

# Nebraska Revenue Department's Audit and Examination Powers Discussed

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## Introduction

The Nebraska Department of Revenue (Department) has audited and examined Nebraska individual income tax returns (returns) and made adjustments to the returns since the income tax was adopted more than 40 years ago. When errors are discovered, the Department informs the taxpayer of the adjustments by issuing either a balance due notice, if the adjustment corrects a mathematical error; or a proposed notice of deficiency determination, if it is not.

Recently, some tax preparers have questioned the Department's authority to audit or examine federal return information shown on Nebraska individual income tax returns. This article examines the legal underpinning of the Department's authority to examine all aspects of a return, including federal items, and make whatever adjustments are necessary to reach the correct result.

## The Nebraska Income Tax

The Nebraska income tax is based upon federal law and uses several items and calculations under federal law to determine Nebraska income tax liability. These statutes direct the Department to administer and enforce the Nebraska income tax consistent with both state and federal law.

This conclusion is compelled by the authorization provided in Neb. Const. art. VIII, § 1B (1966) as follows: "When an income tax is adopted by the Legislature, the Legislature may adopt an income tax law based upon the laws of the United States." Note that the constitutional provision allows the income tax to be based upon the laws of the United States. This is precisely what the Legislature did when it enacted Neb. Rev. Stat. § 77-2714 stating: Any term used in sections 77-2714 to 77-27,123 shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes, unless a different meaning is clearly required. Any reference to the laws of the United States shall mean the provisions of the Internal Revenue Code of 1986, and amendments thereto, other provisions of the laws of the United States relating to federal income taxes, and the rules and regulations issued under such laws, as the same may be or become effective, at any time or from time to time, for the taxable year.

Furthermore, in *Anderson v. Tiemann*, 182 Neb. 393, 155 N.W. 2d 322 (1967), the Nebraska Supreme Court, in upholding the Nebraska income tax against a constitutional challenge, declared "[t]he laws of the United States adopted by reference in L.B. 377 include the Internal Revenue Code, Regulations of the Internal Revenue Department, and court decisions interpreting them."

No mention is made of the federal return or any item on it. What the Legislature incorporated into the Nebraska income tax was the laws of the United States, not federal adjusted gross income, taxable income, or any other item reported on the federal return.

Under the Constitution and statutes of Nebraska, the Department has a legal obligation to administer the income tax consistent with the laws of the United States. This obligation cannot be satisfied by accepting self-reported amounts or ignoring omissions on a federal return that are inconsistent with the whole of federal law.

## **Enforcement Powers of the Department**

The Nebraska Legislature has granted broad statutory powers and duties to the Department to obtain and examine any financial records of taxpayers, examine returns, and determine if the amounts are correct. For example, Neb. Rev. Stat. § 77-376 allows the Department, and its employees the power to examine and copy “any of the financial records of . . . persons . . . subject to the tax laws of this state.” Neb. Rev. Stat. § 77-375 provides that any agent of the Department may “require the production of records as may be necessary for the performance of his or her responsibilities under the applicable state law.” These powers exist without limitation as to the source or nature of the records, or the item on the return to which they apply.

In addition to these general powers to obtain and examine any financial records of taxpayers, the income tax statutes specifically require the Department to examine returns to determine if the amounts reported are correct. Neb. Rev. Stat. § 77-2783, grants the Department authority to correct mathematical errors, and Neb. Rev. Stat. § 77-2776 provides that: As soon as practical after an income tax return is filed, the Tax Commissioner shall examine it to determine the correct amount of tax. If the Tax Commissioner finds that the amount of tax shown on the return is less than the correct amount, he or she shall notify the taxpayer of the amount of the deficiency proposed to be assessed.

As can be seen, neither of these sections limit in any way the Department’s authority to correct anything that may be in error, whether the error was made on the Nebraska income tax return itself or on anything else that determines “if the amounts are correct,” including items reported or omitted on the federal return.

Other states with statutory language similar to Nebraska’s have reached the same conclusion. In the New York case, *In the Matter of the Petitions of William G. Halby*, 821494; 821810, New York Division of Tax Appeals, Administrative Law Judge Determination (2008), the taxpayer, a New York tax attorney, argued that the “Division may not disallow his claimed itemized deductions which were based upon the deductions claimed on his federal income tax returns in the absence of a determination by the Internal Revenue Service disallowing such deductions.” The court stated: “The statutory provision clearly enables the Division to conduct independent audits of any return or person in order to ascertain whether respective filed returns are correct. The Division is not compelled to accept petitioner’s itemized deductions as set forth on the relevant federal returns because the IRS did not conduct its own audit. This argument is rejected.”

See also *Ronald A. Richards v. Department of Revenue*, TC-MD 111239D Oregon Tax Court (2012), and *Ruling of the Tax Commissioner 12-93*, Commonwealth of Virginia (2012).

## **Conclusion**

It is clear, based on the constitutional and statutory provisions which adopted the Nebraska income tax, and case law in other states, that the Department has the authority to examine any item on the federal return and adjust it, so that it complies with the Internal Revenue Code, Treasury Regulations, case law, and any other authority governing federal tax law.

The lesson of this article is that tax preparers need to be aware of this and counsel their clients appropriately. At the same time you inform your client about the powers of the IRS to examine and adjust items on the federal return; you should also advise them that the Nebraska Department of Revenue may be examining and adjusting those same items.