

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

MID CITY STEREO, INC., a Nebraska Corporation,)
LANCASTER COUNTY) Docket 551
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)
) Appellant, CLERK OF
) DISTRICT COURT

v.)

ORDER

)
) NEBRASKA DEPARTMENT OF
) REVENUE, M. BERRI BALKA, STATE
) TAX COMMISSIONER, and STATE OF
) NEBRASKA,
)

)
) Appellees.)

This is an appeal from a decision of the State Tax Commissioner (the Commissioner) rendered on January 2, 1997, sustaining deficiency assessments made by the Nebraska Department of Revenue (the department), brought under the Nebraska Administrative Procedure Act. NEB.REV.STAT. §§ 84-901 through 920 (Reissue 1994, as amended). Accordingly, review is conducted by the court, without a jury, de novo on the record presented to the Commissioner's designated hearing officer. NEB. REV. STAT. § 84-917(5)(a) (Reissue 1994). The record consists of the transcript and the bill of exceptions of the proceedings before the hearing officer. *Slack Nursing Home v. Department of Social Services*, 247 Neb. 452, 528 N.W.2d 285 (1995).

In reviewing the evidence, the court reaches conclusions independent of those of the Commissioner. Where credible evidence is in conflict on a material issue of fact, however, the court gives weight to the fact the hearing officer heard and observed the witnesses and accepted one version of the facts rather than another. *Dieter v. State*, 228 Neb. 368, 422 N.W.2d 560 (1988). Also, the court keeps in mind that "[a] rebuttable presumption of validity attaches to the actions of administrative agencies. The burden of proof rests with the party challenging the agency's actions." *Wagoner v. Central Platte Natural Resources District*, 247 Neb. 233, 236, 526 N.W.2d 422, 425 (1995).

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Statement of the Case

In the Commissioner's order, the deficiency assessments issued against Mid City Stereo, Inc., (Mid City) by the Department for sales and consumer use taxes in the amount of \$138,850.00, inclusive of penalties and interest, were upheld. First, the Commissioner found the most credible source to establish the gross receipts of the business and, therefore, the amount of sales tax due during the audit period, was the computer-generated general ledger. The Commissioner also found Mid City failed to provide credible evidence supporting its position it paid taxes on certain computer software, carpet, tile and a video display unit. (The issue of withholding taxes was not disputed by Mid City and, therefore, was not discussed in the Commissioner's order.)

Statement of Facts

Mid City is owned and operated by Doug and Twyla Speidel. It is located in Norfolk, Nebraska, and retails furniture, appliances, stereo equipment, electronics, carpet, and other related items.

Mid City was informed in August 1991 the department intended to audit the business, concerning its Nebraska sales, use, withholding and corporate income taxes. Sales taxes were to be reviewed from December 1, 1988, through November 30, 1991; use taxes from December 1, 1986, through November 30, 1991; and withholding taxes for 1990, 1991 and January 1992. After rescheduling several times, the audit started on January 6, 1992.

The audit was conducted by Nikki Elwood (Elwood), one of the supervisors for the department. Prior to the audit, Mid City was given a list of records needed during the audit, including sales journals and invoices and/or *daily sales reports*, and was also told additional records may be required during the audit. The audit team followed standard department procedures in conducting the audit and reviewed Mid City's sales invoices, depreciation schedules, cash receipts, cash disbursements and withholding journals.

A sales tax program was performed in relation to Mid City, testing the reliability of the Nebraska sales tax return itself. When asked, Elwood was told that, in order to keep track of the sales tax, the daily sales that accumulated on the daily cash register tapes were added together at the end of the month. It was presumed that, from this, sales tax was calculated. In order to test the sales tax returns, three random months' worth of sales invoices were reviewed. The sales tax on the monthly totals was calculated and compared to what had been entered on the sales tax return forms (Form 10's). The result of this initial test was that the sales tax collected as per the sales invoices was substantially higher than what was reported on the Form 10's. In order to further verify the Form 10's, by making sure all the invoices and sales were being reviewed, the gross sales from the computer-generated general ledger were compared with the gross sales reported on the federal income tax return Form 1120 and the two numbers compared favorably. When the Form 1120 gross sales were compared with the Form 10 gross sales, however, an approximate \$1,200,000 deficiency was discovered.

The audit team was not informed any other information was used in preparing the Form 10's, until February 1996, when the 13-column worksheets, called "green sheets" or "backups," were presented by Twyla Speidel. There is no indication in the record of how or why these sheets were finally given to the auditors, but Elwood testified that, when initially asking for backup documentation to the Form 10's, she was told none existed. At any rate, Twyla Speidel explained to Elwood how the green sheets worked (i.e., by taking the cash sales column, plus the charge sales column, subtracting the received on accounts and sales tax payable columns and then adding the stereo/tax column.) Upon doing an initial test of four months' worth of the green sheets, according to the instructions provided by Twyla Speidel, Elwood found the gross sales figures matched those represented on the Form 10's. After testing the remaining sheets at a later date, however, the auditors determined the green sheets did *not* tie to the Form 10's and, in fact, gross sales were

approximately \$650,000 higher according to the green sheets than on the Form 10's.

Additional problems were uncovered concerning the green sheets. For example, a period of six months' worth of green sheets, from July to December 1990, is missing. Also, the green sheets were done, apparently, for only two out of the three cash registers in the store. Elwood was told Rod Zwygart (Zwycart), Mid City's CPA, was making these adjustments, for the third register, manually, to include them in the Form 10's.

According to standard audit procedures, the audit team also examined the general ledger, in particular the sales and sales tax payable accounts. The team concluded that all the credits, or money flowing into the sales tax payable account, were proper and that most of the subtractions, for example returns, canceled layaway and tax payments, were fine, too. It discovered, however, several large, sporadic debits to the account, which appeared to be transferred into a sales or miscellaneous income type of account, without any explanation in the ledger, except for the notations "Rod's Adj.", "CPA Adj." or "Rod." When asked for backup documentation or explanation for why the adjustments were made, Zwycart said only that they were to balance what was owed the state and that no backup existed. It was not until his deposition that he stated the reason for the adjustments was to account for unapproved finance sales. (A copy of the deposition is not part of the record.) Regardless, no information was ever provided to the auditors concerning customer names, merchandise purchased or date of disapproval to tie in with the amounts subtracted from the sales tax account. Furthermore, there were no corresponding adjustments made to the sales or accounts receivable accounts, which you would expect to see as a good accounting practice. Perhaps most curious, though, is there were debits made to "furniture" or "miscellaneous" accounts, but they were in the *amount of the sales tax debits* and not in the amount of what the corresponding sale price would have been.

The department also found, during the course of its audit, a number of items on which Mid City apparently had not paid sales or use tax. These included computer

software, carpet, tile, paint and a video display. At the hearing before the hearing officer, Mid City produced letters from the various companies from which these items were purchased, which all show Mid City paid the applicable sales taxes.

Discussion

Mid City has offered more than one reason why the sales tax assessment against it should be reversed. First, it asserts it was wrong for the department to rely on the computer-generated general ledger in the audit, because it was completely inaccurate, due to faulty computer software. Instead, Mid City argues its 13-column worksheets or "green sheets" should be used, because they broke down daily sales information into specific categories and were made directly from the cash register tapes. Even if the green sheets are not used, Mid City argues the assessments should be reversed, because the "adjustments" to the sales tax payable account on the general ledger represented turned-down credit sales which were never backed out of the computer. In other words, the sales in the computer, and hence general ledger, were overstated. In regards to the use tax issue, Mid City states the letters from the companies provide conclusive and uncontroverted proof taxes were paid on all items purchased.

1. Sales Tax

Mid City argues the general ledger was completely inaccurate, due to faulty computer software. Therefore, it concludes, it was error for the department to rely on the general ledger in calculating the sales tax deficiency. There are a number of problems with this argument.

First, Mid City never presented any detailed evidence on what exactly the problems with the software were nor was it sufficiently explained why Mid City continued using the software for at least five years, when it knew the software was not performing correctly. Paula Berry (Berry), Mid City's bookkeeper, stated the whole system was "just a mess," when she started in 1990, and that Mid City was still using the software program when she

left in 1995. Even though Berry explained the reason Mid City continued to use the software was to be able to track inventory, she also testified even that part of the program was defective.

Moreover, it was never explained why, if Zwygart had more confidence in the daily green sheets than the computer ledger, he nonetheless used the printout information in preparing the Form 1120's, as testified to by Twyla Speidel and by Zwygart himself. Another fact which suggests the computer-generated ledger was accurate is it was also relied on to secure a bank loan for construction of the new building in which Mid City is currently located. Also, it is difficult to understand why Mid City would have presented the ledger at the beginning of the audit, especially without indicating to the auditors there were problems with the software which generated it, if the ledger was indeed as inaccurate as Mid City now claims.

Perhaps the most troubling issue is the large, sporadic debits made to the sales tax payable account by Zwygart. As stated earlier, Zwygart originally told Elwood the debits were made to balance what was owed to the state and there was no backup documentation. It was not until Zwygart's deposition that he stated the adjustments were made to account for unapproved finance sales that were never backed out of the computer system. Even though this is a logical explanation (Berry testified finance sales were booked immediately on the computer, but were not recorded on the green sheets until they were actually approved), the fact the auditors were never provided any information on customer names, merchandise purchased or dates of disapproval with which to verify the amounts of the adjustments causes the court concern. What is even more puzzling is there were no corresponding debits made to sales or accounts receivable columns, which you would expect to see as good accounting practice. While there were credits made to "furniture" and "miscellaneous" columns, they were in the *amount of the sales tax debits*, not the amount of what the actual sales price would have been. The above tend to persuade the

court the general ledger was indeed an accurate document and the adjustments made to the sales tax accounts are not supported by the evidence.

Even if the court concludes the computer ledger was faulty and could not be relied on in calculating any sales tax deficiencies, Mid City is still not in the clear. Mid City argues the 13 column green sheets were the most reliable source documents and should have been used instead of the ledger; however, there are also a number of problems concerning the reliability and credibility of the green sheets.

According to Elwood, even the green sheets did not match up to the sales tax figures reported on the Form 10's, when compared to the sales invoices. Mid City attempts to explain this difference by claiming the department used the wrong formula in checking the sheets by adding the "stereo tax" column in the equation. This argument holds little water.

First of all, this was the precise method prescribed to the auditors by Twyla Speidel, when the sheets were finally given to them to verify. In addition, when the department tested the first four months' worth of sheets, according to Twyla Speidel's directions, it found they were all "reasonably close" to the figures on the Form 10's. The rest of the sheets, however, when tested by the department, using the same formula, did not tie to the Form 10's. If Elwood had been using the wrong formula, as Mid City claims, how could the first four months of sheets which were tested have come out right? Mid City also fails to explain how Elwood and Twyla Speidel could have come to the same conclusion as to the accuracy of the March 1991 green sheets, Elwood during the audit and Twyla Speidel when Brodkey asked her to double-check the green sheets, if they were reviewing or calculating the information on the green sheets differently from each other.

Apart from the questionable reliability of the green sheets, there exists issues regarding their credibility. Apart from the fact there is a period of six months' worth of sheets missing, the sheets were not presented to the auditors until four years after the audit was completed, in February 1996, despite the auditors' request during the audit for any

backup documentation to the Form 10's. It is curious, to say the least, Mid City withheld these documents, simply because they were not asked for specifically. You would think that, if the green sheets were in fact so heavily relied on, Mid City would have given them to the auditors at the very beginning of the audit, instead of making an incorrect deficiency assessment by presenting the auditors with a computer-generated document which it believed to be completely inaccurate.

Another potential problem is the green sheets themselves appear to be prepared by the same person. The handwriting is strikingly similar for all the months in evidence, with the exception of a few daily entries for the months of April and June of 1991, the sales tax column of November 1991 and all the entries for January and February 1991, which appear to be in another person's writing. This conflicts somewhat with the testimony of Berry that she prepared the green sheets "most of the time," but that a number of people would have been involved in the procedure. First of all, it appears that only two people prepared the figures on the green sheets. It appears one person prepared the entries from December 1988 until January 1991, excluding the six month period the sheets are missing. It appears that same person also made the entries for March, May and July through October of 1991, and most of the daily entries for April, June and November of 1991. In other words, it appears one person completed all the daily entries for 19 out of 24 green sheets, at one entry per day, and a majority of daily entries on another three. Such a large number of daily entries would seem to warrant a stronger characterization of Berry's involvement in the creation of these documents than she prepared them "most of the time."

Also puzzling is Berry's testimony she began working for Mid City in September of 1990, since the person who appears to have prepared the majority of green sheets began doing so in December of 1988, the date of the earliest green sheet in evidence. The only possible conclusions, then, are that either Berry did not, in fact, prepare the green sheets "most of the time," but, rather, at the most, had a very limited role in their preparation

or that Berry inaccurately represented to the hearing officer when she began working for Mid City. Either way, her credibility as a witness for Mid City, as well as the reliability of the green sheets, is called into question.

Considering all the evidence presented and taking into account the presumption of the correctness of the Commissioner's decision, the court concludes it was proper for the auditors to rely on Mid City's computer-generated general ledger in assessing the deficiency in sales tax reported against the plaintiff. Therefore, the sales tax deficiency assessment against the Mid City is affirmed.

2. Use Tax

As stated earlier, Mid City was assessed a use tax deficiency for its alleged failure to pay a sales or use tax on a number of items purchased in conjunction with the construction of its new location. Mid City did produce, however, evidence in the form of letters from the persons or entities from which disputed materials and services were purchased. The letters all state a sales tax was paid on whatever purchase was made.

These letters represent external and, therefore, inherently more reliable documents which support Mid City's position it paid any and all such taxes due on the items in dispute. With the exception of the labor and materials purchased from HF Kruger Planing Mills, which is owned by Doug Speidel's cousin, it is difficult to believe Mid City could persuade all four of these entities to create false documents to be used in a legal proceeding against it.

The department also argues the letter from HF Kruger Planing Mills does nothing to account for the taxes which should have been paid for the designs for the video display unit which were created by JD Design Company. However, according to the testimony of Doug Speidel, no designs were actually purchased from H. F. Kruger Planing Mills. Rather, it appears what JD Design created for Mid City was rough sketches of how the unit could be constructed, apparently with the hopes of enticing Mid City into purchasing

its labor and materials, which Mid City never did. JD Design's involvement in this issue, therefore, appears to be irrelevant.

While it is true Mid City could have presented stronger evidence, in the form of detailed receipts or lease agreements, the external nature of the letters from the various entities gives great weight to the claim by Mid City that it paid any and all sales or use tax due on the items it purchased. The fact the lease for the computer software was arranged by a company other than the one which sold it to Mid City does not imply the selling company did not know how sales tax was charged to its customers. Furthermore, since all of the companies involved are Nebraska companies, it would have been their responsibility for collecting any sales tax due on the items they sold and not Mid City's. Therefore, the use tax deficiencies assessed against Mid City should be reversed.

Conclusion

The decision of the Commissioner should be, and hereby is, affirmed, in part, and reversed, in part, as provided for herein. The costs of this action are taxed to Mid City Stereo, Inc.

A copy of this order is sent to counsel of record.

Dated November 17, 1997.

SO ORDERED.

BY THE COURT:


Paul D. Merritt, Jr.
District Court Judge