

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS
FOR THE MINNESOTA DEPARTMENT OF REVENUE

In the Matter of the Proposed Rules of the Department of Revenue Relating to Lawful Gambling Taxes, Annual Audits and Review. Minnesota Rules Parts 8122.0510, 8122.0550 and 8122.0600.

**REPORT OF THE
ADMINISTRATIVE LAW JUDGE**

A hearing concerning the above rules was held by Administrative Law Judge Kenneth A. Nickolai at 9:30 a.m. on August 26, 1999, at the Minnesota Department of Revenue Building, 600 North Robert Street, Saint Paul, Minnesota.

The hearing held on August 26 and this Report are part of a rulemaking process that must occur under the Minnesota Administrative Procedure Act¹ before an agency can adopt rules. The legislature has designed that process to ensure that state agencies have met all the requirements that Minnesota law specifies for adopting rules. Those requirements include assurances that the proposed rules are necessary and reasonable and that any modifications that the Department may have made after the proposed rules were initially published do not result in them being substantially different from what the Department originally proposed. The rulemaking process also includes a hearing, when a sufficient number of persons request such a hearing. The hearing is intended to allow the Agency and the Administrative Law Judge reviewing the proposed rules to hear public comment regarding the impact of the proposed rules and what changes might be appropriate.

The members of the Department's hearing panel were Patrick J. Finnegan, Attorney; Roger Swanson, Supervisor in the Special Taxes Division; and Emily Klooz, Revenue Tax Specialist in the Special Taxes Division.

Approximately twelve persons attended the hearing. Five persons signed the hearing register. The hearing continued until all interested persons, groups or associations had an opportunity to be heard concerning the proposed amendments to these rules.

¹ Minn. Stat. §§ 14.131 through 14.20 (1998).

After the hearing ended, the Administrative Law Judge kept the administrative record open for ten calendar days, until September 2, 1999, to allow interested persons and the Department an opportunity to submit written comments. During this initial comment period the Administrative Law Judge received one written comment from an interested person and a comment from the Department. Following the initial comment period, Minnesota law² required that the hearing record remain open for another five business days to allow interested parties and the Department to respond to any written comments. Several reply comments were received. The Department made comments in both periods and proposed changes to the rules. The hearing record closed for all purposes on September 10, 1999.

NOTICE

This Report must be available for review by all affected individuals upon request for at least five working days before the agency takes any further action on the rules. During that time, this Report must be made available to interested persons upon request.

Pursuant to the provisions of Minn. Stat. § 14.15, subds. 3 and 4, this Report has been submitted to the Chief Administrative Law Judge for his approval.³ If the Chief Administrative Law Judge approves the adverse findings of this Report, he will advise the Department of actions which will correct the defects and the Department may not adopt the rule until the Chief Administrative Law Judge determines that the defects have been corrected. However, in those instances where the Chief Administrative Law Judge identifies defects which relate to the issues of need or reasonableness, the Department may either adopt the Chief Administrative Law Judge's suggested actions to cure the defects or, in the alternative, if the Department does not elect to adopt the suggested actions, the Department must submit the proposed rule to the Legislative Coordinating Commission for the Commission's advice and comment.

If the Department elects to adopt the actions suggested by the Chief Administrative Law Judge and makes no other changes and the Chief Administrative Law Judge determines that the defects have been corrected, then the Department may proceed to adopt the rule and submit it to the Revisor of Statutes for a review of its form. If the Department makes changes in the rule other than those suggested by the Administrative Law Judge and Chief Administrative Law Judge, then the Department shall submit the rule, with the complete record, to the Chief Administrative Law Judge for a review of the changes before adopting it and submitting it to the Revisor of Statutes.

² Minn. Stat. § 14.15, subd. 1 (1998).

³ For the purposes of this proceeding, the Assistant Chief Administrative Law Judge is designated to provide review pursuant to Minn. Stat. § 14.15. Authority for the Assistant Chief to complete the duties of the Chief Administrative Law Judge in these circumstances is found in a delegation of authority on file with the Secretary of State.

When the Department files the rule with the Secretary of State, the Department shall give notice on the day of filing to all persons who requested that they be informed of the filing.

Based upon all the testimony, exhibits, and written comments, the Administrative Law Judge makes the following:

FINDINGS OF FACT

Procedural Requirements

1. On June 15, 1998, the Department published a Request for Comments on planned rule development in the areas of lawful gambling, annual audits, and reviews. The notice indicated that an advisory committee to consult in this rulemaking was being formed and solicited participation in that committee. The Request for Comments was published at 22 State Register 2256. (Exhibit 1).

2. On January 11, 1999, the Department requested the approval of its notice plan to adopt the proposed rules without a hearing and filed the following documents with the Chief Administrative Law Judge:

- (a) a copy of the proposed rules certified by the Revisor of Statutes;
- (b) the Notice of Intent to Adopt Rules Without a Hearing proposed to be issued; and
- (c) a draft of the Statement of Need and Reasonableness ("SONAR").

4. A notice plan was approved by Administrative Law Judge George Beck on January 14, 1999.

5. On January 21, 1999, the Department mailed a copy of the SONAR to the Legislative Reference Librarian.

6. On February 2, 1999, the Department mailed the Notice of Intent to Adopt Rules Without a Hearing to all persons and associations who had registered their names with the agency for the purpose of receiving such notice and all persons identified in the Additional Notice plan. (Exhibit 8b).

7. On February 8, 1999, a copy of the proposed rules and the Notice of Intent to Adopt Rules Without a Hearing were published at 23 State Register 1673. (Exhibit 7b).

8. On February 10, 1999, the Department posted copies of the proposed rules, the Notice, and SONAR on the Department' website, at <http://www.taxes.state.mn.us>.

9. The Department received over twenty-five signatures from persons requesting a hearing be held on this matter. On July 14, 1999, the Department mailed a notice to persons who requested a hearing that informed them that a hearing would be

held on the proposed rules. (Exhibit 11). The Notice of Hearing on these rules was published at 24 State Register 123, on July 19, 1999. (Exhibit 10b).

10. On the day of the hearing, the Department placed the following documents into the record:

- (a) the Request for Comments published at 22 State Register 2256 (Exhibit 1);
- (b) a copy of the proposed rule as certified by the Revisor of Statutes (Exhibit 2);
- (c) a revised copy of the proposed rule as certified by the Revisor of Statutes (Exhibit 3);
- (d) the SONAR (Exhibit 4);
- (e) a copy of the letter transmitting the SONAR to the Legislative Reference Librarian (Exhibit 5);
- (f) the revised SONAR (Exhibit 6);
- (g) the Notice of Intent to Adopt Rules Without a Hearing and copy of the proposed rules as mailed and published in the State Register (Exhibits 7a and 7b);
- (h) the Department's Certificate of Mailing List, and certification of mailing the Notice of Intent to Adopt Rules Without a Hearing (Exhibits 8a and 8b);
- (i) Certificate of Mailing, and two certificates of additional notice (Exhibits 9a and 9b);
- (j) the Notice of Hearing as mailed and published in the State Register (Exhibits 10a and 10b);
- (k) certificates of mailing list, mailing, and additional notice (Exhibit 11);
- (l) comments received by the Department (Exhibit 12);
- (m) a revised copy of the proposed rule (Exhibit 13); and
- (n) proposed changes to the rule submitted at the hearing (Exhibit 14).

11. The Department has met all of the procedural requirements under the applicable statutes and rules.

Nature of the Proposed Rules

12. This rulemaking proceeding was undertaken by the Department to clarify and update the audit and financial review rules governing organizations engaged in lawful gambling. The Department indicated that the current rules required more audits or reviews than were necessary to provide adequate oversight of lawful gambling. The proposed rules set out the standards for inventorying games used by the organization and a cash count. The Department convened a task force in October 1998 to assist in developing these rules.

Statutory Authority

13. In its SONAR, the Department identifies Minn. Stat. §§ 270.06 (14) and 297E.06, subd. 4(b) as providing the statutory authority for the proposed rules. Minn. Stat. §§ 270.06 (14) states in pertinent part:

(14) administer and enforce the assessment and collection of state taxes and fees, including the use of any remedy available to nongovernmental creditors, and, from time to time, make, publish, and distribute rules for the administration and enforcement of assessments and fees administered by the commissioner and state tax laws. The rules have the force of law.

14. Minn. Stat. §§ 297E.06, subd. 4(b) states:

(b) The commissioner of revenue shall prescribe standards for audits and financial review required under this subdivision. The standards may vary based on the gross receipts of the organization. The standards must incorporate and be consistent with standards prescribed by the American institute of certified public accountants. A complete, true, and correct copy of the audit report must be filed as prescribed by the commissioner.

15. The primary purpose of the proposed rules is to administer and enforce the state tax laws and impose standards for audits and financial reviews. The Chief Administrative Law Judge finds that the Department has the statutory authority to adopt the proposed rules.

Rulemaking Legal Standards

16. Under Minn. Stat. § 14.14, subd. 2, and Minn. Rule 1400.2100, one of the determinations which must be made in a rulemaking proceeding is whether the agency has established the need for and reasonableness of the proposed rule by an affirmative presentation of facts. In support of a rule, the Department may rely on legislative facts, namely general facts concerning questions of law, policy and discretion, or they may simply rely on interpretation of a statute, or stated policy preferences.⁴ The Department prepared a Statement of Need and Reasonableness ("SONAR") in support of the proposed rules. At the hearing, the Department primarily relied upon the SONAR as its affirmative presentation of need and reasonableness for the proposed amendments. The SONAR was supplemented by comments made by Agency staff members at the public hearing and in written post-hearing submissions.

17. The question of whether a rule has been shown to be reasonable focuses on whether it has been shown to have a rational basis, or whether it is arbitrary, based upon the rulemaking record. Minnesota case law has equated an unreasonable rule

⁴ *Mammenga v. Department of Human Services*, 442 N.W.2d 786 (Minn. 1989); *Manufactured Housing Institute v. Pettersen*, 347 N.W.2d 238, 244 (Minn. 1984).

with an arbitrary rule.⁵ Arbitrary or unreasonable agency action is action without consideration and in disregard of the facts and circumstances of the case.⁶ A rule is generally found to be reasonable if it is rationally related to the end sought to be achieved by the governing statute.⁷ The Minnesota Supreme Court has further defined an agency's burden in adopting rules by requiring it to "explain on what evidence it is relying and how the evidence connects rationally with the agency's choice of action to be taken."⁸ An agency is entitled to make choices between possible approaches as long as the choice made is rational. Generally, it is not the proper role of the Administrative Law Judge to determine which policy alternative presents the "best" approach since this would invade the policy-making discretion of the agency. The question is rather whether the choice made by the agency is one that a rational person could have made.⁹

18. In addition to need and reasonableness, the Administrative Law Judge must also assess whether the rule adoption procedure was complied with, whether the rule grants undue discretion, whether the Department has statutory authority to adopt the rule, whether the rule is unconstitutional or illegal, whether the rule constitutes an undue delegation of authority to another entity, or whether the proposed language is not a rule.¹⁰ In this matter, the Department has proposed changes to the rule after publication of the rule language in the State Register. Because of this circumstance, the Administrative Law Judge must determine if the new language is substantially different from that which was originally proposed.¹¹

19. The standards to determine if new language is substantially different are found in Minn. Stat. § 14.05, subd. 2 (1998). The statute specifies that a modification does not make a proposed rule substantially different if "the differences are within the scope of the matter announced . . . in the notice of hearing and are in character with the issues raised in that notice," the differences "are a logical outgrowth of the contents of the . . . notice of hearing and the comments submitted in response to the notice," and the notice of hearing "provided fair warning that the outcome of that rulemaking proceeding could be the rule in question." In determining whether modifications are substantially different, the Administrative Law Judge is to consider whether "persons who will be affected by the rule should have understood that the rulemaking proceeding . . . could affect their interests," whether "the subject matter of the rule or issues determined by the rule are different from the subject matter or issues contained in the . . . notice of hearing," and whether "the effects of the rule differ from the effects of the proposed rule contained in the . . . notice of hearing."¹²

⁵ *In re Hanson*, 275 N.W.2d 790 (Minn. 1978); *Hurley v. Chaffee*, 231 Minn. 362, 367, 43 N.W.2d 281, 284 (1950).

⁶ *Greenhill v. Bailey*, 519 F.2d 5, 19 (8th Cir. 1975).

⁷ *Mammenga*, 442 N.W.2d at 789-90; *Broen Memorial Home v. Minnesota Department of Human Services*, 364 N.W.2d 436, 444 (Minn. Ct. App. 1985).

⁸ *Manufactured Housing Institute*, 347 N.W.2d at 244.

⁹ *Federal Security Administrator v. Quaker Oats Co.*, 318 U.S. 218, 233 (1943).

¹⁰ Minn. R. 1400.2100.

¹¹ Minn. Stat. § 14.15, subd. 3 (1998).

¹² Minn. Stat. § 14.05, subd. 2 (1998).

Impact on Farming Operations

20. Minn. Stat. § 14.111, (1998), imposes an additional notice requirement when rules are proposed that affect farming operations. In essence, the statute requires that an agency must provide a copy of any such proposed rule change to the Commissioner of Agriculture at least thirty days prior to publishing the proposed rule in the State Register.

21. The proposed rules do not impose restrictions or have a direct impact on fundamental aspects of farming operations. The Administrative Law Judge finds that the proposed rule change will not affect farming operations in Minnesota, and thus finds that no additional notice is required.

Cost and Alternative Assessments in the SONAR

22. Minn. Stat. § 14.131 requires an agency adopting rules to include in its SONAR:

- (1) a description of the classes of persons who probably will be affected by the proposed rule, including classes that will bear the costs of the proposed rule and classes that will benefit from the proposed rule;
- (2) the probable costs to the agency and to any other agency of the implementation and enforcement of the proposed rule and any anticipated effect on state revenues;
- (3) a determination of whether there are less costly methods or less intrusive methods for achieving the purpose of the proposed rule;
- (4) a description of any alternative methods for achieving the purpose of the proposed rule that were seriously considered by the agency and the reasons why they were rejected in favor of the proposed rule;
- (5) the probable costs of complying with the proposed rule; and
- (6) an assessment of any differences between the proposed rule and existing federal regulations and a specific analysis of the need for and reasonableness of each difference.

23. The SONAR includes a discussion of the analysis that was performed by the Department to meet the requirements of this statute.¹³ Those who will bear the

¹³ See SONAR at 3-4.

costs of the rule requirement are the organizations engaged in lawful gambling that are required to submit audits or reviews. The Department assessed the increased costs to be minimal. Any additional costs would be primarily the cost of additional time spent by accountants. These same organizations will be benefited by increased clarity in the rules. The Department also indicated that it would benefit from improved accuracy in audits and reviews.¹⁴ The Department anticipates no costs to itself or any other state agency arising from these rules.

24. An agency proposing rules must determine whether there are less costly or less intrusive methods to achieve the purposes of the proposed rules. The Department asserted that there are no such alternative methods. The alternative of publishing a Revenue Notice was considered by the Department.

25. In assessing additional costs, the Department concluded that only the cash count and inventory requirements would impose additional costs and that the costs were minimal. There are no conflicts between federal regulations and the proposed rules.¹⁵

26. The Administrative Law Judge concludes that the Department has met the requirements set forth in Minn. Stat. § 14.131 for assessing the impact of the proposed rules.

27. One comment was received in writing and one person testified at the public hearing. The commentators in this matter have suggested few changes to the rules. This Report is limited to the discussion of the portions of the proposed rules that received significant critical comment or otherwise need to be examined. Accordingly, the Report will not discuss each comment or rule part. Because much of the proposed rules were not opposed and were adequately supported by the SONAR, a detailed discussion of each section of the proposed rules is unnecessary. The Administrative Law Judge specifically finds that the Department has demonstrated the need for and reasonableness of all rule provisions not specifically discussed in this Report by an affirmative presentation of facts. The Administrative Law Judge also finds that all provisions not specifically discussed are authorized by statute and there are no other problems that would prevent the adoption of the rules.

28. Where changes are made to the rules after publication in the State Register, the Administrative Law Judge must determine if the new language is substantially different from that which was originally proposed.¹⁶ The standards to determine if the new language is substantially different from that which was originally proposed by the Department are found in Minn. Stat. § 14.05, subd. 2. Not all the suggestions and amendments will be discussed individually. The Administrative Law Judge finds that modifications made by the Department to provide an accurate statutory

¹⁴ *Id.*, at 3.

¹⁵ *Id.*

¹⁶ Minn. Stat § 14.05, subd. 3.

reference and to add a description of taxes imposed¹⁷ are needed and reasonable, and that these changes do not result in a substantially different rule.

8122.0510 – More than a 12-month Audit or Review

29. All new language is being proposed for part 8122.0510. The proposed rule will allow organizations that are changing year-end dates to prepare audits or reviews for a period longer than twelve months but no longer than 18 months. The current rule requires an audit or review every twelve months without exception. The Department described the rule as needed to accommodate organizations that conclude gambling operations after the fiscal year-end.¹⁸ No commentators objected to the provision.

30. The last paragraph of the rule part consists of an example of how the rule would be applied in a particular fact situation. The language does not constitute a rule. Generally, such language would constitute a defect in rulemaking. But a long standing exception has been made for Revenue rules. In such rules, examples have been allowed to aid in the understanding of how a rule is to be applied.¹⁹ Part 8122.0510 is needed and reasonable as proposed.

8122.0550 – Audit

31. The Department added information that must be supplied with audit results in subpart 2 of part 8122.0550. The additional information is the telephone and fax numbers of the firm performing the audit. The Department also clarified that, where the firm has multiple offices, the office that performed the audit must be specified. These additions are needed to allow Department staff to contact the auditor when questions arise.²⁰ The additions place no significant burden on the auditor. Subpart 2 is needed and reasonable as proposed.

32. Subpart 3 is modified by the proposed rules to adjust the existing rule to statutory changes and modifications to the practices in the gaming industry. No one commented on the proposed language. Subpart 3 is needed and reasonable as proposed.

33. In subpart 4, the Department made two changes to the existing rule that were not controversial. In addition, the Department added item D, which requires organizations to perform a physical inventory of games and a cash count. As originally proposed, the physical inventory and cash count was required to be done by an accountant. The Department received 130 comments, mostly objecting to the requirement that an accountant perform the work. Prior to the hearing in this matter, the

¹⁷ DOR Exhibit 14.

¹⁸ SONAR, at 5.

¹⁹ See In the Matter of Proposed Adoption of the Rule Relating to Sales and Use Tax on Capital Equipment and Replacement Capital Equipment, OAH Docket No. 6-2700-9730-1 (September 1995); In the Matter the Proposed Rules Governing Valuation and Assessment of Personal Property of Electrical, Gas Distribution and Pipeline Companies, OAH Docket No. 7-2700-10425-1 (July 1996).

²⁰ SONAR, at 6.

Department met with representatives of organizations involved in lawful gambling and modified the proposed rule based on their concerns.

34. The modification to item D provided an alternative to using an accountant in the inventory and cash count. The alternative allowed for these tasks to be performed by two employees not otherwise involved in the gambling operation of the organization. King Wilson, Executive Director of Allied Charities, testified that the modifications were supported by organizations involved in legal gambling and needed to reduce the costs of compliance.

35. Rick C. Borden, CPA, Vice President of Gruys, Borden, Carlson & Associates, P.A., objected to requiring visits by an accountant to observe and physically count games and cash. Mr. Borden maintained that the guidance provided auditors is to observe these counts unless adequate alternative controls are provided.²¹ If the physical inventory counts are incorrect, Mr. Borden asserts, it is because those alternative procedures are being done incorrectly. The commentator also objected to performing cash counts since "strict internal controls" are used with cash.²²

36. The rule as modified does not require an accountant to be present for the physical inventory or cash count, so long as two employees are performing those tasks. The Department indicated that "The number one problem identified in annual audits filed with the Department has been a material weakness in internal controls and a lack of segregation of duties."²³

37. The Department is entitled to rely upon its experience with past audits to guide decisions as to what standards should be imposed. Mr. Borden's objection to physical inventories and cash counts is that the procedures are unnecessary due to adequate internal controls. The Department has found those controls to be absent from many organizations. Requiring physical inventories and cash counts has been shown to be needed and reasonable. Subpart 4 is needed and reasonable.

38. The Department proposed language in subpart 7 to clarify the standards for resolution of profit carryover variances. The additions to the subpart are based on policies already followed by the Department. Each addition contains language that does not operate as a rule. The first addition states, "The auditor is encouraged to prepare or assist in preparing" This language introduces vagueness into the rule that could create a problem when issues are raised regarding responsibility for an amended return. This vagueness can be cured by omitting the sentence or modifying it to read, "The auditor must, at a minimum, assist in preparing" The language identifies an auditor's duty and ensures that responsibility for amended returns remains with the organization. The language is needed and reasonable with the modification. The modified language is not substantially different from the rule as published in the *State Register*.

²¹ Borden Comment, at 1.

²² *Id.*

²³ Department Reply, at 2.

39. The second addition to subpart 7 begins, "It is not appropriate to request an approved adjustment every year." This is not rule language insofar as requesting an approved adjustment every year is not prohibited. Impropriety is insufficiently clear to be the standard espoused by the rule. Depending upon what the Department intends to accomplish, the language could be modified to read, "Requests for approved adjustment cannot substitute for correcting the condition resulting in the variance." The language is needed and reasonable with the modification. The modified language is not substantially different from the rule as published in the *State Register*.

40. The third addition to subpart 7 has two similar problems with nonrule language. These problems can be corrected by replacing "it should" with "the organization shall" and "Revenue can" with "Revenue will" in the appropriate locations in the subpart. The language is needed and reasonable with the modifications. The modified language is not substantially different from the rule as published in the *State Register*.

Based on the foregoing Findings of Fact, the Administrative Law Judge makes the following:

CONCLUSIONS

1. The Minnesota Department of Revenue has given proper notice in this matter.

2. The Department has fulfilled the procedural requirements of Minn. Stat. § 14.14 (1998) and all other procedural requirements of law or rule.

3. The Department has demonstrated their statutory authority to adopt the proposed rules, and has fulfilled all other substantive requirements of law or rule within the meaning of Minn. Stat §§ 14.05, subd. 1, 14.15, subd. 3, and 14.50 (i) and (ii) (1998), except as noted at Findings 38, 39 and 40.

4. The Department has demonstrated the need for and reasonableness of the proposed rules by an affirmative presentation of facts in the record within the meaning of Minn. Stat. §§ 14.14, subd. 4 and 14.50 (iii) (1998).

5. The additions and amendments to the proposed rules suggested by the Department after publication of the proposed rules in the State Register are not substantially different from the proposed rules as published in the State Register within the meaning of Minnesota Stat. §§ 14.05, subd. 2, and 14.15, subd. 3 (1998).

6. The Administrative Law Judge has suggested action to correct the defects cited in Conclusion 3, as noted at Findings of Fact Nos. 38, 39 and 40.

7. Due to Conclusions 3 and 6, this Report has been submitted to the Chief Administrative Law Judge for his approval pursuant to Minn. Stat. § 14.15, subd. 3 or 4.

8. Any Findings that might properly be termed Conclusions and any Conclusions that might properly be termed Findings are hereby adopted as such.

9. A Finding or Conclusion of need and reasonableness in regard to any particular rule subsection does not preclude and should not discourage the Department from further modification of the proposed rules based upon an examination of the public comments, provided that the rule finally adopted is based upon facts as appearing in this rule hearing record.

Based upon the foregoing Conclusions, the Administrative Law Judge makes the following:

RECOMMENDATION

IT IS HEREBY RECOMMENDED that the proposed amended rules be adopted, except as otherwise noted above.

Dated this th day of October, 1999.

KENNETH A. NICKOLAI
Administrative Law Judge