

STATE OF MINNESOTA

COUNTY OF RAMSEY

TAX COURT
SECOND JUDICIAL DISTRICT
REGULAR DIVISION

Two Mac, Inc.,

Appellant,

vs.

Commissioner of Revenue,

Appellee.

**FINDINGS OF FACT,
CONCLUSIONS OF LAW AND
ORDER FOR JUDGMENT**

Docket 7469-R
No.

Dated: March 9, 2004

The Honorable Sheryl A. Ramstad, Judge of the Minnesota Tax Court, heard this matter, on September 25, 2003, at the Tax Court Courtroom, Minnesota Judicial Center, 25 Rev. Dr. Martin Luther King Jr. Blvd. St. Paul, Minnesota.

Mark. A Pridgeon, Attorney at Law, appeared for the Appellant.

Catherine M. Keane and Brad Delapena, Assistant Attorneys General, appeared for the Appellee Commissioner of Revenue ("Commissioner").

Both parties submitted post-trial briefs. The matter was submitted to the Court for decision on December 10, 2003.

The Court, having heard and considered the evidence adduced at the hearing, and upon all of the files, records and proceedings herein, now makes the following:

FINDINGS OF FACT

1. Two Mac, Inc. ("Appellant") is a Minnesota corporation formed in October 1993 with its principal place of business at 918 Hennepin Avenue, Minneapolis, Minnesota.
2. Brian MacKenzie and his father Gary MacKenzie each own 50% of the stock of Appellant. Brian MacKenzie is President of Appellant. Neither shareholder has received dividends from Appellant.
3. Since late April or early May of 1994, Appellant has operated a small neighborhood-type pub next to the Orpheum Theater in downtown Minneapolis called MacKenzie's Bar ("MacKenzie's"). Brian MacKenzie manages the bar, while his wife Deborah MacKenzie helps with the day-to-day bookkeeping. Gary MacKenzie was instrumental in the purchase and opening of the bar, but he has not been involved in the operations.
4. Deborah MacKenzie was responsible for tracking daily sales and provided worksheets for each day of the month to the accountant who then completed Appellant's tax returns. In 1999, she discovered an error that resulted in the accountant receiving incomplete information. After discovering the problem and discussing it with the accountant, neither Appellant nor anyone acting on Appellant's behalf contacted the Commissioner or filed amended returns, and she did not advise the Auditor of these reporting inaccuracies at any time during the subsequent audit.

5. A Department of Revenue Auditor (“Auditor”) initially contacted Brian MacKenzie in June of 2000 to advise that a sales and use tax audit would be conducted. MacKenzie’s was selected for audit due to a related audit of Tay-Mac, another corporation in which Gary MacKenzie is an officer.
6. The Auditor met with Brian and Deborah MacKenzie, along with their accountant, in July of 2000 to review the records that he had requested Brian make available, but the records were incomplete. After the Auditor gave the MacKenzies and their accountant several subsequent opportunities to provide records from which a managed audit could be conducted, the Auditor conducted an indirect audit using the unit volume method. Because Appellant’s records were inadequate and incomplete and those that were produced could not be verified, the Auditor resorted to conducting an indirect audit using the unit volume method.
7. The Commissioner issued a Notice of Change in Sales and Use Tax (“Order”) on February 15, 2002, assessing Appellant additional sales tax in the amount of \$183,233.67 and interest of \$55,994.22 for the periods July 1, 1995, to December 31, 2001. The assessment included: (a) state and Minneapolis liquor tax on additional liquor sales; (2) additional downtown Minneapolis restaurant tax; and (3) use tax on certain purchases.
8. By Order dated April 11, 2002, the Minnesota Tax Court granted Appellant a 30-day extension of time within which to appeal. On May 10, 2002, Appellant filed a Notice of Appeal challenging the Order inasmuch as it provided that Appellant failed to fully and properly report its taxable liquor sales. Appellant

did not challenge the Commissioner's assessment of either additional Minneapolis restaurant tax or use tax on certain purchases. Although Appellant initially contended that the statute of limitations barred assessment for periods prior to July 1998 as well.

9. The Commissioner amended the Order based upon information acquired during discovery. The revised Sales and Use Tax Audit Report and Explanation of Adjustments ("Amended Order") dated September 25, 2003, assessed Appellant an additional \$121,462.24 in sales and use taxes for the periods July 1, 1995, to December 31, 2001, and as of September 25, 2003, interest in the amount of \$50,924.18. Appellant does not dispute its liability for \$8,312.08 of the additional sales and use tax (\$8,201.13 for Minneapolis restaurant tax and \$110.95 for use tax).
10. Appellant retained Steve Gildersleeve, President and owner of a company that develops and maintains Bevinco accounts in Minnesota, to determine the variance between the amount of alcohol used by Appellant and the amount of alcohol shown as sold in Appellant's records for the period April 3-9, 2003. Bevinco personnel visited Appellant before the staff was aware of their presence as inventory takers and observed considerable overpouring and some unrecorded sales. Based upon his investigation and analysis, Mr. Gildersleeve testified that Appellant's unreported sales were dramatically lower than the Commissioner claims and that the appropriate overall "shrinkage" rate is 22%. Mr. Gildersleeve observed a 22% loss in April 2003, which was the difference between the volume of alcohol Appellant purchased

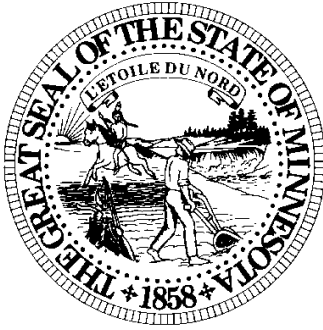
for use and the volume of drink sales actually rung through the cash registers. He offered no evidence or opinion as to the incidence of overpoured drinks, unrung drinks, or spillage and specifically declined to render an opinion as to whether these losses would be taxable. The shrinkage rate Mr. Gildersleeve measured was not relevant for tax purposes because it did not measure a loss in taxable sales.

11. Appellant admits that its liquor sales were underreported on the sales tax returns at issue and that there are no business records accurately maintained reflecting its liquor sales for the audit period.

CONCLUSIONS OF LAW

1. Appellant has failed to rebut the presumption of correctness of the Commissioner's assessment and Amended Order.
2. The Amended Order of the Commissioner of Revenue, dated September 25, 2003, imposing additional tax, penalties, and interest is hereby affirmed.

LET JUDGMENT BE ENTERED ACCORDINGLY. THIS IS A FINAL ORDER. A STAY OF 15 DAYS IS HEREBY ORDERED.



BY THE COURT,

Sheryl A. Ramstad, Judge
MINNESOTA TAX COURT

DATED: March 9, 2004

MEMORANDUM

Background

Two Mac, Inc. ("Appellant") is a Minnesota corporation which operates a small neighborhood-type pub at 918 Hennepin Avenue, Minneapolis, Minnesota, called MacKenzie's ("MacKenzie's"). MacKenzie's was the subject of an audit for the period July 1, 1995, through December 31, 2001 ("Audit Period"). During this Audit Period, MacKenzie's engaged in the retail sale of beer and liquor, consumed on the premises, and a variety of snack and food items. The beverage service, however, has been MacKenzie's primary focus.

Appellant's stock is owned by Brian MacKenzie and his father Gary MacKenzie. Although each own 50% of the stock, Gary MacKenzie has not been involved in the day-to-day operations while Brian MacKenzie manages the pub.

The Audit

The Commissioner selected MacKenzie's for an audit of its sales and use tax returns for two reasons. First, MacKenzie's failed to report any downtown Minneapolis restaurant sales tax between January 1997 and April 1999. Second, the Commissioner noticed that MacKenzie's dramatically increased its reported

sales just as the Commissioner began to audit a related entity.¹ During the initial telephone conversation with the Auditor in approximately June of 2000, Brian MacKenzie acknowledged that the downtown restaurant tax had not been paid, and he and the Auditor discussed the possibility of doing a managed audit of MacKenzie's. In a managed audit, the Auditor verifies the work done by a taxpayer and then makes an assessment based upon the taxpayers' information without conducting an independent records review. Although the parties subsequently signed a Managed Audit Agreement, the Commissioner considered the business records inadequate to rely upon and thus resorted to an indirect method known as the unit volume method.

As part of the unit volume method, the Auditor first determined the identity of MacKenzie's beer and liquor suppliers by sending letters to all the liquor distributors listed in the metro area Yellow Pages, requesting sales made to MacKenzie's from June of 1997 through September of 2000. In response, about half of the distributors provided the Auditor with information regarding dates of sales, liquor types, volume, amounts paid, and to whom it was delivered. On July 20, 2001, the Auditor informed Brian MacKenzie by letter that he had put together a spreadsheet of Appellant's liquor purchases using information provided by the vendors and could not verify numbers or invoices Appellant had originally furnished. In addition, the Auditor advised Mr. MacKenzie that he was enclosing a spreadsheet of Appellant's additional taxable sales that he had compiled based upon Appellant's actual amounts of liquor purchased and the corresponding amounts charged for the sale of each drink. He also factored in a

¹There was a 138.45% increase in liquor sales reflected in MacKenzie's returns after May 1999.

5% spillage rate. Finally, the Auditor requested records for two vendors for which actual figures were missing—Quality Wine and Spirit and East Side Beverage—and indicated that if the information was not forthcoming, he would issue an audit report covering a 6-1/2 year audit period rather than the 3-1/2 year audit period of the managed audit report. When Appellant provided no additional information, and the Auditor received the information from Quality Wine and Spirit and East Side Beverage, the Order was issued covering the period of July 1, 1995, through December 31, 2002.

In performing his sales calculations, the Auditor calculated the estimated retail sales associated with monthly liquor purchases for each period from October 1997 through September 2000 (“Test Period”). With the exception of the two vendors for which limited information was available, the computations involved actual purchases from the identified vendors each month. Because the Auditor did not have actual documentation from East Side Beverage or Quality Wine and Spirits for the entire period, he computed an average monthly purchase amount based upon the records he did have. Using information MacKenzie’s provided as to the size and price of drinks sold, the Auditor determined the estimated retail sales associated with the monthly liquor purchases for the Test Period. He then compared the computed liquor sales with the amounts reported on Appellant’s sales tax returns and, after subtracting the

12.5%² sales tax charged for drinks and an additional 10% for spillage, arrived at a figure representing unreported liquor sales. The Auditor then calculated adjustment factors to apply to other periods by dividing the taxable total by the period total and then taking an average. To project backwards for the period July 1, 1995, through September 30, 1997, he applied an error rate based upon the period October 1, 1997, through December 31, 1998. To project forward for the period January 1, 1999, through September 30, 2000, he applied an error rate based upon the period October 1, 2000, through December 31, 2001. The Auditor applied different error rates because he noticed a dramatic jump of 138.45% in reported sales after January 1, 1999.

Upon completion of the audit, the Auditor found what appeared to be a pattern of substantial underpayment of sales tax. MacKenzie's was notified that it was liable for additional tax of \$183,233.67 and interest of \$55,994.22 for the period July 1, 1995, to December 31, 2001. The assessment included state and Minneapolis liquor tax on additional taxable liquor sales, additional downtown Minneapolis restaurant tax on food sales, and use tax on certain purchases.

On May 10, 2002, Appellant filed a Notice of Appeal in the Minnesota Tax Court, challenging the Commissioner's determination that Appellant failed to fully and properly report its taxable liquor sales and contending that the statute of limitations barred the assessment for periods prior to July 1999. Appellant did not

²The 10% spillage rate is suggested by the IRS publication, Bars and Restaurants Audit Guide, originally released in 1995. A later IRS publication suggests a range of 5-8% for the spillage rate. See MSSP, Market Segment Specialization Program, Bars and Restaurants, Department of the Treasury, Internal Revenue Service, November 2002, found at http://www.irs.gov/pub/irs-mssp/mssp_restaurant_and_bar_atg_final.pdf.

challenge the Commissioner's finding that it owed additional Minneapolis restaurant and use tax.

As a result of information acquired in discovery, the Commissioner modified the assessment, with the adjusted assessment reducing Appellant's liability to an additional tax of \$121,462.24 and as of September 25, 2003, interest in the amount of \$50,924.18, for a total amount due as of that date of \$172,386.42. Appellant does not dispute its liability for \$8,312.08 of this additional sales and use tax (\$8,201.13 for Minneapolis restaurant tax and \$110.95 for use tax).

Appeal

On appeal to this Court, Appellant contends the Commissioner's indirect method of reconstructing Appellant's sales for the period October 1997 through September 2000 resulted in Appellant owing excessive additional sales tax. Appellant urges us to adopt the computations prepared by Steve Gildersleeve of an inventory audit firm, Bevinco, whom Appellant retained in April 2003 to determine how much "product" it was purchasing for use as opposed to selling. After spending a week at MacKenzie's, Mr. Gildersleeve estimated a 22% difference between the volume of alcohol MacKenzie's purchased for use and the volume of drink sales actually rung through the registers.

Appellant disputes a number of the assumptions made and figures utilized in the Commissioner's assessment: failure to allocate appropriate shrinkage allowances; failure to accurately project estimated monthly purchases and sales for the two vendors for which documentation was missing; and failure to use

appropriate adjustment factors for the Test Period to project underreported sales for the remainder of the Audit Period.

Legal Issues

The legal issues presented in this case are:

1. Whether the indirect method of reconstructing sales, used by the Commissioner, is a reasonable method of computing sales tax liability;
2. What, if any, errors were made in using that methodology;
3. Whether the Commissioner properly assessed Appellant's sales tax liability for the period July 1, 1995, to December 31, 2001.

Burden of Proof

Under the Minnesota Sales and Use Tax Act, all gross receipts are presumed subject to tax until the contrary is established. Minn. Stat. § 297A.09.³ A Minnesota seller has a statutory duty to charge and collect sales tax on all of its Minnesota retail sales. See Minn. Stat. § 297A.03, subd. 1. Moreover, the Commissioner's orders assessing additional tax are prima facie correct and valid. Thus, a taxpayer has the burden of establishing the invalidity in a proceeding challenging assessment. Minn. Stat. §§ 271.06, subd. 6 and 289A.37, subd. 3; Wybierala v. Commissioner of Revenue, 587 N.W. 2d 832, 835 (Minn. 1998); Lifer v. Commissioner of Revenue, Dckt. No. 7417 (Minn. Tax Ct. Sept. 5, 2002); Swyningam v. Commissioner of Revenue, Dckt. No. 4706 (Minn. Tax Ct. Dec. 7, 1987). Appellant must demonstrate that the challenged order of assessment is

³It is not disputed that all the items sold at retail by MacKenzie's and included in the audit are subject to the general sales tax or the tax applicable to beer and liquor, as the case may be. Minn. Stat. § 297A.02, subds. 1, 3 (2000) (replaced by § 297A.62 and § 297A.63, 2001).

incorrect by a preponderance of the evidence to overturn an order of the Commissioner. Wyberiala, Id., at 835; Lifer, supra. Using this standard, we shall review each issue in turn.

Use of Indirect Audit Method

Appellant claims that the Commissioner's indirect method of reconstructing MacKenzie's sales for the period October 1997 through September 2000 was not a reasonable method of determining Appellant's taxable income during that time. Appellant's primary criticism, however, relates not so much to the use of the indirect audit methodology but, rather, the Auditor's reliance upon a 10% spillage rate. Specifically, Appellant contends that the spillage rate used by the Auditor was arbitrary and bears no particular relationship to industry wide averages or to rates observed at Appellant's bar. Further, Appellant challenges the Auditor's use of monthly purchases from three months each for two vendors—Far East Side Beverage and Quality Wine and Beverages--to project purchases over wider periods.

The Commissioner argues that because MacKenzie's could not provide reliable records, the Auditor had no other choice than to use the indirect audit methodology, and that the unit volume method was an appropriate form of indirect audit to employ in this case. Additionally, the Commissioner asserts that applying a 10% spillage rate was not only appropriate, but consistent with the Internal Revenue Service's Bars and Restaurants Audit Guide, originally released in February 1995. As further support for the reasonableness of the

spillage rate used, the Commissioner points out that a November 2002 IRS publication suggests a rate of 5-8%.

Minnesota Rule 8130.7500, subp. 6 (1999) provides that a retailer “must keep adequate and complete records showing...gross receipts from sales....”

The rule further provides:

These records must include the normal books of account ordinarily maintained by the average, prudent businessperson engaged in the activity in question, together with all bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account as well as schedules or working papers used in connection with the preparation of tax returns.

Minn. R. 8130.7500, subp. 6 (1999).

Where a retailer fails to keep adequate records, the Commissioner may use “statistical or other sampling techniques consistent with generally accepted auditing standards in examining returns or records and making assessments.”

Minn. Stat. § 289A.35 (2000). “[I]ndirect [audit] methods are typically used when the taxpayer’s records are inadequate.” F-D Oil Co., Inc. v. Commissioner of

Revenue, 560 N.W. 2d 701, 706-07 (Minn. 1997). One such indirect audit

method that we have accepted is the unit volume method used in this case. See

New Corner Bar, Inc. v. Commissioner of Revenue, Dckt. No. 7221 R (Minn. Tax

Ct. Aug. 29, 2001). While the Commissioner’s method of audit must be

reasonable, it need not be either the only method or the most favorable method that could be used. Id.; see also Reed v. Commissioner of Revenue, Dckt. No.

4285 (Minn. Tax Ct. Dec. 3, 1985). For the reasons set forth below, we find the

Commissioner’s method of audit was reasonable in this case.

Brian MacKenzie's wife, Deborah Mackenzie, was responsible for tracking daily bar sales. At first, she took numbers directly from cash register tapes produced by two antiquated mechanical cash registers used by MacKenzie's to keep track of sales and manually recorded them into an Excel Workbook spreadsheet. She then provided the Excel spreadsheets to MacKenzie's accountant who calculated the sales tax owed and completed the bar's sales tax returns. Brian MacKenzie reviewed the returns he received from the accountant before submitting them to the Minnesota Department of Revenue. At some point in early 1999, she discovered that four or five days each month the spreadsheets erroneously subtracted sales rather than adding them to the monthly total. She, therefore, knew that the sales tax returns MacKenzie's had been filing with the Department of Revenue did not accurately report MacKenzie's sales or sales tax liability. When she informed MacKenzie's accountant of her discovery, he told her to ignore it, so she did not report this to the Commissioner or inform the Auditor during the audit process. Furthermore, MacKenzie's did not preserve the cash register tapes so the Excel spreadsheets, which were inaccurate, were the only source of information MacKenzie's had to document its liquor sales. Both Deborah and Brian testified that MacKenzie's had no documents from which an accurate record of its liquor sales could be compiled.

In this case, the Auditor gave Appellant multiple opportunities to provide information regarding purchases and sales made during the Test Period. Despite these repeated requests, the information received was inadequate and incomplete at best. Appellant does not dispute the Auditor's inability to verify

information on the records that were produced. In fact, Appellant's owner/manager and bookkeeper both testified that they maintained no business records from which accurate spreadsheets could now be compiled. Under these circumstances, we find that the Auditor was reasonable in using an indirect method of audit and that the unit volume method was an appropriate form of indirect audit. In New Corner Bar, supra, this Court approved the very method the Auditor applied here. In both cases, it was undisputed that the taxpayer lacked sufficient records to allow for a direct audit of its sales and use tax returns so the Auditor contacted the taxpayers' liquor supplies to determine their previous sales and obtained from the taxpayers the retail sales prices for various items sold at the bar, as well as the average size of drinks poured. Based upon the size of the drinks served, the Auditor in each case recreated probable sales by taking the gross volume of alcoholic beverages it had purchased from wholesalers and calculating the number of individual drinks that would be sold from that gross volume. Making an allowance for spillage and waste, the resulting figure was multiplied by the sales price of drinks to arrive at the bar's gross sales of alcoholic beverages. As in New Corner Bar, supra, the "unit volume method" was an appropriate form of indirect audit in this case. See also Kirby v. Commissioner of Revenue, Dckt. Nos. 4985, 4986 (Minn. Tax Ct. Jan. 17, 1989); Bryan v. Commissioner of Revenue, Dckt. No. 351 (Minn. Tax Ct. Nov. 12, 1986). We next examine some of the assumptions used by the Auditor to determine whether or not they were erroneous.

Methodology

Shrinkage/Spillage Rate

In doing the audit, the Auditor applied a 10% “spillage” or “shrinkage” rate. That is, he reduced the estimate of Appellant’s total unreported sales by 10% in order to allow for unavoidable or accidental loss of volume through broken bottles, not pouring into the glass, pouring the wrong drinks, and other problems.⁴ Appellant contends that the Auditor should have used a rate of 22% based upon the “shrinkage rate” Bevinco determined during the one-week Test Period in April 2003.

Appellant relies upon Mr. Gildersleeve’s assessment of the “loss” he says occurred at MacKenzie’s during the week of April 3 to April 9, 2003. Mr. Gildersleeve testified at trial that he observed overpouring of drinks and drinks that were not rung into the cash register during his investigation. In his analysis, Mr. Gildersleeve measured the difference between liquor used and liquor that got rung through the register. As Mr. Gildersleeve defined it, the shrinkage rate was the difference between the volume of alcohol purchased for use and the volume of drink sales actually rung through the cash registers.

The Commissioner urges us to distinguish between “shrinkage” and “spillage.” “Shrinkage” refers to the difference between: (a) the amount of liquor a retailer purchases for use, and (b) the amount rung through the retailer’s cash registers as sales and can result from overpoured drinks, complimentary drinks, unring sales, theft, and “spillage.” “Spillage” refers to the unavoidable or

⁴Since the Auditor could not precisely determine what percentage of mixed drinks sold by Appellant used premium rather than well liquor, he used the lowest drink price per category to give Appellant the benefit of any doubt.

accidental loss of volume through broken bottles, pouring not in the glass, etc. The Commissioner contends that “shrinkage”—the figure estimated by Bevinco—is irrelevant because measuring what inventory does not get converted into drinks rung through the register is not a pertinent figure for sales tax purposes. In other words, drinks that are not rung through the register, resulting in “shrinkage”, are still taxable events.⁵ The Commissioner maintains, therefore, that an adjustment for “spillage” rather than “shrinkage” is the appropriate way to account for any nontaxable use of liquor caused by accidents and inadvertence. We agree.

Since Mr. Gildersleeve looked only at the difference between the volume of liquor purchased for use and the volume of drink sales actually rung through the cash registers, the loss Mr. Gildersleeve purported to measure did not measure a loss in taxable sales. In fact, he specifically testified that he was offering no opinion as to whether or not the types of losses he observed were taxable. There is no evidence that Mr. Gildersleeve had any knowledge of MacKenzie’s operation during the Audit Period so any opinion as to the shrinkage rates during that time is unconvincing. Furthermore, Appellant cites no case law supporting its position as to shrinkage. We, therefore, find that the record supports the Auditor’s use of the lowest-price-per-category method of determining gross income and then deducting an additional 10% for spillage to determine Appellant’s taxable sales.

⁵A retailer has the duty to collect and remit tax on all retail sales except those specifically exempted. Minn. Stat. §§ 297A.03, subd. 1 (2000); 297A.023; 297A.09. Drinks sold to bar patrons but not rung through a cash register are standard retail sales subject to sales tax. See Minn. Stat. § 297A.01, subd. 3(c) and 4(a).

Error Rates

When the Auditor's calculations for the Test Period revealed that MacKenzie's had systematically underreported its taxable liquor sales, he determined adjustment factors to apply to other portions of the Audit Period preceding and following the Test Period. To project backward to the period July 1, 1999, through September 30, 1997, the Auditor applied an error rate based on the earlier portion of the Test Period. To project forward to the period January 1, 1999, through September 30, 2000, he applied an error rate based upon the later portion of the test rate. The Commissioner argues that the Auditor appropriately applied different error rates because the reporting activity of MacKenzie's dramatically changed in 1999, when MacKenzie's reported sales doubled, thereby creating two distinct rates of underreporting.

Appellant objects to the use of underreporting rates for the Test Period to derive underreporting rates for the remainder of the Audit Period, arguing that the underlying calculations are unreliable. Appellant more specifically alleges errors concerning the use of averages for two vendors and the percentage allowed for spillage, discussed above. By using average monthly purchases from three months each for East Side Beverage and Quality Wine and Beverages to project purchases over wider periods creates what Appellant terms a "projection within a projection." Since there is no average month for purchases given the variable and fluctuating nature of Appellant's business, Appellant claims the calculations based upon "averages" have only "arithmetic plausibility." Appellant finally argues

that if any projection should be used, it should be based upon error rates derived from Mr. Gildersleeve's calculations.

The Commissioner maintains that where as here, the taxpayer has failed to keep and/or produce adequate records, the Auditor reasonably based his samples on the best information available and reasonably applied them to other parts of the Audit Period. As for East Side Beverage, the Commissioner contends that Appellant failed to understand the analysis the Auditor ultimately used.

Although the Auditor initially used purchase information for a period of three months to create an average which he applied to other parts of the Audit Period, he recalculated the probable retail sales and computed a new average based upon ten months after the audit was completed. He did this because Appellant provided a "Monthly Account History" from December 1999 through September 2000, which the Auditor cross-checked with the receipts he had. As for Quality Wine and Spirit, the Commissioner argues that the average was based upon only three months because this was the only information the Auditor had, and Appellant provided nothing more specific other than to assert it made no purchases from that vendor for certain periods. In response, the Auditor eliminated all alleged purchases from Quality Wine and Spirit for those periods.

We find that the Auditor's projections for East Side Beverage and Quality Wine and Spirit were based upon the best information available and authorized by Minn. Stat. § 289A.35 (2000), which provides that where a retailer fails to keep adequate records, the Commissioner may use "statistical or other sampling techniques consistent with generally accepted auditing standards in examining

returns or records and making assessments.” Id.; see Shetakis Distributing Co. v. State Dept. of Taxation, 108 Nev. 901, 905-07, 839 P.2d 1315, 1317-1319 (1992) (stating that absolute minimum and maximum sample periods cannot be determined and depend upon the circumstances, and approving 45 day Test Period for determining proper sales tax on sales over a three-year period).

Based upon the record here, the Auditor’s use of averages for three-month and ten-month periods for East Side Beverages and Quality Wine and Spirit was reasonable. Absent evidence that the Auditor’s method resulted in an over-assessment, his use of averages in this case is not sufficient to overcome the prima facie validity of the Commissioner’s assessment. See, e.g., Giordano v. State Tax Commissioner, 145 A.D. 2d 726, 727-28, 535 N.Y.S. 2d 255, 256 (N.Y. 1988) (use of six-month test period to project for a three-year audit period was reasonable); Bradford v. Commissioner, 796 F. 2d 303, 306-07 (9th Cir. 1986)(extrapolation of annual income from a receipt book covering last three months of the year was reasonable).

Here, Appellant failed to produce accurate records of its actual sales for any part of the Audit Period. Because Appellant operated MacKenzie’s over the entire Audit Period in a consistent manner, the Auditor reasonably assumed that the same errors that were made in the Test Period would be present in the other years. See New Corner Bar, supra. Indeed, in this case the Auditor used a more refined methodology than in New Corner Bar, where the auditor applied a single error rate to the entire Audit Period. Because MacKenzie’s reporting pattern changed midway through the Test Period, however, the Auditor derived two

separate rates. Except for the so-called “errors” concerning the use of averages for East Side Beverages and Quality and Spirit and the percentage allowed for “spillage,” which have been previously discussed, Appellant agrees that the Auditor’s estimate of its liquor sales for the Test Period was fair. Despite Appellant’s assertion that its accounting improved from the Test Period forward, it produced no direct evidence of its liquor sales. In fact, Appellant has indicated that no such evidence exists for any part of the Audit Period. In any event, the Auditor used a lower error rate for the later periods, taking into account Appellant’s claim of improved reporting. Any inexactness in the calculations was attributable to Appellant’s own recordkeeping inadequacies. Regardless of the new accountant Appellant retained, the new system ultimately used, and any improvements resulting therefrom, Appellant never produced reliable records upon which the Auditor could base a direct or managed audit.

At trial, Appellant failed to impeach or even ask more than a few questions of the Auditor; yet, now he claims that Mr. Gildersleeve’s analysis should be substituted for that of the Auditor. Appellant’s suggestion of a theoretical alternative to the Commissioner’s analysis is insufficient. See New Corner Bar, supra. In summary, we find that Appellant has failed to meet its burden of establishing that the Commissioner’s reliance upon projected error or adjustment rates based upon test periods resulted in an unreasonable or excessive assessment.

Assessment Period

Appellant does not challenge the statute of limitations for all periods after July 1998. However, because Minn. Stat. § 289A.38, subd. 1 (2000) provides that “the amount of taxes assessable must be assessed within 3-1/2 years after the date the return is filed,” Appellant argues that the assessments for all periods prior to July 1998 are barred. The Commissioner contends that all periods from July 1995 forward are open under Minn. Stat. § 289A.38, subd. 6(2)(2000), which provides that if “the taxpayer omits from a sales...tax return an amount in excess of 25 percent of the taxes reported in the return, [a]dditional taxes may be assessed within 6-1/2 years after the due date of the return.” We agree.

Appellant has offered no evidence to refute the Commissioner’s calculations showing Appellant omitted in excess of 25 percent of the taxes reported on its sales tax returns for all periods between July 1995 and June 1998. Here, the due date of the July 1995 return was August 20, 1995. Minn. Stat. § 289A.18, subd. 4(1)(2000). Six and one-half years from that due date would have ended on February 20, 2002. The Commissioner’s Notice of Change issued on February 15, 2002, was within the six and one-half year statute of limitations. The Order is, thus, affirmed.

Conclusion

Appellant admits that it underreported sales throughout the Audit Period. After discovering that several months’ sales had not been reported, Appellant took no action to correct the record or file amended returns. Appellant failed to maintain and/or produce records upon which a direct or managed audit could be

conducted. Appellant did not meet its burden of proving that the Commissioner's method of calculating sales during the Audit Period was unreasonable or invalid. The Commissioner's determination of Appellant's liability for the 6-1/2 year period was appropriate because Appellant had omitted from its sales tax returns an amount in excess of 25% of the liquor tax due for all periods from July 1995 through July 1998. The assessment of additional sales and use tax is affirmed in all respects.

S. A. R.