NEBRASKA INCOME TAX: AUDITING, ASSESSMENT AND APPELLATE PROCEDURES

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The broad scope of the subject matter intended to be covered by this article, admittedly only by a broad brush, may be introduced by an equally broad generalization, to wit: One who has a working knowledge of auditing, assessment, and appellate procedures under the Federal Internal Revenue Code will find little that is new or surprising in the procedural sections of the Nebraska Revenue Act of 1967.[1]

One may well question at the outset the significance of the auditing, assessment, and appellate procedures of the Act to the average Nebraska taxpayer. If the state income tax is to be little more than a percentage of the federal tax, then the federal tax becomes the *sine qua non* upon which the Nebraska tax will rise or fall, and there would appear to be little cause for concern about the state procedural provisions. The answer appears to be that while a taxpayer is suffering the agony of a federal tax audit and proposed adjustments to his federal tax liability, he may well receive a notice from the Nebraska tax commissioner proposing similar adjustments to his state tax liability. It is at this stage, while the federal tax liability is still an open question, that the taxpayer or his representative will be well advised to know the appellate channels available to prevent the state notice from becoming a final assessment.

In dealing with an unknown quantity, such as a new law and new procedures, one may perhaps obtain a quicker comprehension of the subject by relating it to or identifying it with a familiar subject. Therefore, assuming that the reader has at least a casual acquaintance with the auditing and appellate procedures under the Federal Internal Revenue Code, a comparative chart of the procedural processes under the two tax systems appears appropriate. Set forth below is a chart demonstrating the parallel courses which a typical tax case would follow under the two systems. It is the intent of this article to pursue such a tax case through its Nebraska channels.

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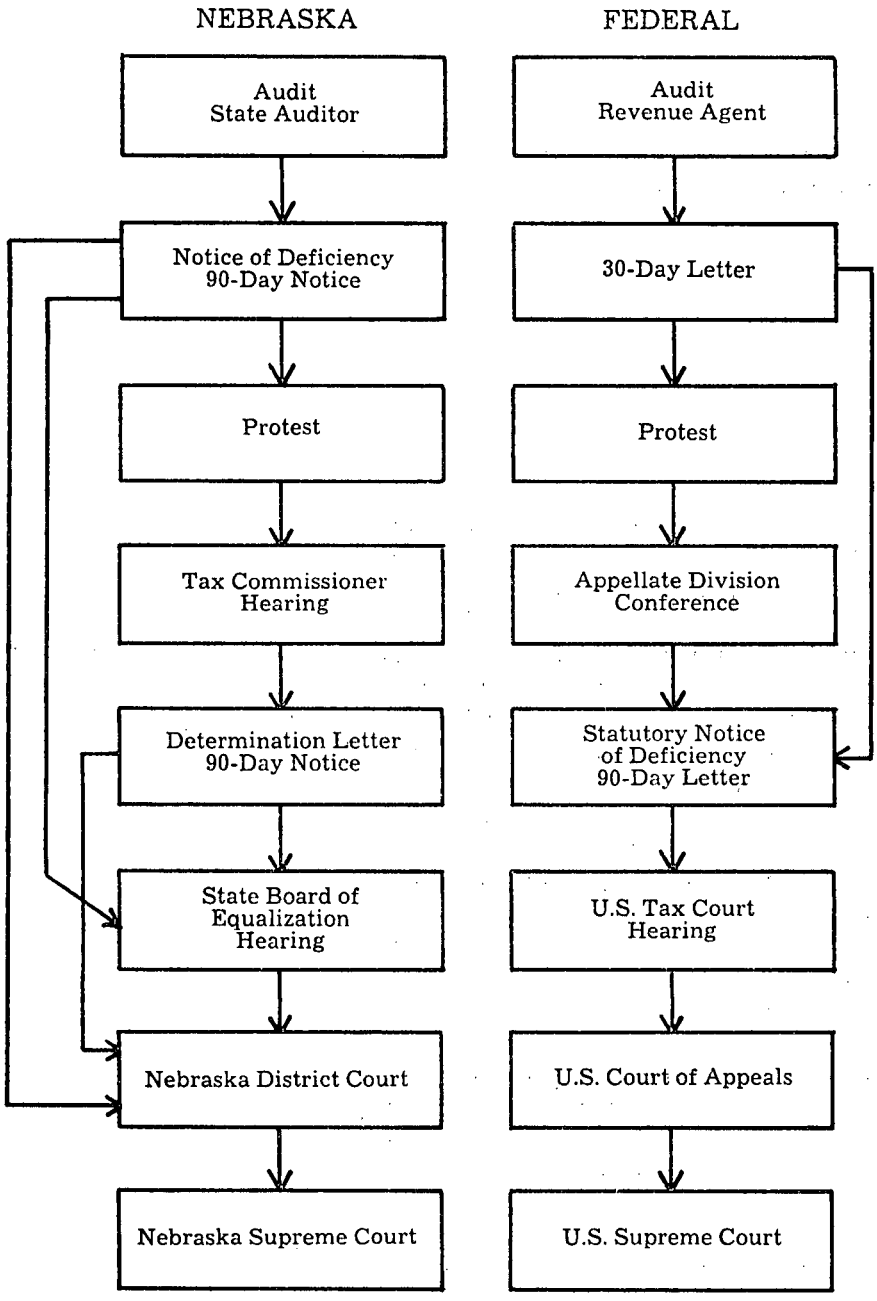
1. Neb. Laws 1967, c. 487. *See also* NEB. REV. STAT. § 77-2701 to -27,135 (Supp. 1967).

TAX CASE ROUTES



The fountainhead of all tax audit activity flows from the filing of a tax return, or from the failure to file a required tax return. Section 77-2776 of the Act provides quite succinctly in part: "As soon as practical after an income tax return is filed, the Tax Commissioner shall examine it to determine the correct amount of tax."[2]

Similarly, in the case of a Rip van Winkle who has slumbered through the filing period, this same section further provides: "If the taxpayer fails to file an income tax return, the Tax Commissioner shall estimate the taxpayer's tax liability from any available information . . . ."[3]

The tax commissioner, having examined the return as directed, and having found it *not* to be correct, is required by section 77-2776 to send the taxpayer a notice of deficiency setting forth his proposed tax adjustments. In the words of the statute:

> (1) [H]e shall notify the taxpayer of the amount of the deficiency proposed to be assessed.
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> * * *
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> (3) A notice of deficiency shall set forth the reason of the proposed assessment.[4]

This statutory notice of proposed tax deficiency must be sent by either registered or certified mail. There is some language in the section which appears to make the use of certified or registered mail permissive on the part of the tax commissioner,[5] but a later section dispells any doubt:

> Whenever any notice required to be given by the Tax Commissioner under the provisions of Sections 77-2701 to 77-27,135 may be given by mail, it shall be given by either registered or certified mail, return receipt requested, and not otherwise.[6]

Thus, the Nebraska notice procedure is considerably more formal than the federal procedure, where a number of the earlier notices, such as the so-called 10-day letters, 15-day letters, and 30-day letters, are all sent by regular mail. Perhaps the Nebraska tax commissioner is more affluent than the Federal Commissioner of Internal Revenue, or perhaps the Nebraska Legislature feels that the federal postal system needs the money. In any event, *all* notices from the tax commissioner must be sent by either registered or certified mail.

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2. NEB. REV. STAT. § 77-2776(1) (Supp. 1967).
3. NEB. REV. STAT. § 77-2776(2) (Supp. 1967).
4. NEB. REV. STAT. § 77-2776(1), (3) (Supp. 1967).
5. NEB. REV. STAT. § 77-2776(3): "The notice may be mailed by certified or registered mail to the taxpayer at his last-known address."
6. NEB. REV. STAT. § 77-27,135 (Supp. 1967).

Having introduced the tax commissioner and his basic audit function, it is appropriate to digress briefly to examine the commissioner's office and the personnel with which he hopes to perform the audit and appellate functions. Section 77-27,119 authorizes the commissioner to designate agents to assist him in his audit functions. It further authorizes him to divide the state into districts in which branch offices may be maintained. Also, even prior to the adoption of the Nebraska Revenue Act of 1967, the commissioner had been given the power to establish agencies and bureaus to administer the tax laws of the state.[7]

The director of the income tax division in the tax commissioner's office has advised the writer that the commissioner intends to have only two offices, one in Lincoln and one in Omaha. Each of these will have both office auditors and field men, comparable to the federal system with its office auditors and revenue agents. In the case of the Nebraska state auditors, however, when they call on a taxpayer, they will audit not only his income tax returns, but his sales tax returns as well—assuming the taxpayer is a business man subject to sales tax return filings. The state auditors on their circuit rides across the state may also act as troubleshooters in collecting delinquent accounts and attending to similar matters.

The director of the income tax division also advises that the tax commissioner does not plan to have a separate conference staff to conduct taxpayer appeal hearings. All hearings will be conducted by the tax commissioner himself, by the director of the income tax division, or by the chief accountant in the income tax division. It was also mentioned that a member of the commissioner's legal staff, which presently consists of four attorneys, may assist in such hearings. Whether or not the commissioner and his personal staff will be able to handle the conference work by themselves will depend, of course, upon the volume of taxpayer appeals. It would appear, however, that the time may come when a conference staff, or interim level of tax personnel between the auditor and the commissioner, will be not only desirable but an absolute necessity.

Perhaps the keystone to the entire audit procedure under our state system is contained in section 77-2775 of the Act which provides in pertinent part as follows:

> If the amount of a taxpayer's federal tax liability reported on his federal income tax return for any taxable year is changed or corrected by the Internal Revenue Service or

7. NEB. REV. STAT. § 77-326 (Reissue 1966).

> other competent authority . . . the taxpayer shall report such change or correction in federal tax liability within ninety days after the final determination of such change, correction, or renegotiation and shall concede the accuracy of such determination or state wherein it is erroneous.[8]

This provision, plus the fact that the Internal Revenue Service and the tax commissioner have by agreement provided for the mutual exchange of information,[9] means that any tax deficiency determined with reference to a taxpayer's federal income tax return will almost automatically mean that a determination of a state income tax deficiency will follow. The commissioner is further fortified in this regard in that evidence of a federal tax determination is admissible as evidence in a state tax matter.[10]

Two conclusions may logically be drawn from these audit provisions. First, most of the auditing activity of the tax commissioner's office will be in the nature of followups to federal audits—which would appear to be the most practical and expedient use of audit manpower. Second, one may well conclude that for all practical purposes, when the taxpayer is contesting or conceding adjustments in federal tax liability, he is at the same time contesting or conceding comparable adjustments in state income tax liability. The two go hand in hand and certainly will tend to rise and fall together.

The exact stage at which the Internal Revenue Service, in its audit of a taxpayer's federal income tax return, will make its information available to the state tax commissioner does not appear to have been established as yet. It appears, however, that if a federal audit results in an agreed case at either the director's office or the appellate division level, and a waiver is signed by the taxpayer, the Internal Revenue Service will then furnish the commissioner with a summary of the audit. In the event of an unagreed case in the federal audit, where the Internal Revenue Service is required to issue a statutory notice of deficiency (90-day letter), a copy of such notice will probably be furnished to the commissioner, notwithstanding that the federal tax case is obviously not concluded.

If the taxpayer has conceded the federal adjustments and signed a waiver leading to an immediate federal assessment, it is likely that he will concede to the corresponding state tax adjustments, which will cost him only a fractional amount of the

8. NEB. REV. STAT. § 77-2775 (Supp. 1967).
9. NEB. REV. STAT. § 77-324 (Reissue 1966) authorizes agreements with federal agencies.
10. NEB. REV. STAT. § 77-2782 (Supp. 1967).

federal concession. However, if the taxpayer decides to litigate all or a part of the federal tax adjustments, either through the Tax Court or through a claim for refund in a federal district court (or Court of Claims), it is equally probable that he will likewise wish to contest the state adjustments. At a minimum, he will wish to defer any final state tax determination until after a final determination of the federal tax question has been made. This, then, brings us back to the state appellate procedures which will prevent the state notice[11] from becoming a final assessment.

When the taxpayer receives the section 77-2776 notice of proposed tax deficiency from the tax commissioner, he appears to have three choices. First, he may, if he wishes, file a written protest with the commissioner and ask for a conference in the commissioner's office.[12] Second, he may bypass the commissioner and file an appeal directly with the State Board of Equalization and Assessment.[13] Finally, the statute indicates that the taxpayer may be able to appeal the section 77-2776 notice directly to district court. The questionable language on this last alternative reads as follows:

> Any final action of the Tax Commissioner, if the person aggrieved thereby elects not to appeal first to the State Board of Equalization and Assessment, shall be subject to judicial review as provided in Section 84-917 to 84-919, as though it were a final decision of the State Board of Equalization and Assessment.[14]

The key phrase, which gives rise to the doubt, is "final action." Does a section 77-2776 notice constitute a "final action" of the tax commissioner within the meaning of the above-quoted section, or does that section refer to the commissioner's notice under section 77-2779, which is mailed after a hearing on the taxpayer's protest? Since section 77-2777 provides that the section 77-2776 notice "shall constitute a final assessment" unless the taxpayer files a protest with the commissioner, the writer believes that a section 77-2776 notice may well constitute a "final action" of the commissioner, entitling the taxpayer to appeal directly to district court. If the commissioner's notice is capable of being a "final assessment," it would seem to qualify as a "final action of the Tax Commissioner" for purposes of the appeal.

The tax commissioner's interpretation of the above quoted section as to whether a taxpayer may appeal directly from a section 77-2776 notice to the district court is not presently known, since the

11. NEB. REV. STAT. § 77-2776 (Supp. 1967).
12. NEB. REV. STAT. § 77-2778 (Supp. 1967).
13. NEB. REV. STAT. § 77-27,126 (Supp. 1967).
14. NEB. REV. STAT. § 77-27,127 (Supp. 1967).

Regulations have not been issued on the section at this writing. Until the present doubt has been removed, however, it would seem advisable not to jeopardize the appellate rights by attempting a direct appeal of this type.

In any event if the taxpayer wishes to exhaust *all* of his appellate procedural rights, he must file a written protest in the commissioner's office within 90 days after the receipt of a section 77-2776 notice.[15] The protest must set forth the tax adjustments being protested and the grounds upon which the protest is made; and, as in a federal protest, it must also request an oral conference if such conference is desired. The commissioner will then grant the taxpayer or his representative a conference in either the Lincoln or Omaha office. Facts and arguments submitted by the taxpayer will be considered by the commissioner, after which the commissioner's determination will be mailed to the taxpayer.[16] This statutory notice, comparable to the federal statutory notice of deficiency (90-day letter), must set forth the commissioner's findings of fact and the basis of his decision on adjustments decided adversely to the taxpayer.

After he has received the section 77-2779 notice, the taxpayer's appellate choices are narrowed to appealing to the State Board of Equalization and Assessment or to the district court. Again assuming that all remedies are to be pursued, the state board route will be discussed. Section 77-2780 provides that the tax commissioner's section 77-2779 notice becomes final unless the taxpayer seeks review within *90* days. However, it should be noted that section 77-27,126, relating to the right of appeal to the State Board of Equalization and Assessment, provides in pertinent part as follows:

> An appeal may be taken to the State Board of Equalization and Assessment from any finding, ruling, order, decision, determination or other final action of the Tax Commissioner by any person aggrieved thereby. Notice of such appeal shall be filed with the secretary of the board within *thirty* days after the date of mailing notice of the Tax Commissioner's action to the person aggrieved.[17]

Thus section 77-2780 gives the taxpayer 90 days within which to appeal the section 77-2779 notice of tax determination, whereas section 77-27,126 provides that notice of appeal must be filed within 30 days. A statutory amendment to correct this apparent inconsistency would seem to be in order.

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15. NEB. REV. STAT. § 77-2778 (Supp. 1967).
16. NEB. REV. STAT. § 77-2779 (Supp. 1967).
17. NEB. REV. STAT. § 77-27,126 (Supp. 1967) (emphasis added).

Proceedings before the State Board of Equalization and Assessment are governed by the statutory rules relating to administrative agencies.[18] The board of equalization has issued its own rules of procedure, but they were issued prior to the enactment of the 1967 Nebraska Revenue Act and are not designed for income tax appeals. It is possible that the board will see fit to issue new rules or supplemental rules comparable to the rules of procedure issued by the United States Tax Court, which would be considerably more helpful to taxpayers and tax practitioners.

The present statutory provisions regarding income tax hearings before the State Board of Equalization and Assessment do not appear to be either adequate or practical. There is, for example, no provision which would permit such hearings to be held by less than a quorum of the board,[19] or by hearing examiners appointed by the board. The state board is a five-man board consisting of the Governor, the secretary of state, the state treasurer, the state auditor, and the tax commissioner.[20] The practicality of having these state officers sit from time to time, for a half day or a full day, to listen to a parade of witnesses in an income tax case involving a nominal dollar amount, such as an irate taxpayer appealing the disallowance of a dependency credit, appears dubious to say the least. Also, it may not be equitable in a small tax case to require a taxpayer in Western Nebraska to travel to Lincoln to have his appeal heard. At the same time, if the appeal must be heard by the above-mentioned state officers sitting as the board of equalization, it is apparent that they may not be expected to ride circuit around the state.

Income tax justice, if justice it be, may be swifter in Nebraska than on the federal level. Section 77-27,126 provides that the state board shall hear the appeal within 90 days after notice of the appeal is filed, and the statute further provides that the board shall render its decision within 30 days after the hearing. This would be considerably faster than in the United States Tax Court where it frequently takes a year from the filing of the petition to the hearing, and another year until the decision is entered.

The State Board of Equalization and Assessment hearing exhausts the taxpayer's administrative remedies. An adverse decision at this stage leaves only an appeal to a state district court.[21]

18. NEB. REV. STAT. §§ 84-901 to -919 (Reissue 1966).

19. NEB. REV. STAT. § 77-501 (Reissue 1966) provides that three members shall constitute a quorum.

20. NEB. REV. STAT. § 77-501 (Reissue 1966).

21. NEB. REV. STAT. § 77-27,127 (Supp. 1967) authorizes such an appeal. *See also* NEB. REV. STAT. § 84-917 (Reissue 1966), regarding appeals from administrative agencies in general.

If appeal is to be taken to district court, the petition must be filed within 30 days of the board's decision. It is important to note here that the statute provides:

> Proceedings for review shall be instituted by filing a petition in the district court of the county where the action is taken within thirty days after the service of the final decision of the agency.[22]

Since, insofar as the writer has been able to determine, the State Board of Equalization and Assessment sits only in Lincoln, and it does not appear likely that its members will become circuit riders, the present statutory provisions would require all income tax cases to be tried in the District Court of Lancaster County, which would appear to be the only county where "the action is taken" within the meaning of the statute. Perhaps the district court judges of Lancaster County will suggest some statutory changes in this regard. A more practical approach would appear to be that contained in the statutory language relating to the litigating of income tax refund claims. In such cases the suit may be filed either in Lancaster County or in the county where the taxpayer resides.[23]

An income tax case is tried in district court de novo without a jury.[24] Either party may appeal the court's decision to the Nebraska Supreme Court, where the appeal is "de novo on the record."[25] Presumably this means that the Supreme Court must review the entire record of the trial court from which it must make its own findings of fact without regard to the factual conclusions reached by the trial court—a sizable task in a case involving multiple tax issues which may be of some complexity.

A few general comments about the Nebraska audit and appellate procedure appear in order. First, it may be noted that the statute of limitation provisions on audit assessments are comparable to the federal provisions. The general rule is that no deficiency may be assessed unless the notice relating thereto was mailed within three years after the return was filed; if the gross income was understated on the return in excess of 25 percent, the period is six years; and if the return is fraudulent, or no return was filed, the notice of tax decifiency may be mailed at any time.[26] Additionally, if the taxpayer fails to report a change in his federal tax liability, as required by section 77-2775 of the Act, the notice of

22. NEB. REV. STAT. § 84-917 (Reissue 1966).
23. NEB. REV. STAT. § 77-2798 (Supp. 1967).
24. NEB. REV. STAT. § 84-917(5) (Reissue 1966).
25. NEB. REV. STAT. § 84-918 (Reissue 1966).
26. NEB. REV. STAT. § 77-2786 (Supp. 1967).

deficiency may be mailed at any time.[27] If such change is reported, the notice may be mailed within two years thereafter.[28] The tax commissioner and the taxpayer may agree in writing to extend the statutory period.[29]

The tax commissioner has subpoena power over both the taxpayer and third-party witnesses.[30] The taxpayer has the burden of proof in proceedings before the tax commissioner, with the exceptions of fraud cases, transferee cases, and increased deficiencies after the mailing of the original notice.[31] It is suggested, however, that these exceptions may be somewhat meaningless since the person deciding whether or not the burden of proof has been met in such situations is the party having the burden—namely the tax commissioner himself. The possibility of the commissioner determining that he himself has not met the burden of proof seems extremely remote to the writer, especially since the point would not appear to be subject to appeal, inasmuch as the tax cases are in effect heard de novo at both the State Board of Equalization and Assessment level and in any court proceeding.

Sections 77-2778 and 77-2795, relating to hearings before the tax commissioner, refer to the taxpayer "or his authorized representative." Such authorized representative is not otherwise identified or defined in the Act, and thus it is not known if the term is intended to include nonlawyers. However, it does appear that the Act makes no provision for nonlawyers to represent taxpayers before the State Board of Equalization and Assessment or in court proceedings involving income tax cases. The Nebraska Supreme Court has ruled that taxpayers may not be represented by nonlawyers in a proceedings before the State Railway Commission, since participation in such a hearing constitutes the practice of law.[32] Presumably the same rule would apply to a similar administrative agency such as the State Board of Equalization and Assessment, in the absence of a statutory provision to the contrary. The merit of permitting certified public accountants or other nonlawyers to handle tax cases before administrative agencies or in the courts is not within the scope of this article. It is sufficient to note here that the legislature to date has not seen fit to change the Nebraska law on the subject with reference to its particular application to the field of tax law.

27. NEB. REV. STAT. § 77-2786(4) (Supp. 1967).
28. NEB. REV. STAT. § 77-2786(5) (Supp. 1967).
29. NEB. REV. STAT. § 77-2786(6) (Supp. 1967).
30. NEB. REV. STAT. § 77-27,119(3) (Supp. 1967).
31. NEB. REV. STAT. § 77-2781 (Supp. 1967).
32. State *ex rel.* Johnson v. Childe, 147 Neb. 527, 23 N.W.2d 720 (1946).

In conclusion it may be observed that our state income tax auditing and appellate procedures are modeled largely on the federal system, and, more importantly, the state tax audits undoubtedly will be, in most instances, carbon copies of federal tax audits. The procedures and concepts appear for the most part to be both workable and expedient. In the limited areas where inconsistencies and problems may exist, the test of time and experience, plus the amendatory power of the legislature, should function to reduce such problems to an acceptable minimum.