STATE OF MINNESOTA | TAX COURT

COUNTY OF HENNEPIN | REGULAR DIVISION

HKD Lo, Inc., dba Jun Bo Chinese Restaurant,

Appellant,

vs.

Commissioner of Revenue,

Appellee.

FINDINGS OF FACT CONCLUSIONS OF LAW ORDER FOR JUDGMENT

Docket No. 8028 R

Dated: March 21, 2011

The Honorable Kathleen H. Sanberg, Judge of the Minnesota Tax Court, heard this matter, on August 5 and 6, 2010, at the Minnesota Tax Court courtroom 210, Minnesota Judicial Center, St. Paul, Minnesota.

Thomas E. Brever, Attorney at Law, represented the Appellant.

Mark Levinger, Assistant Attorney General, represented the Commissioner.

Both parties submitted post trial briefs. The matter was submitted to the court for decision on December 21, 2010.

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. HKD Lo, Inc. dba Jun Bo Chinese Restaurant ("Appellant") operates Jun Bo, a Chinese restaurant located in Richfield, Minnesota. The premises include a restaurant area, a bar area, and a reception center. Jun Bo is owned by Appellant and Appellant is owned by Kee Lo, Dan Lo, and parents, Yik Lo and Yak Lo.
2. The Minnesota Department of Revenue conducted an Audit of the Jun Bo restaurant for the period December 1, 2004, through November 30, 2007. (Ex. 101). The Revenue Specialists performed an indirect audit of Appellant's liquor sales and use tax at Jun Bo.
3. On June 25, 2008, the Minnesota Department of Revenue issued a Notice of Change in Sales and Use Tax (Ex. 101) that assessed an additional tax of $156,458.39, a fraud penalty of $78,229.32 and interest of $25,944.26, for a total amount due of $260,631.97.
4. The major components of the assessment include:

    1) Sales tax on alcohol sales;

    2) Sales tax on cover charge revenues from attendance at concert/dance events;

    3) Use tax on fixed asset purchases; and

    4) sales tax on revenues from parties/banquets.
5. The period of time at issue is December 1, 2004 through November 30, 2007.
6. Certain portions of the assessment are not contested:

1) State and Hennepin County Sales Tax on alcohol sales (Ex. II of Ex. 101, schedules A-D), which total tax is $72,660.29;

2) State and Hennepin County Sales Tax on party/banquet revenues (Ex. 101, schedules E-F), which total tax is $2,259.4;

3) Jun Bo Food Tax difference (schedule G)—this is a credit to Appellant;

4) Hennepin County food sales tax (schedule H);

5) South China Island sales tax (schedules L-M); and

6) Use tax imposed on fixed asset purchases (schedules N-O), for at least one-third of the amount listed.

7. In 2005, Appellant purchased the building for Jun Bo. Kee Lo acted as general contractor and coordinated remodeling and refurbishment of the building. Kee Lo purchased all of the material for the remodeling and hired all the contractors. All receipts were held by him at the premises and were paid by him.
8. In May 2006, Jun Bo opened. (Tr. at 7.) Since the opening, brothers Dan and Kee Lo have been managers of the restaurant and have handled all day to day business. Parents Yik and Yak Lo have never been actively involved in managing the restaurant.
9. Included in the premises are a dining area and an event hall. The capacity of the dining area is 500 persons with about 7,000 square feet and in the event hall, 300 persons, with about 6,000 square feet. The entire building is about 20,000 square feet. The event hall hosts

banquets, weddings and other events. Appellant does not charge for the renting of the event hall. Appellant treats the event hall as a restaurant and requires those that reserve the hall to purchase their food and alcohol from Appellant.

10. Deposits are only charged for big parties and reservations. When deposits are taken for large reservations, the security deposit is taken by Kee Lo and deposited into the bank. Deposit slips from the bank are then given to the company's accountant. At no time are records of the deposits entered into the computer system.
11. Jun Bo operated a bar on the premises. Beer is served, along with various liquors, wines and spirits. Alcohol is delivered to Jun Bo by several distributors. Appellant requested that all alcohol deliveries take place on Fridays. Appellant preferred to pay the distributors Monday, for the deliveries.
12. Four persons were able to pay the alcohol suppliers. Dan Lo and Kee Lo, with authority to do so, made most of the payments to the distributors. Yik Lo and Kee Lo's wife were the other two persons.
13. Dances or concerts were held at Jun Bo beginning in November 2006. Appellant contracted with a promoter, Producciones Montoya, holding himself out as "Mingo," who ran the dance/concert events. The promoter was in charge of scheduling the band, hiring security, and securing music system. The promoter controlled the gate and collected the cover charges.

14. Appellant treated the promoter's events like they would any other event booked by an outside person.
15. According to newspaper ads, the promoter charged a $10 cover charge for women and a $15 cover charge for men. The cover charge for women was waived at certain times. After May 2007, attendance was between 50 and 130 for disc jockeys and between 200 and 300 for live music. The capacity for the event center is 350.
16. Appellant received all profits from sales at the bar but received no cover charges for the dance events prior to August 2007. At no time during any of the promoter's events, did any employee of Appellant receive a cover charge. After August 2007, Appellant received all cover charges, but did not report the revenue or keep records regarding the numbers of persons attending or cover charges
17. A computer system has been used at Jun Bo to record sales. This computer system and the books and records comprise the books and records of the restaurant. The computer system is a point of sale system, in which employees of Jun Bo enter several keys to record what was ordered by the customer. All employees use this system to enter drink and food orders.
18. The order entered by employees includes the item requested, the table number, the server, the time and the cost of the item. Different categories exist for entering alcohol orders including individual brands of beer, red wine, white wine, liquor, and a category for miscellaneous

liquor. Should an order be cancelled, the system holds no record of that transaction. At the end of the each business day, a copy of the day's sales is printed.

19. In October 2006, the database crashed due to the installation of a Chinese language program into the computer system. As a result of the database crash, there is no background sheet for the October 2006 sales records.

20. Appellant hired Curt Swanson and Genesis Accounting Firm as its accountants. Mr. Swanson was responsible for preparing sales and use tax returns, payroll and all other taxes. (Tr. at 26; Swanson Affidavit–submitted to the Court subsequent to trial.)

21. All books and records of Appellant including deposit slips, check stubs, sales records, and other documents were given to Mr. Swanson. Appellant withheld no documents from Mr. Swanson.

22. Mr. Swanson prepared Appellant's income and sales tax returns for all tax years at issue–December 1, 2004, through November 30, 2007. When the audit took place, records were reviewed at Mr. Swanson's office.

23. The auditors, Mr. Miller and Ms. Shenouda, saw invoices for the purchase of alcohol that showed they had been paid in cash at Mr. Swanson's office. The documents were returned to Appellant, who now claims they were lost, destroyed or stolen.

24. Appellant consistently and substantially underreported taxes owed.

25. Appellant lacks adequate records to permit a full and complete audit.

26. On June 30, 2008, Appellant filed the Appeal of the June 25, 2008, Order with the Minnesota Tax Court.

CONCLUSIONS OF LAW

The June 25, 2008, Order of the Commissioner of Revenue imposing additional tax, penalties and interest is hereby modified as follows:

The Commissioner of Revenue shall recompute Appellant's tax liability, consistent with our findings below. In addition, we affirm the fraud penalty.

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

BY THE COURT,

Kathleen H. Sanberg, Judge
MINNESOTA TAX COURT

DATED: March 21, 2011

Memorandum

Background and Facts

The issues in this sales and use tax case concern the sale of alcohol and the revenue for cover charges, fixed assets, and parties or banquets. HKD Lo, Inc. ("Appellant") operates Jun Bo, a Chinese restaurant located in Richfield, Minnesota. The premises include a restaurant area, a bar area, and a reception center. Jun Bo is owned by Appellant, and Appellant is owned by Kee Lo, Dan Lo, and their parents, Yik Lo and Yak Lo.

The Minnesota Department of Revenue conducted an audit of the Jun Bo restaurant for the period December 1, 2004, through November 30, 2007. (Ex. 101). On June 25, 2008, the Minnesota Department of Revenue issued a Notice of Change in Sales and Use Tax (Ex. 101) that assessed an additional tax of $156,458.39, a fraud penalty of $78,229.32 and interest of $25,944.26, for a total amount due of $260,631.97 ("Order").

The major components of the assessment include sales tax on alcohol sales, sales tax on cover charge revenues from attendance at concert/dance events, use tax on fixed asset purchases, and sales tax on revenues from parties/banquets.

The Commissioner of Revenue ("Commissioner") argues that certain portions of the Order are not contested:

1) State of Minnesota and Hennepin County sales tax on alcohol sales, Schedules A-D, Ex. 101, in the total taxable amount of $72,660.29

2) State of Minnesota and Hennepin County sales tax on party and banquet revenues, Schedules E-F of Ex. 101, totaling $2,259.41. A spreadsheet created by Dan Lo represents his calculations for the amount of tax owed by Appellant; it includes a column entitled “Tax Paid from banquets.”
3) Jun Bo food tax difference, Schedule G; this is a credit to Appellant which is not at issue in this case.
4) Hennepin County food sales tax, Schedule H; Appellant admitted that it was not aware of this tax, so it was not paid.
5) South China Island sales tax, Schedules L-M. Appellant agreed that these amounts are uncontested.
6) Use tax imposed on fixed asset purchases, Schedules N-O. Appellant contests some of the use tax assessed, but admits that it owes more than one- third of the use tax assessed.

Appellant disputes most of the taxes for items on Schedules I-J, alleging that the cover charges were collected and retained by a promoter; Appellant says that the promoter owes the tax. For the period August through November 2007, Appellant collected cover charges and was fully responsible for events. Taxes on these amounts are not contested.

The Jun Bo building was purchased in 2005. Appellant renovated and refurbished the Jun Bo building in 2006. Mr. Kee Lo paid for all costs associated with the work. Appellant says that it paid applicable taxes on supplies and labor in the remodeling of the Jun Bo building in 2006. Mr. Kee Lo purchased all the material for Appellant’s labor contractors, but had no documentation for the

purchases. He kept Appellant's remodeling and refurbishing invoices in a black briefcase that was in his office at Jun Bo. According to Mr. Lo a theft occurred at the premises and he surmises that the briefcase was stolen along with power tools, a plasma television and other equipment were stolen. Appellant produced no police report or insurance claim regarding the theft.

The audit found that there was consistent and substantial underreporting of tax owed. Appellant lacks adequate records to permit a full and complete audit. According to the Commissioner, up to 62% of the daily sales transaction records are missing. Revenues from the parties and other events did not go through the computer system. Appellant produced no documentation from which revenue and taxes owing could be determined.

Appellant filed this Appeal of the Order with the Minnesota Tax Court on June 30, 2008.

Discussion

Burden of Proof

Here we must determine whether Appellant paid the proper amounts of sales and use tax due on sales of alcohol, cover charges, and fixed assets. We must also determine whether the fraud penalty imposed by the Commissioner was justified.

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. In addition, orders of the Commissioner are presumed valid and correct.[1] The

[1] *See* Minn. Stat. § 271C.61, subd. 5 (2008); Dreyling v. Commissioner of Revenue, 753 N.W.2d 698, 701 (Minn. 2008).

taxpayer has the burden of proving that a challenged order is incorrect or invalid.[2]

The standard of proof required to overturn an order of the Commissioner is a preponderance of the evidence.[3] The preponderance of the evidence standard and burden also apply to the challenge of a fraud determination and imposition of penalties, including the civil fraud penalty.[4]

The major components of the assessment at issue here are:

1) Use tax on fixed asset purchases;
2) Sales tax on cover charge revenues from attendance at concerts and dances;
3) Sales tax on alcohol sales; and
4) Sales tax on revenues from parties and banquets.

We shall consider each issue in turn.

Use Tax on Fixed Assets

The Commissioner asserts that Appellant made substantial fixed asset purchases and assessed a use tax on those purchases. Most of the purchases occurred when the restaurant was being remodeled prior to its opening. The Commissioner alleges that Appellant made taxable purchases but avoided paying tax by wrongly using an exemption certificate. If a purchaser who gives an exemption certificate makes any use of the item that is not for a purpose

[2] Minn. Stat. § 271.06, subd. 6; Minn. Stat. § 289A.37, subd. 3; *See* New Corner Bar, Inc. v. Commissioner of Revenue, Docket. No. 7221 R (Minn. Tax Ct. Aug. 29, 2001). Wybierala v. Commissioner of Revenue, 587 N.W.2d 832, 835 (Minn. 1998); Swyningan v. Commissioner of Revenue, Docket. No. 4706 (Minn. Tax Ct. Dec. 7, 1987).
[3] Wright v. Commissioner of Revenue, Docket. No. 4498 (Minn. Tax Ct. Apr. 22, 1987).
[4] New Corner Bar citing, F-D Oil Co. v. Commissioner of Revenue, 560 N.W.2d 701 (Minn. 1997); Beaudet & Beaudet v. Commissioner of Revenue, Docket. No. 6949 (May 19, 1999).

under Chapter 297A, that use is considered a retail sale by the purchaser and the sales price to the purchaser is considered gross receipts. Minn. Stat § 297A.73 (2006)

Appellant kept no receipts, invoices, or other records to show what material or labor was purchased from each vendor. Kee Lo's testimony was that the records were in a briefcase and were stolen along with a plasma television and some tools. Appellant presented no other evidence to support this claim. The claim that someone stole the records at the time of a burglary is doubtful, when one considers Mr. Kee Lo's testimony that he made no attempt to obtain copies of receipts or other documents. Because of the lack of evidence, we find that Appellant has failed to show that the assessment for use tax was not reasonable.

Cover Charges

Appellant was assessed for tax due on the cover charges for events such as dances or concerts held at Jun Bo. Appellant argues that it received no cover charges prior to May 2007. Prior to May 2007, the events were managed and run by a man named "Mingo." He was responsible for getting the band, advertising and collecting the cover charge. According to Kee Lo, they did not know Mingo's last name or how to contact him. Mingo would simply come into Jun Bo and ask if he could put on an event. After Mingo stopped booking, they had no way of contacting him. Appellant maintains that Mingo is an independent contractor and should be responsible for the sales tax on the cover charges.

There were no written contracts for the events; Appellant has no records of the events. The auditors found three ads in Spanish language newspapers for

dances at Jun Bo. The ad states that the promoter was Producciones Montoya. The Commissioner asserts that the ads show that Appellant is the principal of the promoter. We disagree. The ads show Jun Bo as the location but there is nothing in the ads which would indicate that Jun Bo is involved as a principal or that Producciones Montoya was its agent.

There were no bank deposits corresponding to cover charges from the dances. Appellant argues that this lack of bank deposits shows that they did not receive any cover charges for the events that Mingo organized. On the other hand, there were no records of revenue when the Lo brothers managed the events and received the cover charges. This was admitted by the Lo brothers.

During the audit, the auditors requested that Appellant keep records about the dances and concerts being held at Jun Bo. Appellant was also asked to keep records about price and attendance. Appellant did not do so.

The audit determined an additional $760,000 in taxable sales from the sale of admission into events from May 2006 through November 2007, resulting in an additional $49,400 in taxes. The charge assumed by the Commissioner in the calculation was $20 per person.

In assessing tax on the coverage charges, the Commissioner estimated the amount of revenue by multiplying an estimated cover charge per event times an estimated number of events times the number of persons attending the event. The prices listed in the Spanish newspaper ads were used in calculating revenue along with information from the Bloomington police department about the size of a crowd attending one of the concerts. A report of the size of crowds was also

obtained from an ex-HKD Lo, Inc. bartender who left on bad terms. The police did not go inside Jun Bo but estimated the number of people based on the number of cars.

Appellant argues that the Commissioner never attempted to find Mingo or enter the last name into the Department of Revenue's data base to determine if Mingo had paid sales tax. Further, Appellant argues that the cover charge and numbers attending events were overstated

The only documented cover charge during the time that Mingo was running the events was that listed in the Spanish newspaper ads. This was $15. This should be the amount used in calculating revenue. Further, the numbers of persons attending the events when Kee and Dan Lo ran the events should be used to calculate the cover charge for the period Mingo ran the events. We find that number should be 175, which is an average. Thus, the revenue and tax should be recomputed.

After Mingo stopped running the dances, Kee Lo and Dan Lo took them over. The brothers testified that they were charging $5 -15 per person as a cover charge. Attendance was between 50 and 130 persons for disc jockeys and between 200 and 300 for live music. The capacity for the event center is 350. Kee Lo testified that some events were canceled because of poor attendance and admissions charges were refunded, but there was no documentation about how many events were canceled or admissions refunded.

Appellant failed to report and pay sales tax on the cover charges for the time period when Mingo ran the events and fro the time period when the Lo brothers ran the events.

Therefore, based on the newspaper ads and information about attendance after the Lo brothers began running the dances, we find that the cover charges should be recalculated at 175 persons per event at a charge of $15 per person.

Sales Tax on Revenues from Parties and Banquets

Admission charges to musical concerts, dances, and other similar events constitute sales.[5] Appellant admits that it kept no records of revenues received from parties or banquets. Appellant does, however, contest the amounts used in the assessment. We find Appellant has not produced evidence sufficient to show that the Commissioner's assessment was invalid.

Sales Tax on Alcohol Sales

The next issue is whether the Commissioner properly assessed tax on alcohol tax. First, we note that Appellant admits that it paid no Hennepin County alcohol sales tax. This part of the Order is not contested. Second, The Commissioner has agreed that the Court can and should direct an adjustment of assessment for credit given for the end of year inventory.

The main issue regarding sales tax on the alcohol sales is whether the indirect audit used by the Commissioner was appropriate. The indirect audit calculated alcohol sales for the tax period here using the unit volume method. Appellant argues that improper assumptions were made in using the unit of volume method of indirect audit in calculating alcohol sales. The basic points of

[5] Minn. Rule 8139.0900, subp. 2 (2008); Minn. Stat § 297A.61, subd 3.

contention are the size of the alcoholic drink pour per serving, spillage amounts, the mislabeling of non alcoholic beverages as alcoholic and the effect of mixers.

Appellant did not maintain accurate or sufficient records to determine the amount of alcohol sold. The records from the computer were admittedly incorrect and incomplete and a significant number of the sales invoices were missing. Thus, as in New Corner Bar, we find using an indirect method of calculating the sales was appropriate.

Under the unit volume method of calculating alcohol sold, the size of the drink pour is very important. This method recreates sales by taking the gross volume of alcoholic beverage purchased by the bar from the wholesalers (which is a verifiable amount) and calculating the number of individual drinks that would be sold from that gross volume. An allowance is made for spillage and waste. This is then multiplied by the sales price of the drinks to get total sales from alcoholic beverages.

In New Corner Bar, this Court approved the method the auditors applied here. Here, the taxpayer lacked sufficient records to allow for a direct audit of its sales and use tax returns. The auditors contacted the taxpayers' liquor supplies to determine sales to Appellant, obtained from the taxpayers the retail sales prices for various items sold at the bar, and obtained the average size of drinks poured. Based upon the size of the drinks served, the auditors 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, the "unit volume method" was an appropriate form of indirect audit in the present case.[6] We next examine some of the assumptions used by the auditors to determine whether or not they were erroneous.

The drink pour size used by the auditors in their calculations came from a questionnaire filled out by Appellant. The drink pour size was 2.0 ounces of liquor and 6 ounces for wine (allowing for spillage and waste). Appellant asserts that the amount of alcohol in the bar audit questionnaire did not reflect the true amount poured because of overpours by the bartenders and spillage. Appellant argues that the amount should be adjusted.

Using Appellant's inventory numbers and pour size, the Commissioner estimated the sales of alcohol for the audit period to be nearly nine times the level of sales reported by Appellant on its sales tax returns. This, according to the Commissioner, is supported by the fact that there were a significant number of alcohol purchase invoices missing– approximately 62% according to the auditors' testimony.

While Appellant initially argued that the inventory numbers and sales figures provided by suppliers were overstated, Ms. Shenouda, one of the auditors, stated that she saw invoices marked "paid in cash," contradicting testimony by both Dan and Kee Lo. The cash invoices supported the figures reported by Appellant's suppliers. In his Affidavit, Mr. Swanson also says that he

[6] *See also* Kirby v. Commissioner of Revenue, Docket. Nos. 4985 et al. (Minn. Tax Ct. Jan. 17, 1989); Bryan v. Commissioner of Revenue, Docket. No. 351 (Minn. Tax Ct. Nov. 12, 1986).

saw invoices marked “cash,” which in his experience with the restaurant industry indicates that the invoices were paid in cash. Mr. Swanson believed that Mr. Yik Lo was the person likely to have paid an invoice in cash.

Another explanation for the difference in the reported sales and inventory, according to Appellant, is due to theft and overpouring. Appellant suspected Erik, a bartender, of overpouring, giving free drinks and stealing money. Appellant put a video system in bar area, but could not get a clear enough video to see misconduct. Appellant also counted money coming in, but this was inconclusive. Appellant felt it could not terminate Erik without clear evidence. Thus, Erik was not terminated for over four months after Appellant began suspecting him of theft.

The Commissioner asserts that Appellant did not take reasonable steps to determine if Erik was overpouring and taking money from the till. We agree with the Commissioner. The story about Erik is suspicious, given the lack of supporting documentation or witnesses. It seems highly unlikely that Jun Bo would keep a bartender for over four months when they believed he was committing theft.

In this case, the auditors gave Appellant multiple opportunities to provide information regarding purchases and sales made during the tax period. Despite these repeated requests, the information received was inadequate and incomplete at best. Appellant does not dispute the auditors’ inability to verify information on the records that were produced. Under these circumstances, we find that the auditors were reasonable in using an indirect method of audit and that the unit volume method was an appropriate form of indirect audit.

Mr. Kee Lo had stated that the size of a drink pour was 2 ounces, and wine was 6-8 ounces. The Commissioner argues that even given drinks poured at these sizes, the quantities of alcohol sold do not match up with reported sales and inventory. At trial, however, Appellant asserted that there was considerably more spillage than the 5% used in the Commissioner's calculations. This, according to Appellant is due in part to the fact that beer in a keg produces more foam depending on the temperature and the auditors never determined the proper amount of spillage due to beer foam.

We agree with one explanation given by Appellant in disputing the inventory numbers; the auditors mistook some of the mixers and other nonalcoholic beverages as alcoholic beverages when analyzing the inventory list. Thus, the alcohol inventory was miscounted. It was clear from the cross examination of the auditors that there were errors due to these mistakes. This must be factored into the calculations.

We find that using the indirect method of determining sales in this case was appropriate, with the exception of the mislabeling of inventory.[7] Appellant has failed to establish that the Commissioner's method of determining sales was unreasonable.[8] We also find that the method used by the auditors is reasonable in light of the lack of records. The amount assessed shall be recomputed to factor in the mislabeled mixer and nonalcoholic items as stated above.

Fraud

[7] Id.
[8] New Corner Bar, Wright; Itsa v. Commissioner of Revenue, Docket. No. 6731 (Minn. Tax Ct. Nov. 26, 1997).

Minnesota Statute Section 289.60, subd. 6 provides for the assessment of a 50% penalty when a person "files a false or fraudulent return, or attempts in any manner to evade or defeat the tax or payment of tax." To prove tax fraud, the taxing authority must show that the taxpayer intended to evade a tax known to be or believed to be owing.[9] The presence of fraud is a question of fact.[10] Fraud is not presumed, but can only be established by independent evidence that demonstrates the taxpayer's fraudulent intent.[11]

Because direct proof of intent is usually not available, tax fraud may be shown by circumstantial evidence.[12] In tax cases, the Commissioner can establish fraud from the transactions themselves, as well as from the conduct of the taxpayer.[13] Intent to commit fraud may be shown by various factors or indicia. These include knowledge of tax laws, failure to keep records, consistent and substantial understatements of amounts subject to tax, understatements so large and regular that they cannot be attributed to mere negligence or ignorance, failure to cooperate with taxing authorities, and implausible or inconsistent explanations of behavior.[14]

The Commissioner argues that the fraud penalty assessment is justified because Appellant meets all the indicia of fraud. Appellant argues that the Commissioner did not meet its burden to prove fraud. Appellant argues that the

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[9] New Corner Bar, citing Stoltzfus v. United States, 398 F.2d 1002,1004 (3d Cir. 1968).
[10] *See* Gajewski v. Commissioner, 67 T.C. 181, aff'd w/o pub. Op. 578 F.2d 1383 (8th Cir. 1978).
[11] New Corner Bar; Otsuki v. Commissioner, 53 T.C. 96 (Oct. 29, 1969).
[12] Stoltzfus; McClung-Logan Equip. Co. v. Thomas, 226 Md. 136 (1960); Spill v. Commissioner, 57 T.C.M. 314 (1989); Genie & Co., Inc. v. Comptroller of Treasury, 668 A.2d 1013 (Md. App. 1995).
[13] New Corner Bar; Reed v. Commissioner of Revenue, Docket No. 4285 (Minn. Tax Ct. Dec. 3, 1985).
[14] New Corner Bar; Bradford v. Commissioner, 796 F.2d 303 (19th Cir. 1986); Genie.

Commissioner failed to show that the taxpayer intended to evade a tax known to be or believed to be owing. Further, the burden of establishing fraud is on the Commissioner. We agree with Appellant on the point that proof of fraud belongs to the taxing authority.[15] We turn to the indicia of fraud to determine whether The Commissioner has met its burden.

Knowledge of Tax Law

The first factor indicating fraud is whether the taxpayer had knowledge of tax laws. Here, the Lo brothers relied on their accountant to calculate and file sales tax returns. Appellant argues that the Lo brothers were naive about taxes and did not know that they owed Hennepin County taxes. Mr. Swanson was not called to testify and his Affidavit, submitted after trial, does not give us additional facts to know how much the Lo brothers knew about filing taxes. The admissions, stories and excuses for failing to have records, however, lead us to believe that sales were not being reported to Mr. Swanson. This would indicate that they knew taxes were due on the sales.

Failure to Keep Records

Another factor used to prove intent to commit tax fraud is the failure to keep records. Appellant argues that it gave all of the records it had to the auditors, and gave the auditors access to the documents in the hands of its accountants. The Commissioner argues, and we agree, that the record keeping was woefully inadequate. There was a significant number of missing invoices. There was a lack of computer records. (Appellant admitted that it did not enter revenue regarding dances or banquets in the computer system.) Documents

[15] New Corner Bar.

viewed by the auditors at the accountant's office showed cash purchases of alcohol. These documents were returned to Appellant. Appellant now claims they were lost or stolen.

The fact that critical documents disappeared during the investigation in which payment of cash for inventory was a major focus, leads to an inference that the documents may have been destroyed or hidden. While we cannot determine that as many as 60% of documents are missing as alleged by the Commissioner, the large number of missing invoices, computer records, the admitted failure to record information, and the loss of records returned by the accountant persuade us that Appellant failed to keep adequate records from which a direct audit could be done. Further, the contention that someone stole the records at the same time as stealing tools and a television is simply not believable.

Consistent and Substantial Understatement of Amounts Subject to Tax

Appellant consistently and substantially underreported its sales tax burden to such an extent that the underreporting could not be attributed to mere negligence. No sales were reported from weddings, banquets or parties. No revenue from cover charges was reported during the time that the Lo brothers were managing the dances. The amount of alcohol said to have been sold does not match the amount of alcohol purchased, even considering spillage and the alleged stealing by one of the bartenders. This factor showing fraud is met.

Implausible or Inconsistent Explanations of Behavior

Another indicator of a taxpayer's intent to fraudulently underreport tax is implausible or inconsistent explanations of behavior. We listened to testimony from Mr. Dan Lo and Mr. Kee Lo over the course of the trial. We found much of the testimony to be not credible. The story about a burglar stealing records of the company, as well as a television and tools is not believable. There was no independent evidence that a theft had occurred. Further, the story that Eric, the bartender, was stealing cash out of the till, giving drinks for free, or not entering sales is also not credible. The bartender was kept on for four months after they suspected theft. While they put in recording cameras, they said the video quality was not good enough to fire the bartender. They took no other action to determine if Eric was stealing.

Mr. Kee Lo and Mr. Dan Lo both testified that they were not aware that their father had paid cash for alcohol. This was also dubious considering the large amount of inventory and the fact that one or both the Lo brothers were on site at almost all times.

Cooperation with Authorities

We acknowledge that Appellant cooperated with the audit to a certain degree. However, the failure of Appellant to record attendance at dances, as requested by the auditors, and the failure to turn over records that had been in the hands of the company’s accountant show a lack of cooperation.

Therefore, the only two factors that Appellant meets, in part, is lack of tax obligations, and cooperation with authorities. Again, that is only in part. Thus, we affirm the fraud penalty.

Conclusion

Appellant admits that it under reported sales throughout the audit period. We find the Commissioner did make some errors in its calculation of sales and we direct the Commissioner to recalculate the sales in accordance with this opinion. We find that Appellant did not meet its burden of proving that the indirect method of calculating alcohol sales was unreasonable.

With respect to the fraud penalty, we do not find Mr. Kee Lo's testimony or Mr. Dan Lo's testimony and explanations to be credible or substantiated by independent and verifiable evidence. Appellant meets all but two of the indicia of fraud. Appellant has failed to prove the Order to be incorrect or unreasonable and we, therefore, affirm the fraud penalty.

The Commissioner of Revenue is hereby directed to recalculate the taxes and penalty amounts due based on our findings about the inventory and cover charges. The remaining portions of the Order are affirmed.

K. H. S.