by the total volume of sales or the gross receipts. The laws of such States generally provide that the tax is to be passed on to the purchaser and penalties are provided in the case of merchants who claim to absorb the tax. In such cases, the purchaser who bears the tax, which is passed on to him directly by the seller, is denied the deduction for such taxes in computing net income for Federal income-tax purposes. Thus, the deductibility of such taxes in computing net income hinges upon the legal technicality which constitutes the seller as the taxpayer in one instance and the purchaser as the taxpayer in the other. There seems to be no just reason for this distinction.

S. Rep. No. 1631, 77th Cong. 2d Sess. 55 (1942).

imposed on the buyer if the tax is separately stated and if actually paid by the buyer.

The separately stated rule, however, has some limitations. When a state imposes a general sales tax on the seller, the buyer who gets the deduction by operation of section 164(b)(5) is that buyer who paid the seller in the particular transaction on which the state has imposed the tax. A second buyer in the resale of the same property will not be entitled to a deduction even if the tax is separately stated for the second transaction and actually paid by the second buyer.[26]

Deduction of the gross receipts tax also hinges on the definition of "general sales tax." The statute defines a general sales tax as a "tax imposed at one rate in respect to the sale at retail of a broad range of classes of items."[27] The regulation merely restates the statutory definition with one very small, but significant, change. The regulation defines "general sales tax" as a "sales tax," not just a tax on the sale at retail of various items. The addition of the word "sales" in front of tax becomes important when considering the definition of "sales tax," because the regulation further defines "sales tax" as a tax on the sale at retail of tangible personal property.[28] Interestingly enough, the statute provides no definition of the words "sales tax" without the word "general" preceding them.

The definition of "sales tax" is found only in the regulation, which states that the "term 'sales tax' means a tax imposed upon persons engaged in selling tangible personal property, or upon the consumers of such property. . . . The term also includes a tax imposed on persons engaged in furnishing services which is measured by the gross receipts for furnishing such services."[29] The reference to the sale of tangible personal property (to the possible exclusion of the sale of real property) occurs only in the regulation. But when read together, the statute and regulation define general sales tax as a sales tax (not just a tax) imposed on the sale of tangible personal property.

REVENUE RULING 82-173

In Revenue Ruling 82-173, the Internal Revenue Service applied the restrictive definition contained in the regulations and concluded that the new-home buyer who paid the separately stated gross receipts tax could

26. *See* Wise v. Commissioner, 78 T.C. 270 (1982) (Michigan sales tax is imposed on seller of materials to a builder who constructs home for home buyer; tax separately stated to and paid by home buyer did not satisfy requirement of § 164(b)(5) because builder, not home buyer, was the consumer).

27. I.R.C. § 164(b)(2)(A). The Service acknowledges that the "New Mexico gross receipts tax is a general sales tax within the meaning of section 164(a)(4). . . ." Rev. Rul. 82-173, 1982-42 I.R.B. 5.

28. Treas. Reg. § 1.164-3(e).

29. *Id.*

not deduct that tax on his federal income tax return. According to Revenue Ruling 82-173, the buyer could not deduct the gross receipts tax paid on the purchase of the house because the house is real property, not tangible personal property.

To illustrate its reasoning, the Service considered two different factual situations. In situation one of the ruling, an individual purchases a personal residence in New Mexico from a builder who is engaged in the business of subdividing land, building houses on the land, and selling the newly constructed homes. The builder, in order to avoid immediate payment of the gross receipts tax imposed on the purchase of the materials used to construct the houses, secures a nontaxable transaction certificate and delivers it to the materials seller. The buyer of a new home then purchases the house and lot for a stated price, to which is added an amount separately stated as the New Mexico gross receipts tax.

In situation two, the prospective home buyer contracts with a builder to construct a personal residence. Under the terms of the agreement, the builder acts as the home buyer's agent in the purchase of the building materials. The cost of these materials and the separately stated gross receipts tax must be billed directly to the home buyer. As the home buyer's agent, the builder then constructs the home.[30] The agency relationship between the home buyer and the builder is sufficient to make the home buyer liable for any tortious acts committed by the builder during the course of the home construction.

According to Revenue Ruling 82-173, the gross receipts tax is deductible under section 164(a)(4) in situation two but not in situation one. The ruling notes that the New Mexico gross receipts tax is a general sales tax as that term is used in section 164(b)(5). Although the statute itself defines "general sales tax" as a state or local tax imposed at one rate on the sale at retail of a broad range of classes of items,[31] the ruling turns to the Treasury Regulations, which define "general sales tax" in a two-step process. First, the regulations define "sales tax" as a tax imposed on persons engaged in selling tangible personal property or on persons furnishing services.[32] Then, the regulations define "general sales tax" as a "sales tax" imposed at one rate on the sale at retail of a broad range of classes of items.[33] The Service concluded that the regulation's reference to tangible personal property necessarily meant that New Mexico's gross receipts tax, if imposed on the sale of a new house that is classified as real property, is not for that particular transaction a general sales tax within the meaning of section 164(a)(4) and therefore not deductible on

30. *See, e.g.*, Underwood v. Commissioner, 45 T.C.M. (CCH) 77 (1983).
31. I.R.C. § 164(b)(2)(A).
32. Treas. Reg. § 1.164-3(e)(1).
33. *Id.* § 1.164-3(f).

the buyer's federal income tax return. Accordingly, the gross receipts tax in situation one is not deductible, but is deductible in situation two because the incidence of the gross receipts tax takes place before the materials and labor (i.e., tangible personal property and services) are incorporated into the house, which then becomes real property.

THE SOUNDNESS OF REVENUE RULING 82-173

A revenue ruling is the Service's official interpretation of the Internal Revenue Code, Treasury Regulations, decided cases, and other revenue rulings. Revenue rulings are published in the Internal Revenue Bulletin for the stated purpose of providing information and guidance to taxpayers, Service officials, and other concerned parties.[34] Revenue rulings should be distinguished from private letter rulings, which are not officially published. A private letter ruling is accorded no precedential authority; consequently, a taxpayer may not rely on such a ruling when it is issued to another taxpayer.[35]

The judicial effect given to a revenue ruling is minimal. Generally speaking, the courts approach revenue rulings as no more binding than the opinion of any other lawyer.[36] In some cases, however, a court will give a revenue ruling some weight and accord it respectful consideration.[37] Ultimately, the validity of a revenue ruling depends on the soundness of the legal principles on which it is based. Accordingly, the validity of Revenue Ruling 82-173 depends on the correctness of the Service's legal analysis.

34. Rev. Proc. 83-1, 1983-1 I.R.B. 16, 17, states:

> A "revenue ruling" is an interpretation by the Service that has been published in the Internal Revenue Bulletin. It is the conclusion of the Service on how the law is applied to an entire set of facts. Revenue rulings are issued only by the National Office and are published for the information and guidance of taxpayers, Internal Revenue Service officials, and other interested parties.

35. Rev. Proc. 83-1, 1983-1 I.R.B. 16, 26. The Revenue Procedure states: "A taxpayer may not rely on a ruling [as opposed to a revenue ruling] issued to another taxpayer. A ruling, except to the extent incorporated in a closing agreement, may be revoked or modified at any time under appropriate circumstances." *Id.*

36. Stemkowski v. Commissioner, 76 T.C. 252, 295 (1981). In *Stemkowski*, nonresident professional hockey players sought to apportion their United States and foreign source income based on training periods rather than on the playing season. To support their proposition, the taxpayers cited a revenue ruling. The court responded by stating that: "A revenue ruling 'has no more binding or legal force than the opinion of any other lawyer.'" (Citing United States v. Bennett, 186 F.2d 407 (5th Cir. 1951)). *See* Kaiser v. United States, 262 F.2d 367 (7th Cir. 1958), *aff'd*, 363 U.S. 299 (1960).

37. Groves v. United States, 533 F.2d 1376, 1380 (5th Cir. 1976). In *Groves*, the taxpayers sued for a refund of income taxes on the grounds that income earned as teachers employed by the government of the trust territory of the Pacific Islands should be excluded from gross income. On appeal, the taxpayers argued that the trial court incorrectly relied on an Internal Revenue Service revenue ruling as a legal basis for its decision. The circuit court noted that the trial court could not rely on the ruling as its sole basis for deciding the issue, but could accord the ruling respectful consideration.

The soundness of Revenue Ruling 82-173 hinges on the validity of the regulations that define a general sales tax as not including a tax imposed on the sale of real property. Even if the regulations are valid, the revenue ruling may still be invalid because of its erroneous application of the regulations. The ruling may also be incorrect in its conclusion because of its potentially mistaken interpretation of the New Mexico statute that imposes the gross receipts tax. If the revenue ruling is found invalid on any of these grounds, the Service may contend that the New Mexico gross receipts tax when imposed on the sale of a newly constructed home does not meet the separately stated test of section 164(b)(5).

The Validity of Treasury Regulation § 1.164-3

Regulations are accorded much more weight than revenue rulings. The courts, in judging the validity of Treasury Regulations, have noted two different types of regulations: legislative and interpretative. Legislative regulations refer to regulations issued under statutes that expressly authorize the Secretary of the Treasury to promulgate such regulations as he may deem necessary.[38] Legislative regulations theoretically have the force of law under the theory that Congress has expressly delegated to the Secretary of the Treasury authority to promulgate supplementary regulations.[39]

In contrast, interpretative regulations are of a lower order and merely clarify or explain the rules established by Congress in the relevant statute.[40] Section 164 does not authorize the Secretary of the Treasury to prescribe regulations that will complete certain portions of the statute. Therefore, Treasury Regulation section 1.164-3(e) and (f) has the lesser status of an interpretative regulation. Where the regulation is merely interpretative in nature, the court will uphold the validity of such a regulation to the extent it "harmonizes with the plain language of the statute,

38. *See, e.g.*, I.R.C. § 385.

39. United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982). Taxpayer challenged treasury regulations that defined a brother-sister controlled group of corporations for purposes of limiting, under § 1561(a), the corporate surtax exemption provided in § 11(d) (as in effect for taxable years ending on or before December 31, 1973 and 1974). The Supreme Court explained:

> The framework for analysis is refined by consideration of the source of the authority to promulgate the regulation at issue. The Commissioner has promulgated Treas. Reg. § 1.1563-1(a)(3) interpreting the statute only under his general authority to "prescribe all needful rules and regulations." 26 U.S.C. § 7805(a). Accordingly, "we owe the interpretation less deference than a regulation issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision."

455 U.S. at 24 (citing Rowan Cos. v. United States, 452 U.S. 247, 253 (1981)). *See* Estate of Boeshore v. Commissioner, 78 T.C. 523 n.5 (1982).

40. The Secretary of Treasury's authority to promulgate interpretative regulations derives from I.R.C. § 7805(a).

its origin, and its purpose."[41] The particular regulation is invalid,[42] to the extent inconsistent with the underlying statute, precisely because the Secretary of the Treasury does not have the authority to usurp the power of Congress by adding to a statute restrictions that are not there.[43]

In looking at the plain language of the statute, one immediately notes that section 164 already contains a definition of a "general sales tax."[44] Normally, an interpretative regulation is most appropriate when the term or phrase it defines is too general.[45] In section 164, the term "general sales tax" has already been defined in the statute itself. If too general, the statutory definition itself may be the proper subject of an interpretative regulation. The statutory definition contained in section 164(b)(2)(A), however, is sufficient and requires no further elaboration or limitation.

The origin of section 164(a)(4) further illustrates that the Treasury Regulation defining a general sales tax as applying only to tangible personal property is inconsistent with the language of the statute. Before 1964, the statute used only the term "sales tax" without the adjective "general" preceding it. At that time the statute defined "sales tax" as a tax "imposed on persons engaged in selling tangible personal property . . . or . . . on persons engaged in furnishing services at retail. . . ."[46] After 1964, Congress dropped all references to tangible personal property and to services. The statutory definition of a general sales tax as a tax imposed at one rate on a broad range of classes of items replaced the previous definition of a sales tax.[47]

The committee reports do not explain the change in terminology in the statute. The committee reports, however, do express a concern for not impairing a state's ability to raise revenues. For example, the House Report states:

> If property and income taxes are to be deductible in computing

41. National Mufflers Dealers Ass'n v. United States, 440 U.S. 472, 477 (1978) (taxpayer sought tax-exempt status under section 501(c)(6) as a "business league" and challenged the validity of Treas. Reg. § 1.501(c)(6)-1; the court upheld the validity of the challenged regulation).

42. *See, e.g.*, United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982).

43. Estate of Boeshore v. Commissioner, 78 T.C. 523 (1982). In *Boeshore*, the Tax Court invalidated Treas. Reg. § 20.2055-2(e)(2)(vi)(e) as it applied to the taxpayer estate. The court stated: "Treasury regulations are entitled to considerable weight; however, respondent [Commissioner of Internal Revenue] may not usurp the authority of Congress by adding restrictions to a statute which are not there." 78 T.C. at 527.

44. I.R.C. § 164(b)(2)(A) states: "The term 'general sales tax' means a tax imposed at one rate in respect of the sale at retail of a broad range of classes of items."

45. Helvering v. Reynolds, 306 U.S. 110, 114 (1939).

46. I.R.C. § 164(c)(2) (1958).

47. The House Report, which contains a table summarizing the revenues of state and local governments, makes it obvious that a general sales tax was meant to include a state's gross receipts tax. The table classifies a gross receipts tax as a general sales tax. H.R. Rep. No. 749, 88th Cong., 1st Sess. 48, *reprinted in* 1964-1 (pt. 2) C.B. 172.

> income subject to Federal income tax, it also becomes important to allow the deduction of general sales taxes as well. These are the three major sources of State and local government revenue, and were the Federal Government to allow the deduction of some but not all of these taxes, it would be encouraging State and local governments to use one or more of the other types of taxes.[48]

Without any other language in the committee reports expressing the reason for the change in terminology, one can conclude that "general sales tax" was intended as a term of broader application than "sales tax," the term it replaced.

The Treasury, in promulgating regulations that restate removed portions of an amended statute, has reversed the intended change made by Congress. The Treasury's overly narrow definition of a "general sales tax" as a "sales tax" imposed only on the sale of tangible personal property, to the exclusion of state and local taxes imposed on the sale of real property or intangible personal property,[49] does not reflect the congressional intent embodied in the legislative history of section 164.

The Treasury's overly narrow definition, however, appears to be a case of inadvertance rather than an attempt to limit the deductibility of the New Mexico gross receipts tax. The drafters of Treasury Regulation section 1.164-3 could not have been aware of the New Mexico gross receipts tax statute because the New Mexico legislature did not enact the statute until 1966.[50] Before 1966, New Mexico had a sales tax that applied only to sales at retail of services or tangible personal property.[51] The Treasury's regulation, at the time it was drafted and as applied to New Mexico's sales tax then in force, in no way diminished or precluded the deductibility of the sales tax. Only after New Mexico enacted the predecessor to its current gross receipts statute did the Treasury's regulation have the potential of limiting the deductibility of the gross receipts tax on the sale of a newly constructed home. Until Revenue Ruling 82-173, the Service administratively had allowed New Mexico taxpayers a deduction for the gross receipts tax paid on the purchase of a newly constructed home. The absence of judicial authority on the question is, therefore, not surprising.

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48. *Id.* at 48-49, *reprinted in* 1964-1 (pt. 2) C.B. 172-73.

49. The reader should note that the regulation might also exclude from the definition of "sales tax" taxes paid on the sale of intangible personal property. The New Mexico gross receipts tax applies to the sale of all property, including licenses, franchises, patents, trademarks, and copyrights, which are all species of intangible personal property. The application of the regulation to these items is illogical and inconsistent with the intended broad scope of the statute. One must further question the soundness of the regulation.

50. Gross Receipts and Compensating Tax Act, 1966 N.M. Laws, ch. 47.

51. N.M. Stat. Ann. §§ 72-16-1 to -47 (Repl. 1961).

In arguing the validity of Treasury Regulation section 1.164-3, the Service has some recent judicial support based on a Tax Court[52] memorandum decision[53] that disallowed a taxpayer's claimed deduction for the Arizona transaction privilege tax imposed on the taxpayer's purchase of a newly constructed home. In reaching its conclusion, the Tax Court found that the Arizona tax was not a tax on tangible personal property[54] nor a tax on a sale at retail.[55] The Tax Court did not address the issue of the validity of the regulation as applied to the taxpayer because the taxpayer failed to raise the issue. Although the Tax Court's decision is distinguishable from the situation in New Mexico,[56] the court based its reasoning and conclusion on the unstated assumption that the regulation's very limited definition of a sales tax was valid.

If Treasury Regulation section 1.164-3 is invalid to the extent it improperly redefines the meaning of "general sales tax" to exclude a gross receipts tax imposed on the sale of real property, then Revenue Ruling 82-173 is also invalid for having relied on a faulty regulation. The literal reading of section 164(a), unencumbered with the narrowing definition of the regulation, allows the new-home buyer to deduct the New Mexico gross receipts tax imposed on the sale of a newly constructed home.

The Revenue Ruling's Application of the Regulation

Because courts are usually hesitant to invalidate a Treasury Regulation,[57] the taxpayer might be more successful in asserting that the Service has incorrectly applied Treasury Regulation section 1.164-3(e) and (f) to the facts in Revenue Ruling 82-173. The taxpayer could argue that the regulation's definition of "sales tax" is illustrative and inclusive, rather than restrictive and exclusive. Language in the regulation supports such a reading. The regulation states that the "term 'sales tax' means a tax imposed upon persons engaged in selling tangible personal property, or upon the consumers of such property. . . ."[58] The next sentence states

52. Karpinski v. Commissioner, 45 T.C.M. (CCH) 589 (1983).

53. The United States Tax Court considers its memorandum decisions as not being controlling precedent. Nico v. Commissioner, 67 T.C. 647, 654 (1977).

54. Treas. Reg. § 1.164-3(e)(1).

55. Treas. Reg. § 1.164-3(f).

56. Under the Arizona statute, the terms "sale" and "sale at retail" have statutory definitions relevant for certain purposes. *See* Ariz. Rev. Stat. Ann. § 42-1301(19) & (20) (Supp. 1982–83). These concepts are not an important part of the New Mexico gross receipts tax and, accordingly, have no statutory definitions. In New Mexico, the sale at retail requirement of the regulation could be satisfied with little difficulty.

57. *See, e.g.*, National Mufflers Dealers Ass'n v. United States, 440 U.S. 472 (1978), and Helvering v. Reynolds, 306 U.S. 110 (1939). See also Northern Natural Gas Co. v. O'Malley, 277 F.2d 128, 134 (8th Cir. 1960), in which the court stated: "In interpreting a regulation, courts will ordinarily avoid a construction which raises doubt as to the validity of the regulation."

58. Treas. Reg. § 1.164-3(e)(1).

that the "term also *includes* a tax imposed on persons engaged in furnishing services. . . ."[59] The use of the verb "includes" demonstrates that the regulation was not intended to limit deductible sales taxes only to the two examples enumerated.

In *General Motors Corp. v. United States*,[60] a case involving a potentially invalid regulation, the court chose to construe the challenged regulation in a way that yielded a result favorable to the taxpayer. General Motors attempted to deduct from gross income amounts it had paid as a dividend tax to the State of Wisconsin. The applicable statute, when read literally, seemed to allow the deduction. The Treasury argued, however, that its regulations, which narrowed the general language of the statute, forbade the deduction. The applicable regulation, as is the case with Treasury Regulation section 1.164-3(e)(1), contained language from a predecessor statute that Congress had repealed and replaced with the statute seemingly allowing the deduction. The court observed that there was "strong internal evidence in the regulations themselves that the variation of language between the statute and regulations was an inadvertance."[61] This observation led the court to conclude that the Treasury did not have "the intent to restrict the effect of the statute. . . ."[62]

The same logic applies to Treasury Regulation section 1.164-3(e)(1), which is a regulation that adopts language dropped from an amended statute. The Service, in Revenue Ruling 82-173, determined that the regulation's definition of the term "sales tax" meant that the term "general sales tax" did not apply to a gross receipts tax imposed on the sale of real property; such a conclusion yields a result that is inconsistent with the plain meaning of the statute. The Internal Revenue Service should not adopt a strained interpretation that produces an inequitable and probably unintended result. A more logical and equitable result follows if Treasury Regulation section 1.164-3(e)(1) is construed to be a definition that is illustrative and not exclusive. Construed in such a fashion, the regulation remains valid, and the taxpayer receives the deduction he is entitled to under the statute.

The Revenue Ruling's Interpretation of New Mexico Law

If Treasury Regulation section 1.164-3 is upheld as valid, Revenue Ruling 82-173 is still subject to attack because of its potentially erroneous interpretation of New Mexico law. The new home buyer seeking to deduct the gross receipts tax could argue that the measure of the New Mexico

59. *Id.* (emphasis added).
60. 283 F.2d 699 (Ct. Cl. 1960).
61. *Id.* at 701.
62. *Id.*

gross receipts tax is the value of the tangible personal property and services added to the raw land. As components of the real property, these items retain their character as tangible personal property and services for state taxing purposes.[63]

In determining the incidence of a general sales tax, the courts have looked to local law.[64] Accordingly, the courts should look to local law to determine if the tax imposed by New Mexico is on real property or on tangible personal property and services. When computing his gross receipts tax, the seller is entitled, by statute, to deduct the value of the real property sold.[65] The deduction does not include "that portion of the receipts from the sale of real property which is attributable to improvements constructed on the real property by the seller in the ordinary course of his construction business. . . ."[66]

To insure that the gross receipts tax is not imposed twice on the sale of the same property or services, the New Mexico statute allows the seller of building materials[67] and construction services[68] to deduct the value of these items in determining gross receipts if the purchaser provides the seller with a nontaxable transaction certificate.[69] To be entitled to a nontaxable transaction certificate, the purchaser of materials or services must later collect the gross receipts tax on the later sale of the construction project property.[70] In this way, the statute measures the gross receipts tax by looking to the value of the real property attributable to the materials and labor added by the builder. Because the gross receipts are measured by the value of the materials and labor that have become part of the real property, arguably the gross receipts tax is imposed on the sale of such materials and labor and not on the sale of the real property.[71] If so, then

63. The Service has recognized the potential for this argument. See G.C.M. 38902 (Oct. 6, 1982), *reprinted in* Federal Taxes: Internal Memoranda of the IRS (P-H) ¶ 278(82) (1982), which states:

> Admittedly, an argument can be made that the New Mexico gross receipts tax is, in substance, a tax on the sale of the component tangible personal property and services that is postponed until such property and services become a part of a final composite piece of tangible property, whether such property and services remain personal or under law have technically become a part of realty.

64. *See, e.g.*, Wise v. Commissioner, 78 T.C. 270 (1982) (Michigan sales tax) and Petty v. Commissioner, 77 T.C. 482 (1981) (North Carolina sales tax).

65. N.M. Stat. Ann. § 7-9-53(A) (Repl. Pamp. 1980).

66. *Id.*

67. N.M. Stat. Ann. § 7-9-51(A) (Repl. Pamp. 1980). *See supra* note 14 for text of § 7-9-51.

68. N.M. Stat. Ann. § 7-9-52(A) (Repl. Pamp. 1980). *See supra* note 16 for text of § 7-9-52.

69. N.M. Stat. Ann. § 7-9-51(B); § 7-9-52(B) (Repl. Pamp. 1980).

70. N.M. Stat. Ann. § 7-9-51(B)(1) & (2); § 7-9-52(B)(1) & (2) (Repl. Pamp. 1980).

71. As a matter of state property law, improvements to real property become real property. *See* Garrison Gen. Tire Serv. v. Montgomery, 75 N.M. 321, 404 P.2d 143 (1965), and Taylor v. Shaw, 48 N.M. 395, 151 P.2d 743 (1944). Whether the New Mexico gross receipts tax statute creates an exception to this rule is an open question. Because the amount of the gross receipts tax remains the same without regard to the classification of the improvements on real property, one should not expect any judicial clarification.

Revenue Ruling 82-173 is invalid because it erroneously concludes that the New Mexico gross receipts tax is imposed on the sale of real property and not on the sale of tangible personal property or services that are a part of the real property.

The Separately Stated Rule

In Revenue Ruling 82-173, the Service did not determine if the facts in situation one satisfied the separately stated rule contained in section 163(b)(5). The separately stated rule allows the purchaser to deduct a general sales tax imposed under state law on the seller if the tax is separately stated and actually paid by the purchaser. This rule of convenience eliminates the need to determine the legal incidence of the tax as on either the seller or purchaser.

If Revenue Ruling 82-173 were attacked as being invalid because Treasury Regulation section 1.164-3 was itself invalid or because the ruling erroneously interpreted New Mexico law, then one might expect the Service to argue that the New Mexico gross receipts tax is not deductible because it does not meet the separately stated rule contained in section 164(b)(5). In other cases involving home purchasers seeking to deduct a general sales tax paid on the purchase of a new home, the Service has asserted non-compliance with the separately stated rule. In each of the cases, the Service argued that the state sales tax was imposed on the transaction between the materials seller and the home builder. As a result, the separately stated rule would operate only to shift the incidence of the general sales tax to the home builder. The tax could not later be shifted to the home buyer simply by billing him for the tax.[72]

The Service has had considerable success in the Tax Court on the separately stated argument.[73] The Service's separately stated argument does not apply to the New Mexico gross receipts tax. The statute itself imposes the gross receipts tax on the sale of the completed home. Therefore, section 164(b)(5) applies, and the home buyer is entitled to treat the tax as if imposed on him.[74] The Service has unofficially conceded this point.[75]

72. *See* Wise v. Commissioner, 78 T.C. 270 (1982) (Michigan sales tax); Petty v. Commissioner, 77 T.C. 482 (1981) (North Carolina sales tax); Armentrout v. Commissioner, 43 T.C. 16 (1964) (Florida sales tax); Belline v. Commissioner, 42 T.C.M. (CCH) 1292 (1981) (Minnesota sales tax); Porter v. Commissioner, 37 T.C.M. (CCH) 1594 (1978) (New York sales tax); Rev. Rul. 58-292, 1958-1 C.B. 106 (North Carolina sales tax).

73. *See* cases cited *supra* note 72.

74. This conclusion follows from the application of the following statutory provisions: N.M. Stat. Ann. § 7-9-4(A) (Cum. Supp. 1982); § 7-9-3(F) (Cum. Supp. 1982); § 7-9-53 (Repl. Pamp. 1980); § 7-9-51 (Repl. Pamp. 1980); § 7-9-52 (Repl. Pamp. 1980).

75. *See* G.C.M. 38902 (Oct. 6, 1982), *reprinted in* Federal Taxes: Internal Memoranda of the IRS (P-H) ¶ 278(82) (1982), which states: "We . . . note that the imposition of the New Mexico gross receipts tax . . . [under the stated facts] is a separately stated tax on the sale of the house . . . and thus such tax is imposed on the sales transaction that involves . . . [the purchaser] directly."

CONCLUSION

New Mexico's gross receipts tax is unique to the extent it applies to sales of real property and intangible personal property. Most other states have sales taxes that impose a tax only on the privilege of selling tangible personal property or services. For the other states, the regulation's definition of a general sales tax as a tax on sales that do not include real property is of little importance because those states do not impose a sales tax on real property. For New Mexico home buyers, the Service has attempted to deny a deduction for a general sales tax imposed by state law. The Service's overly restrictive reading of section 164(a)(4) is contrary to the congressional intent behind the statute. Revenue Ruling 82-173 is erroneous because it relies on a regulation that exceeds the scope of the statute by attempting to limit the meaning of "general sales tax," a term that the statute adequately defines.