

STATE OF MINNESOTA

TAX COURT

COUNTY OF HENNEPIN

REGULAR DIVISION

More, Inc., d/b/a Blarney Pub & Grill,

**ORDER FOR
FURTHER PROCEEDINGS**

Appellant,

vs.

Commissioner of Revenue,

Docket No. 8395-R

Appellee.

Filed: February 19, 2016

This matter came on for hearing before The Honorable Joanne H. Turner, Chief Judge of the Minnesota Tax Court, on the prima facie validity of the Commissioner's assessment of sales and use tax against appellant More, Inc.

Mark A. Pridgeon, Attorney at Law, Edina, Minnesota, appeared on behalf of appellant More, Inc.

John R. Mulé and Shannon M. Harmon, Assistant Minnesota Attorneys General, appeared on behalf of appellee Commissioner of Revenue.

The court, having heard the testimony of witnesses and the arguments of counsel, having reviewed the exhibits and written submissions, and based upon all the files, records, and proceedings herein, now makes the following:

FINDINGS OF FACT

Background

1. Appellant More, Inc., owns and operates Blarney's Pub & Grill, a full-service Irish-pub-style restaurant and bar near the University of Minnesota. Tr. 12-13. Blarney's opened for

business in August 2004 on the main floor and loft space of the building. Tr. 11-12. In 2010, Blarney's began operating in the basement of the building as well. Tr. 13.

2. Blarney's clientele is primarily University of Minnesota students between the ages of 21 and 25, although the establishment serves an older demographic around dinner time during sporting events and concerts. Tr. 13.

3. During the audit period, Blarney's was open seven days a week, from 9:00 a.m. to 2:00 a.m. Mondays through Fridays, and from 8:00 a.m. to 2:00 a.m. on Saturdays and Sundays. Tr. 15; Ex. J46. The bar held "happy hour" from 3:30 p.m. to 7:00 p.m., but did no more than about 10% of its business during those times. Ex. J46; Ex. J42. The bar's busiest times are between midnight and 2:00 a.m., Tr. 15; Ex. J46, and Thursday nights, Tr. 50.

4. Blarney's uses three pour sizes for tap beer: 15 ounces (pint), 24 ounces (mug), and 58 ounces (pitcher). Ex. J46. Blarney's uses recommended pour sizes of 1.25 ounces for liquor and 6 ounces for wine. Ex. J46; Tr. 60.

5. Blarney's generally sets its prices for the upcoming academic year each August, offering different specials and discounts every night. Tr. 49-50. On Thursday nights during the audit period, for example, Blarney's offered Long Island iced teas for \$2.50 (a discount from the regular price of \$6.00 or \$6.50) and Coors Light 15-ounce tap pints for \$2.00 (a discount from the regular price of \$4.25). Tr. 50.

6. The majority of Blarney's beer sales were discounted. Tr. 50-51. For example, on Thursday nights, when Blarney's discounted Coors Light on tap, it sold seven or eight kegs' worth, as compared to less than one keg during the rest of the week. Tr. 53-54.

7. Blarney's discounts both "regular" (domestic) and "premium" beers. Ex. J46; Tr. 53-55.

8. Blarney's does not use a tiered pricing system for liquor; each drink is individually priced, ranging from \$4.25 for rail and call drinks to as much as \$16.50 for premium drinks depending on the brand. Tr. 55. A majority of Blarney's liquor sales are made at discounts of half or more. Tr. 55-56.

9. Blarney's sells wine in only 6-ounce pours, at prices between \$4.50 and \$5.00. Wine is never discounted. Tr. 56.

Point-of-sale system

10. During its entire existence, Blarney's has used a point-of-sale system called Xyng to record sales of both food and drink. Tr. 15-16. During the audit period, there were two Xyng terminals at the front bar, two terminals at the back bar, a server station near the front bar, and another station in the kitchen. Tr. 16. When Blarney's expanded to the building's basement in 2010, it installed four additional terminals there. Tr. 16. The Xyng terminals and workstations tie to a computer in the office on the second floor of the building. Tr. 16.

11. The point-of-sale system records the quantity of each particular item of food and drink sold, the time of each sale, and total revenues from the sale of that particular item, but apparently does not record the price specific to each sale. Tr. 80-81. For example, the point-of-sale system might indicate that nine pints of Coors Light were sold at a total of \$20.25, but apparently does not record the price of each pint.

12. The point-of-sale system must be programmed with prices for individual food items and drinks. Tr. 289. During at least part of 2010, some drinks were mistakenly programmed as food. For example, Gnarleyhead Pinot Grigio (a wine), Black & Tan (a beer), Malbec (a wine), and Smithwicks (a beer) were all incorrectly programmed as food. Ex. J8, at T01044.

13. The point-of-sale system is programmed to automatically shift to discounted prices at particular times of the day. Tr. 87.

14. When a customer places an order for food or drinks or both, a server enters the order into the point-of-sale system. Tr. 17-18. Food orders are sent to a printer in the kitchen to be prepared; drink orders are sent to a printer at the bar to be prepared. Tr. 18.

15. When the customer is ready to leave, the server presents the customer with an itemized ticket. Tr. 18. The customer gives the server a credit or debit card or cash (the establishment does not take personal checks). Tr. 18. If payment is by credit or debit card, the server swipes the customer's card, generates two receipts (one for the customer to sign and one for the customer to keep), and "closes" the table. Tr. 18-19, 285. If payment is by cash, the server makes change for the customer from her personal "bank" of cash and, back at the workstation, "closes" the table in the point-of-sale system. Tr. 19.

16. Because drink and food orders are prepared in response to tickets generated by the point-of-sale system, a server cannot serve food or drinks without entering the order into the point-of-sale system, or without colluding with a bartender and/or a kitchen staffer. Tr. 157-58.

17. A server cannot generate a credit card slip without entering the customer's order into the point-of-sale system. Tr. 157.

18. A bartender can pour a drink for a customer and take payment for it in cash without entering it into the point-of-sale system, but cannot generate a credit or debit card slip for the customer to sign without entering it into the point-of-sale system. Tr. 158-9.

19. At the end of the server's shift, the point-of-sale system generates a sales summary for that server. Tr. 19. The server presents the summary to the bartender, along with the signed credit card receipts and cash to equal her total sales for the shift. Tr. 19-20. The cash is placed in

the drawer of a particular workstation, called the “bank.” Tr. 20. Each server is responsible for making up any shortage in cash receipts for his or her shift. Tr. 21.

20. A similar procedure is used to close the “bank.” The point-of-sale system generates a summary of sales, both credit card and cash, which should equal the credit card receipts and cash in the “bank.” Tr. 20-21. The “bank” is closed at least once a day and, on busy days, may have been closed more often to reduce the amount of cash in the drawer. Tr. 20. The bartender is responsible for making up any shortage in cash receipts in the “bank.” Tr. 21.

21. Credit card sales are credited directly to the taxpayer’s bank accounts by the respective credit card companies. Tr. 24. During the audit period, the taxpayer maintained bank accounts at U.S. Bank. One account was used only for deposits of sales made using American Express and Discover credit cards and for paying some commercial loans. Tr. 24-25; Exs. J20, J21. Another account was used for deposits by Heartland (the credit card processing company used by Visa and MasterCard) for deposits of cash sales (labeled “Customer Deposits” on U.S. Bank’s statements) and for payment of the expenses of the business. Exs. J24, J25, J26, J27.

22. Cash removed from the “bank” is placed in an envelope and secured in a locked safe until the following day, when Mr. Mulrooney recounts and deposits it. Tr. 21-22. During the audit period, deposits were always made on Thursdays, Fridays, and Mondays, but not always on other days of the week unless the amount of cash to be deposited was particularly large. Tr. 22.

23. To alleviate pressure on the bartenders on busy nights, Blarney’s sells bottled beer from a tub near the front door for \$3 per bottle. Tr. 35-36, 38. The employee responsible for the tub records the number of bottles of each brand placed in the tub; beer is always added to the tub by the case. Tr. 38. At the end of the night, the server responsible for the tub tallies the number

of bottles of each brand of beer remaining in the tub and subtracts that from the number of bottles of each brand placed in the tub. Tr. 38-39. The bartender records the number of bottles of each brand sold from the tub in the point-of-sale system, and the server is responsible for depositing with the bartender enough cash to cover those sales. Tr. 38-39.

24. The only expenses of the establishment paid in cash are incidental purchases, such as a head of lettuce or a bottle of ketchup from a nearby convenience store. Tr. 22. Cash for those purchases comes from the “bank.” Tr. 22-23. The purchases are recorded in the point-of-sale system, and receipts for the purchases are placed in the “bank” register drawer. Tr. 22-23.

Other controls

25. In addition to the point-of-sale system, the taxpayer uses QuickBooks to track revenues and expenses. Tr. 32; Exs. J29-J32. The taxpayer’s accountants, Pitzl and Pitzl, make entries into QuickBooks using information from the point-of-sale system and from the checking account register. Tr. 32-33.

26. There are security cameras on the first floor of the establishment trained on both the front and back bars, on the hallway, and on the front door; an additional camera monitors the second-floor office. Tr. 33-34. The system retains images for 15 days, after which they are deleted. Tr. 34. During a portion of the audit period, the cameras were not operational, but Mr. Mulrooney did not tell staff that the system was not working. Tr. 35.

27. The taxpayer also hires staff to check customer identification at the front door, to monitor activities inside the establishment, and to report potential theft to Mr. Mulrooney. Tr. 48-49. Mr. Mulrooney is certain that security staff brought issues to his attention during the audit period, Tr. 49, although he provided no examples.

Bevinco inventorys

28. Starting in 2009, the taxpayer retained Bevinco, a beverage inventory service, to monitor its use of alcohol. Tr. 40. Each week, Bevinco inventories the amount of alcohol in the establishment, weighing each open bottle to one-thirtieth of an ounce. Tr. 91-92. By comparing the amount of each brand and type of alcohol in inventory to the amount on hand the previous week plus the amount purchased during the week, Bevinco calculates the amount of each brand of alcohol “used” during the week. Tr. 92-93; Exs. J36-J41. Bevinco then compares those amounts to the amount sold during the week, relying on sales as recorded in Blarney’s point-of-sale system. Tr. 93; Exs. J36-J41.

29. A “shortage” of a particular brand of alcohol could be the result of several things. A bartender could overpour, or could use the wrong brand of alcohol in a particular drink (Crown Royal in a drink calling for whiskey, for example, when a generic brand would do). Tr. 40-41. A “shortage” of a particular brand of liquor could also reflect the sale of a “double,” because the point-of-sale system records a “double” as an “unknown” brand. Tr. 41. Bevinco’s calculation of the amount of a “shortage” does not attempt to determine the cause of the shortage.

30. Each week, Bevinco estimates potential revenues lost due to shortages, in both absolute and relative terms (the latter being termed an “effectiveness” rating). Tr. 95-96; Exs. J37, J39, J41. Over time, Blarney’s “effectiveness” rating generally improved. Tr. 96-98; *compare* Ex. J37 *with* Exs. J39 & J41.

Sales tax filings

31. Mr. Mulrooney files electronic sales and use tax returns for Blarney’s using an on-line form found on the Department of Revenue’s website. Tr. 72-73. To do so, Mr. Mulrooney uses information from the point-of-sale system. Tr. 73-76, 82.

32. Sales and use tax returns filed for Blarney's during the audit period differed from sales as recorded by the point-of-sale system. For example, for September 2007 the point-of-sale system recorded net sales subject to tax of \$97,686.01. Ex. J11A. Blarney's sales and use tax return for September 2007 reported sales subject to sales tax of only \$88,726, Ex. J3, a difference of \$8,960.

33. For September 2007, the point-of-sale system also recorded liquor sales of \$33,460.31; beer sales of \$25,449.69; and wine sales of \$247.58. Ex. J11A. Blarney's sales and use tax return, however, improperly reported sales subject to liquor gross receipts tax of only \$33,460 (that is, sales of liquor for the month but excluding sales of beer and wine). Ex. J3.

34. As a second example, for December 2007 the point-of-sale system recorded net sales subject to tax of \$94,618.83. Ex. J11D. Blarney's sales and use tax return for December 2007 reported sales subject to sales tax of only \$54,851 (apparently the sum of beer and liquor sales for the month but excluding sales of food and wine). Ex. J3.

35. For December 2007, the point-of-sale system also recorded liquor sales of \$33,929.58; beer sales of \$20,921.98; and wine sales of \$385.47. Ex. J11D. Blarney's sales and use tax return, however, improperly reported sales subject to liquor gross receipts tax of only \$33,929, that is, sales of liquor but not beer and wine. Ex. J3.

36. As a third example, for January 2008 the point-of-sale system recorded net sales subject to tax of \$102,279.65. Ex. J12A; Blarney's sales and use tax return for January 2008 reported sales subject to sales tax of only \$80,732 (apparently the sum of food and liquor sales for the month but excluding sales of beer and wine), Ex. J4.

37. For January 2008, the point-of-sale system also recorded liquor sales of \$38,328.12; beer sales of \$21,747.49; and wine sales of \$502.04. Ex. J12A. Blarney's sales and use tax return,

however, improperly reported sales subject to liquor gross receipts tax of only \$38,328 (apparently sales of liquor but not of beer and wine). Ex. J4.

38. The Commissioner calculates that for the entire audit period, Blarney's sales and use tax returns underreported sales subject to sales tax of \$638,000.13 and underreported liquor gross receipts of \$1,182,707.15. Appellee's Post-Trial Br. 3-5; *compare* Exs. J9 – J15 with Exs. J3 – J7.

Sales and use tax audit

39. In 2010, the taxpayer was selected for a sales and use tax audit. Ex. J42.

40. On November 3, 2010, the auditor spoke with Mr. Mulrooney to set up an initial appointment. Ex. J42, at 11/03/10. Mr. Mulrooney instructed the auditor to contact his accountants, Pitzl and Pitzl. Ex. J42, at 11/03/10.

41. On November 17, 2010, the auditor contacted John Pitzl to set an initial meeting for December 1, 2010. Ex. J42, at 11/17/10. By letter dated the same day, the auditor requested certain information from Mr. Pitzl for the period June 1, 2007, through October 31, 2010, including the taxpayer's "Sales and Use Tax Filings and/or supporting documentation," "Federal Income Tax Returns," "General Ledger," "Purchase Invoices," "Sales Invoices," "Bank Statements," and "Credit Card Statements." Ex. J44. The auditor's letter did not request "z-tapes" from the taxpayer's point-of-sale system (showing each individual item included in a sale and the price of each individual item) or deposit slips for the taxpayer's bank accounts.

42. During the December 1 meeting, the auditor reviewed the questions on the Bar Audit Questionnaire, noting Mr. Mulrooney's answers on the form. Ex. J46; Ex. J42, at 12/01/10. The questionnaire asked about the taxpayer's then-current operations, and did not solicit any information about drink prices during the bulk of the audit period itself. Ex. J46.

43. Neither Mr. Mulrooney nor Mr. Pitzl provided the auditor with any documents at the December 1 meeting.

44. During the December 1 meeting, the auditor asked whether the business retained “receipts” from the establishment’s cash registers. Tr. 285. Mr. Mulrooney told the auditor that he retained signed credit card receipts for 30 days, in case of a disputed charge, and then shredded them. Tr. 285-86. The auditor misunderstood Mr. Mulrooney to be referring to z-tapes, and indicated on the Bar Audit Questionnaire that the taxpayer shredded z-tapes after 30 days. Ex. J46.

45. Mr. Mulrooney nevertheless initialed the completed questionnaire as correct and dated it. Ex. J46.

46. During the December 1 meeting, the auditor observed the point-of-sale terminal near the bar and confirmed that it was operating. Tr. 196. Mr. Mulrooney offered the auditor access to the point-of-sale system and to the vendor’s helpline, but the auditor declined. Tr. 52.

47. The auditor met with accountant Pitzl on December 13. Ex. J42, at 12/13/10. At the December 13 meeting, Mr. Pitzl provided the auditor with bank statements, a chart of accounts, invoices for purchases of assets, and invoices for purchases of alcohol, but no printouts from the point-of-sale system. Ex. J42, at 12/13/10. Mr. Pitzl told the auditor that Mr. Mulrooney discarded z-tapes from the point-of-sale system at the end of each month. Ex. J42, at 12/13/10.

48. The auditor told Mr. Pitzl she needed information from the point-of-sale system to complete the audit. Tr. 198.

The decision to conduct an indirect audit of alcohol sales

49. After meeting with Mr. Pitzl, the auditor decided to audit the business’s alcohol sales using the unit volume method for two reasons: (1) she had no “hard copies” of sales

information and therefore the business's sales information was "unverifiable," and (2) she believed the taxpayer made no cash deposits. Ex. J42, at 12/13/10.

50. The taxpayer made substantial cash deposits on a regular basis, as demonstrated by its bank statements. Exs. J24-J27.

51. The point-of-sale system generated reports from which the auditor could verify the taxpayer's sales tax filings.

The indirect audit

52. To conduct the indirect audit using the unit-volume method, the auditor entered the taxpayer's 2009 liquor and beer purchases into a spreadsheet, using records obtained directly from the taxpayer's alcohol suppliers. Ex. J1, at Worksheet 1 Purchase Detail. The bar audit spreadsheet automatically calculated the number of cans of beer purchased (63,708), the number of ounces of tap beer purchased (2,470,553.6), the number of ounces of liquor purchased (296,113.3), and the number of ounces of wine purchased (11,721.4). Ex. J1, at Worksheet 1 Purchase Detail.

53. The auditor labeled each keg and case of beer purchased as either "premium" or "regular," arriving at a total of 7,992 cans and bottles of "premium" beer; 948,826 ounces of premium tap beer; 55,560 cans and bottles of "regular" beer; and 1,521,728 ounces of regular tap beer. Ex. J1, at Worksheet 2 – On-Sale Tap Beer Sales; Ex J1, at Worksheet 3 – On-Sale Canned or Bottled Beverage Sales.

The auditor's estimates of tap beer sales

54. Believing that she had received conflicting information about prices of tap beer, on March 22, 2011, the auditor called Blarney's and obtained "prices of regular and premium beer at non promotional times and happy hour" from someone named "Marta." Ex. J42, at 03/22/11.

55. From the number of ounces of tap beer purchased during 2009, the auditor estimated the total revenues that could have been generated from tap beer sales, assuming:

- (a) 90% of tap beer sales were made at “regular” prices and only 10% during “happy hour”;
- (b) 75% of tap beer sales at regular prices were 15-ounce pints, 20% were 24-ounce mugs, and 5% were 58-ounce pitchers;
- (c) the regular price of regular beer was \$4.25 for a pint, \$6.50 for a mug, and \$7.00 for a pitcher;
- (d) the regular price of “premium” beer was \$6.50 for a pint, \$8.25 for a mug, and \$18.00 for a pitcher;
- (e) 75% of tap beer sales during “happy hour” were 15-ounce pints and 25% were 24-ounce mugs;
- (f) the happy hour price of regular beer was \$2.00 for a pint and \$3.00 for a mug;
- (g) there were no sales of premium beer during happy hour;
- (h) 7% of tap beer purchased was lost to spillage; and
- (i) 2% of tap beer purchased was given away or personally consumed.

Ex. J1, at Worksheet 2 – On-sale Tap Beer Sales.

56. Based on her assumptions, the auditor estimated that during 2009, the taxpayer must have generated revenues of \$687,410.55 from the sale of tap beer. Ex. J1, at Worksheet 2 – On-sale Tap Beer Sales.

57. The auditor miscategorized some purchases of “regular” tap beer as “premium,” resulting in an overstatement of the amount of “premium” beer sold, spilled, and given away.

Ex. J1, at Worksheet 1 Purchase Detail, p. 13. The auditor's miscategorization of beer resulted in an overestimate of the amount of revenues generated by purchases of tap beer.

58. The auditor assumed that only 10% of tap beer sales occurred during "happy hour." Ex. J1, at Worksheet 2 – On-sale Tap Beer Sales. Mr. Mulrooney estimated during the auditor's initial meeting on December 1 that only 2% of tap beer sales occurred during the time period designated as "happy hour," Ex. J46, but increased that estimate to 10% later in the audit, Ex. J42, at 03/16/11.

59. The software used by the auditor to estimate unreported revenues uses the term "happy hour" to refer to "any promotional pricing," rather than to any specific time period. Ex. J1, at Instructions for the Indirect Bar Audit Spreadsheet, p. 5. By applying promotional prices to sales occurring only between 3:30 and 7:00 p.m., the auditor significantly underestimated the percentage of tap beer sales made at promotional prices.

The auditor's estimates of canned and bottled beer sales

60. From the number of cans and bottles of beer purchased, the auditor estimated the total revenues that must have been generated from sales of canned and bottled beer, assuming:

- (a) cans of "regular" beer sold for \$4.25 each;
- (b) cans of "premium" beer sold for \$6.00 each;
- (c) 1% of canned and bottled beer was lost to spillage or breakage; and
- (d) 2% of canned and bottled beer was given away or personally consumed.

Ex. J1, at Worksheet 3 – On-sale Canned or Bottled Beverage Sales.

61. The auditor erroneously assumed that cans and bottles of beer were never sold at discounted prices. See Ex. J1, at Worksheet 3 – On-sale Canned or Bottled Beverage Sales. On busy nights, Blarney's offered bottled beer at the front door at \$3.00 each, a discount from the

regular price of \$4.25 each. Tr. 35-36, 38. The auditor therefore underestimated the percentage of canned and bottled beer sold at promotional prices.

62. The auditor estimated that during 2009, the taxpayer must have generated revenues of \$277,375.38 from the sale of canned and bottled beer. Ex. J1, at Worksheet 3 – On-sale Canned or Bottled Beverage Sales.

The auditor's estimates of liquor sales

63. From the number of ounces of liquor purchased, the auditor estimated the total revenues that must have been generated from liquor sales, assuming:

- (a) 90% of liquor sales were made at “regular” prices and only 10% at “happy hour” prices;
- (b) an average pour size of 1.5 ounces;
- (c) 75% of liquor sales were “rail” drinks, 20% were premium or call drinks, and 5% were top-shelf drinks;
- (d) rail drinks were sold at a regular price of \$4.25 each and during happy hour at \$2.50 each;
- (e) premium and call drinks were sold at a regular price of \$4.25 each and were never discounted;
- (f) top-shelf drinks were sold at a regular price of \$10.65 each and were never discounted;
- (g) 3% of liquor purchased was lost to spillage;
- (h) 2% of liquor purchased was given away or personally consumed.

Ex. J1, at Worksheet 4 – On-sale Liquor Sales.

64. Based on her assumptions, the auditor estimated that during 2009, the taxpayer must have generated revenues of \$832,436.04 from the sale of liquor. Ex. J1, at Worksheet 4 – On-sale Liquor Sales.

65. In estimating the percentage of liquor sold at promotional prices, the auditor erroneously considered only sales made during “happy hour,” resulting in an underestimate of the percentage of liquor sold at promotional prices. Ex. J1, at Worksheet 4 – On-sale Liquor Sales.

The auditor’s estimates of wine sales

66. From the number of ounces of wine purchased, the auditor estimated the total revenues that must have been generated from wine sales, assuming:

- (a) all wine was sold at a “regular” price of \$6.00 per 6-ounce glass;
- (b) 3% of all wine purchased was lost to spillage; and
- (c) 2% of wine purchased was given away or personally consumed.

Ex. J1, at Worksheet 5 – On-sale Wine Sales.

67. Based on her assumptions, the auditor estimated that during 2009, the taxpayer must have generated revenues of \$11,135.35 from the sale of wine. Ex. J1, at Worksheet 5 – On-sale Wine Sales.

68. On the bar audit questionnaire, the auditor indicated that the average price of a glass of wine was between \$4.50 and \$5.00, based on a list provided to her during the initial meeting on December 1. Ex. J46.¹

69. The auditor miscategorized some wines as liquor, and miscategorized some liquors as wines, Ex. J1, at Worksheet 1 Purchase Detail, resulting in a net overstatement of the amount of liquor purchased. By overstating the amount of liquor purchased, the auditor overestimated the

¹ The list used by the auditor is not part of the record before us.

number of ounces of liquor sold, spilled, and given away. The auditor's overstatement of the amount of liquor sold overestimated the taxpayer's total revenues from sales of liquor and wine.

The auditor's estimate of total 2009 alcohol sales

70. In all, the auditor concluded that during 2009 the taxpayer must have generated revenues from the sale of alcohol totaling \$1,808,357.32. Ex. J1, at Worksheet 6 – On-Sale Sales Summary. The auditor subtracted from that amount \$707,654—the amount of sales reported by the taxpayer to the Commissioner during 2009—to arrive at total unreported sales during 2009 alone of \$936,176.44, or \$78,014.70 per month. Ex. J1, at Worksheet 6 – On-Sale Sales Summary.

The auditor overstates alcohol purchases seven-fold

71. The auditor's calculation of the total dollar amount of alcohol (beer, wine, and liquor) purchased by the taxpayer in 2009 was \$1,981,365.10. Ex. J1, at Worksheet 1 – Use Tax Summary.

72. After trial, the Commissioner stipulated that the taxpayer's actual alcohol purchases were \$277,971. Appellee's Post-Trial Br. 22.

73. The taxpayer's actual purchases of alcohol during 2009 totaled \$277,971.

74. The auditor's calculation of the total amount of alcohol purchased by the taxpayer in 2009 overstated the taxpayer's actual purchases by \$1,703,394.

The auditor's use tax calculations

75. To estimate the amount of use tax owed, the auditor multiplied her calculation of total purchases of liquor, wine, and beer (\$1,981,365.10) by 2%, her assumed giveaway percentage, resulting in estimated total liquor giveaways of \$39,627.30 during 2009. Ex. J1, at Worksheet 1 – Use Tax Summary. By overstating the amount of alcohol purchased, the auditor overstated the amount of alcohol given away or consumed personally, resulting in an overestimate

of the amount of use tax owed. Because the auditor's calculation of total alcohol purchases was erroneous, her calculation of the amount of use tax owed on liquor giveaways was likewise erroneous.

76. The auditor reviewed the taxpayer's general ledger for purchases during 2009 of goods, services, and fixed assets on which it appeared no sales tax had been paid. Ex. J42, at 05/17/11. The auditor divided this sum by 12 to arrive at her estimate of monthly purchases of goods, services, and fixed assets on which no sales tax had been paid during 2009, and projected this amount across the entire audit period. Ex. J1, at Schs. O, P, Q, R & S.

The auditor's entertainment tax estimates

77. Using figures supplied by Mr. Mulrooney, the auditor estimated the revenues generated during periods when Blarney's offered live entertainment on Friday nights, and which are subject to Minneapolis entertainment tax. Ex. J1, at Sch. S, part 2.

The auditor's preliminary audit report and the taxpayer's response

78. The auditor arrived at a preliminary figure of \$479,000 in sales and use tax, interest, and late-filing penalties due and owing. Ex. J42, at 04/01/11. The auditor presented her calculations to Mr. Mulrooney and Mr. Pitzl on April 5, 2011. Ex. J42, at 04/05/11.

79. On May 5, 2011, Mr. Pitzl sent the auditor a spreadsheet showing the taxpayer's calculation of sales. Ex. J42, at 05/05/11.² The auditor believed that Mr. Pitzl's spreadsheet used different drink prices than those previously provided to her. Ex. J42, at 05/19/11.

80. On May 13, 2011, the auditor received reports from the taxpayer's point-of-sale system for certain drinks sold during three "test months" (January, April, and September 2009). Ex. J42, at 05/13/11; Ex. J45. For April 2009, for example, the report showed sales of 3,432 Long

² Mr. Pitzl's spreadsheet is not part of the record before us.

Island iced teas—a drink that was regularly discounted on Thursday nights to \$2.50—for a total of \$9,528.50, or an average price of \$2.776 each. Ex. J45. According to the auditor, the point-of-sale reports showed substantially lower drink prices than previously provided to her during the December 1 meeting (when Mr. Mulrooney reported a mixed drink price of \$4.25), or during her March 22 call to “Marta.” Ex. J42, at 05/19/11. The auditor concluded that the taxpayer was “unable to provide [her] reliable backup records to refute using the Bar Audit Spreadsheet.” Ex. J42, at 05/19/11.

June 30, 2011 order and taxpayer’s appeal

81. By order dated June 30, 2011, the Commissioner assessed the taxpayer \$366,358.31 in additional sales and use tax; \$12,965.31 in late-filing penalties; and \$30,048.07 in interest. Ex. J1.

82. The taxpayer timely appealed the assessment to this court. Ex. J2.

Grant Thornton opines on the reliability of the taxpayer’s records

83. During the appeal, the taxpayer retained the accounting and auditing firm of Grant Thornton to determine whether Blarney’s books and records for the period between September 2007 and February 2011 were sufficient to be audited, and whether Blarney’s point-of-sale system properly reflected taxable sales of liquor and food for purposes of Minnesota sales and use tax. Ex. J8, at 2.

84. Grant Thornton opined that the assessment produced an unrealistic sales multiple, that is, sales divided by the cost of purchases. According to Grant Thornton, the industry standard for bars is 2.3, Ex. J8, at 8, meaning a dollar spent on alcohol should produce \$2.30 in revenues. Ex. J8, at 8. For single-location full-service restaurants, the industry standard is 4.5, Ex. J8, at 10, meaning a dollar spent on alcohol should generate \$4.50 in revenues. In this case, the auditor

estimated total alcohol sales during 2009 of \$1,808,357.32 (both reported and unreported) on total alcohol purchases assumed to be \$1,981,365.10, Ex. J8, at 8, or a sales multiple of less than 1.

85. Grant Thornton divided the auditor's calculation of total alcohol sales (\$1,808,357) by \$277,971, the taxpayer's total alcohol purchases according to its general ledger, to arrive at a sales multiple of 6.95, Ex. J8, at 10, meaning that (even using a correct purchases amount) the auditor assumed a dollar spent on alcohol must have generated nearly \$7.00 in revenues, a figure far in excess of industry averages.

86. Grant Thornton opined that Blarney's books and records fairly reflect the transactions conducted by the business and may be relied upon when conducting a sales and use tax audit. Ex. J8, at 17.

87. Because the taxpayer filed its sales and use tax returns on-line, Grant Thornton did not have access to all of the taxpayer's sales and use tax returns while it was preparing its report. Ex. J8, at 17. For the periods for which Grant Thornton did have return information (January 2009 through February 2011), Grant Thornton noted that sales of food and alcohol reflected in the point-of-sale system varied from the amounts reported on the sales tax returns for the same period, although by less than the Commissioner's estimates. Ex. J8, at 17-18. Grant Thornton further noted that Blarneys had not paid Minneapolis sales tax on either food or liquor between January 2009 and February 2011, despite its Minneapolis address. Ex. J8, at 18.

Commissioner's recalculation during litigation

88. After the close of discovery, the Commissioner provided the taxpayer's counsel with a "recalculation" of the taxpayer's liability relying in part on the taxpayer's books and records rather than the indirect unit-volume audit. Pridgeon Aff. Ex. 3 (Sept. 12, 2014).

89. Because the taxpayer's point-of-sale system does not generate a report of each individual sale entered into the point-of-sale system, the auditor reviewed a report generated by the taxpayer's point-of-sale system that showed the total number of sales for each type or brand of drink and the aggregate net sales revenue for that drink for each hour of each calendar day during July 2009 and February 2010. Lencowski Aff. ¶ 8 (Sept. 18, 2004).

90. The auditor then calculated monthly taxable sales from the itemized reports of daily sales. Lencowski Aff. ¶ 20. Although the totals did not match exactly, the auditor determined that the taxpayer's point-of-sale system fairly represented actual sales as estimated by the auditor's summation of daily sales. Lencowski Aff. ¶ 22.

91. The auditor compared taxable sales from the monthly summary reports generated by the taxpayer's point-of-sale system to the sales tax returns filed by the taxpayer and determined that the taxpayer had underreported its sales during the audit period. Lencowski Aff. ¶ 24.

92. The auditor then "adjusted [the taxpayer's] purchase total" and, on the basis of the adjustment, determined that the taxpayer owed additional use tax. Lencowski Aff. ¶ 25.

93. The auditor separately calculated sales tax owed on sales of alcohol misclassified as "food" in the point-of-sale system. Lencowski Aff. ¶ 26.

94. The auditor also "used the unit volume method to calculate [the taxpayer's] additional sales tax liability to account for discrepancies between records of [the taxpayer's] purchases and [the taxpayer's] books and records." Lencowski Aff. ¶ 27.

95. Any assertion by the Commissioner that there are unrecorded purchases is inconsistent with the Commissioner's agreement that the taxpayer's books and records accurately reflect the taxpayer's total 2009 alcohol purchases of \$277,971. *See Appellee's Post-Trial Br.* 22.

96. The Commissioner's recalculation reduced the taxpayer's purported liability for Minnesota sales tax from \$218,831.32 to \$41,396.03. *Compare* Ex. J1, at Sch. A, *with* Pridgeon Aff. Ex. 3, at Sch. A.

97. The Commissioner's recalculation reduced the taxpayer's purported liability for Minneapolis sales tax on liquor from \$16,382.94 to \$3,174.78. *Compare* Ex. J1, at Sch. B, *with* Pridgeon Aff. Ex. 3, at Sch. B.

98. The Commissioner's recalculation reduced the taxpayer's purported liability for Hennepin County sales tax on liquor from \$4,914.84 to \$952.45. *Compare* Ex. J1, at Sch. C, *with* Pridgeon Aff. Ex. 3, at Sch. C.

99. The Commissioner's recalculation reduced the taxpayer's purported liability for transit improvement sales tax on liquor from \$6,241.28 to \$954.42. *Compare* Ex. J1, at Sch. D, *with* Pridgeon Aff. Ex. 3, at Sch. D.

100. The Commissioner's recalculation reduced the taxpayer's purported liability for sales tax on gross receipts from sales of liquor from \$81,915.54 to \$29,567.87. *Compare* Ex. J1, at Sch. E, *with* Pridgeon Aff. Ex. 3, at Sch. E.

101. The Commissioner's recalculation reduced the taxpayer's purported liability for Minnesota use tax on liquor purchases from \$9,262.90 to \$1,270.48. *Compare* Ex. J1, at Sch. F, *with* Pridgeon Aff. Ex. 3, at Sch. F.

102. The Commissioner's recalculation reduced the taxpayer's purported liability for Minneapolis use tax on liquor purchases from \$693.42 to \$94.92. *Compare* Ex. J1, at Sch. G, *with* Pridgeon Aff. Ex. 3, at Sch. G.

103. The Commissioner's recalculation reduced the taxpayer's purported liability for Hennepin County use tax on liquor purchases from \$207.90 to \$28.56. *Compare* Ex. J1, at Sch. H, *with* Pridgeon Aff. Ex. 3, at Sch. H.

104. The Commissioner's recalculation reduced the taxpayer's purported liability for transit improvement use tax on liquor purchases from \$264.32 to \$36.16. *Compare* Ex. J1, at Sch. I, *with* Pridgeon Aff. Ex. 3, at Sch. I.

105. The Commissioner's recalculation reduced the taxpayer's purported liability for gross receipts use tax on liquor from \$3,467.52 to \$475.44. *Compare* Ex. J1, at Sch. J, *with* Pridgeon Aff. Ex. 3, at Sch. J.

106. The Commissioner included in her recalculation, for the first time, gross receipts tax of \$4,350.80 on liquor miscategorized by the taxpayer's point-of-sale system as food. Pridgeon Aff. Ex. 3, at Sch. T.

107. The Commissioner included in her recalculation, for the first time, general Minnesota sales tax of \$9,430.88 on the "average discrepancy between what volume of liquor was sold based on the POS sales records and what volume of liquor was purchased based on liquor distributor records." Pridgeon Aff. Ex. 3, at Sch. U. The recalculation provides no details about the discrepancy nor explains why the Commissioner's original computation did not include any amount for this asserted liability.

108. The Commissioner's recalculation included, for the first time, Minneapolis sales tax of \$706.02 on the "average discrepancy between what volume of liquor was sold based on the POS sales records and what volume of liquor was purchased based on liquor distributor records." Pridgeon Aff. Ex. 3, at Sch. V. The recalculation provides no details about the discrepancy nor

explains why the Commissioner's original computation did not include any amount for this asserted liability.

109. The Commissioner's recalculation included, for the first time, Hennepin County sales tax of \$211.68 on the "average discrepancy between what volume of liquor was sold based on the POS sales records and what volume of liquor was purchased based on liquor distributor records." Pridgeon Aff. Ex. 3, at Sch. W. The recalculation provides no details about the discrepancy nor explains why the Commissioner's original computation did not include any amount for this asserted liability.

110. The Commissioner's recalculation included, for the first time, transit improvement tax of \$269.12 on the "average discrepancy between what volume of liquor was sold based on the POS sales records and what volume of liquor was purchased based on liquor distributor records." Pridgeon Aff. Ex. 3, at Sch. X. The recalculation provides no details about the discrepancy nor explains why the Commissioner's original computation did not include any amount for this asserted liability.

111. The Commissioner's recalculation included, for the first time, gross receipts tax of \$3,530.32 on unspecified "underreported sales." Pridgeon Aff. Ex. 3, at Sch. Y.

112. The Commissioner's recalculation included, for the first time, Minneapolis sales tax of \$23,245.37 on sales of \$4,649,061—the amount of sales actually reported by the taxpayer on its sales and use tax returns for the audit period. Pridgeon Aff. Ex. 3, at Sch. Z. The Commissioner's recalculation does not explain why this tax was not included in the June 2011 order on appeal, given that it was based on information (the amount of sales actually reported by the taxpayer during the audit period) available to the Commissioner during the indirect audit.

113. Although the Commissioner's recalculation was not signed, it bore a Notice Date, referred to itself as an "assessment," informed the taxpayer that the Commissioner had "made adjustments" for the audit period, included an Explanation of Adjustments, and informed the taxpayer:

If you paid a tax in excess of the taxes lawfully due, you can file a written claim for refund within 3-1/2 years from the date the tax return was due or one year from the date of *an order assessing tax*, an order determining an appeal or a commissioner filed return, whichever is later, provided that you have paid in full the amount shown on the order or return made by the commissioner. The refund claim must identify the taxpayer, the type of tax paid, the period for which the tax was paid, the amount of the overpayment and the grounds on which the refund is being claimed.

Pridgeon Aff. Ex. 3.

CONCLUSIONS OF LAW

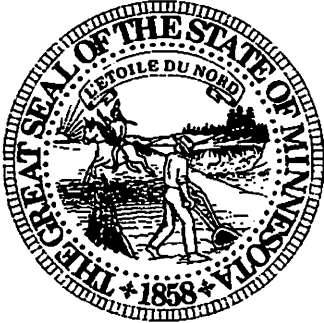
1. Appellant has overcome the prima facie validity of the order on appeal.
2. Appellant has shown by a preponderance of the evidence that the Commissioner's assessment is incorrect.

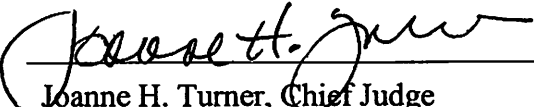
ORDER

The tax court administrator shall contact the parties to schedule a further evidentiary hearing, limited to whether the taxpayer owes additional sales and use tax (and associated interest and penalties) or is owed a refund and, if so, in what amounts.

IT IS SO ORDERED.

BY THE COURT:




Joanne H. Turner, Chief Judge
MINNESOTA TAX COURT

DATED: February 19, 2016

MEMORANDUM

Appellant More, Inc., appeals a June 30, 2011 assessment for sales and use tax, penalties, and interest in the total amount of \$409,371.69. We bifurcated the proceedings and, in the first phase, received evidence concerning the propriety of the Commissioner's decision to audit More, Inc., indirectly and the prima facie validity of the assessment. Appellant contends it has overcome the prima facie validity of the assessment and urges us to reverse the Commissioner's order in its entirety. Appellant's Post-Trial Mem. Law 1; *but see* Appellant's Supplemental Post-Trial Mem. 2 (urging the court to reverse "[t]hat portion of the Commissioner's order dated June 30, 2011 that determined additional sales tax was due based on the use of the indirect, volume pour, method"). The Commissioner, on the other hand, contends that appellant has not proven her order either erroneous or incorrect. Appellee Comm'r's Post-Trial Br. 1. We conclude that appellant has overcome the prima facie validity of the assessment and has proven by a preponderance of the evidence that the assessment is incorrect. We further conclude that the record thus far establishes

that More underreported sales during the audit period. We order further proceedings to establish the amount of More's liability.

Legal standard. The Commissioner's order is prima facie valid; this proceeding is "in the nature of a suit to set aside or modify the order" in which all parties "shall have an opportunity to offer evidence and arguments at the hearing." Minn. Stat. § 271.06, subd. 6 (2014).

The Minnesota Supreme Court has applied the paradigm of property tax appeals to appeals from orders of the Commissioner. *Conga Corp. v. Comm'r of Revenue*, 868 N.W.2d 41, 53 (Minn. 2015) (citing *S. Minnesota Beet Sugar Coop. v. Cty. of Renville*, 737 N.W.2d 545 (Minn. 2007)). In a property tax appeal, the assessor's estimate of the market value of the property is prima facie valid. See Minn. Stat. § 271.06, subd. 6. Although trial in the tax court is de novo, Minn. Stat. § 271.06, subd. 6, "the presumptive validity of the county's assessment remains, and the burden is on the party appealing that assessment to show that it is excessive." *S. Minn. Beet Sugar*, 737 N.W.2d at 558 (citing *In re McCannel*, 301 N.W.2d 910, 923 (Minn. 1980)).

The taxpayer in a property tax appeal overcomes the prima facie validity of the assessment by offering evidence to invalidate it. *Id.* That evidence typically takes one of two forms. Perhaps more commonly, the taxpayer presents affirmative evidence, such as a competent fee appraisal, that the assessed value of the subject property differs from its market value. As we have noted, this approach both overcomes the prima facie validity of the assessed value and helps to meet the taxpayer's ultimate burden to prove market value. *Ford Motor Co. v. Cty. of Ramsey*, No. C5-07-4696 et al., 2014 WL 3888226, at *13 (Minn. T.C. Aug. 5, 2014). But the taxpayer can also overcome prima facie validity of the assessed value by challenging the methodology by which the county arrived at the assessment, such as by "presenting evidence of truly comparable sales that the county had not considered or showing that the county taxed property that is not taxable." *S.*

Minn. Beet Sugar, 737 N.W.2d at 559-60. Once the taxpayer has demonstrated that the assessment does not reflect the true market value of the property, the court may affirm the assessment only if “there is independent support for it in the record.” *Id.* at 560.

In other words, if the taxpayer meets its burden to show that the assessment does not reflect the true market value of the property, the court cannot affirm the county’s assessment simply because it is presumed valid; rather, if the court affirms the county’s assessment, it must be because the evidence indicates that the county’s assessment reflects the actual market value of the property

Id. at 560 n.14. If the assessment is unsupported by the record, “the court must determine for itself the market value of the subject property.” *Id.* at 560.

Applying this paradigm to appeals from assessments made by the Commissioner, the burden is on the taxpayer to overcome the prima facie validity of the Commissioner’s assessment by presenting substantial evidence that the Commissioner’s assessment is incorrect.³ The taxpayer may do so in at least two ways. The taxpayer may present evidence of its own calculation of tax liability lower than the Commissioner’s assessment. Alternately, the taxpayer may challenge the methodology by which the Commissioner arrived at the assessment. If the taxpayer rebuts prima facie validity, we can affirm the assessment only if there is independent evidence in the record to support it. In the absence of such independent evidence, we must determine for ourselves whether the taxpayer is liable for additional tax or is entitled to a refund and, if so, the amount.

In this case, the taxpayer has thus far chosen the latter route, attacking on various grounds the methodology used by the Commissioner to arrive at the assessment. The taxpayer contends

³ We note that it is the *evidence* which need be substantial, *Conga*, 868 N.W.2d at 53, not the amount by which the assessment is shown to be incorrect. In the property tax regime, we have found that a taxpayer rebutted prima facie validity through expert testimony of its expert that the assessment overstated market value by only 10%. *Geneva Exchange Fund XVII, LLC v. Cty. of Dakota*, No. 19-C6-07-8009 et al., 2009 WL 4017075, at *2-3 (Minn. T.C. Nov. 19, 2009). In other words, any error affecting the nominal amount of the assessment will invalidate it, assuming that the evidence of the error is substantial.

that the Commissioner erred in conducting an indirect audit in the first place. The taxpayer further challenges the numerous assumptions used by the Commissioner in conducting the indirect audit. We first address the challenges to the Commissioner's methodology.

A. Challenges to the Commissioner's methodology.

We conduct "a proper, thorough analysis of the Commissioner's audit" and its conclusions. *Conga*, 868 N.W.2d at 53-54.

1. The conduct of the indirect audit. We begin with an overview of the indirect audit process itself. In doing so, we rely at least in part on the exhibits and explanations incorporated in the June 30, 2011 order on appeal, Ex. J1.

By letter dated November 17, 2010, the auditor requested various records from the taxpayer, including "Sales and Use Tax Filings and/or supporting documentation," "Accounts Receivable Ledger," "Sales Journal," "Federal Income Tax Returns," "Bank Statements," and "Credit Card Statements." Ex. J44. The auditor's November 2010 letter indicated that "sampling techniques" could be used "to expedite completion of the audit," and offered that "[r]emoval of all of your records from storage might not be necessary." Ex. J44. Notably, the auditor's November 17, 2010 letter did not request either "z-tapes" or deposit slips for the taxpayer's bank accounts.

The auditor met with Mr. Mulrooney and his accountant, John Pitzl, on December 1, 2010. Ex. J42. During that meeting, the auditor completed a Bar Audit Questionnaire, Ex. 46. Although the questionnaire required detailed information about the bar's operations that could have been assembled in advance, there is no evidence in our record that the auditor provided the taxpayer a copy of the questionnaire before the December 1 meeting. Nor, more significantly, is there any evidence in our record that the auditor informed Mr. Mulrooney of the questionnaire's purpose,

particularly the fact that the information on the questionnaire might be used as data critical to an indirect audit. Indeed, Mr. Mulrooney testified that the auditor did not tell him that his answers to the Bar Audit Questionnaire could be used “in computing sales by the indirect method of proof.” Tr. 288.

We note that each question on the December 2010 Bar Audit Questionnaire asked about the establishment’s then-current operations, even though the auditor’s November 2010 letter indicated the audit was “tentatively scheduled to include the periods of June 1, 2007 through October 31, 2010.” See Ex. J44.⁴ For example, the questionnaire asked “What *are* your drink prices?” rather than “What *were* your drink prices between June 1, 2007, and October 31, 2010?” Although the questionnaire solicited the date of the most recent price increase, it did not ask what prices were *before* that price increase. Simply put, the questionnaire solicited no information about drink prices during the bulk of the audit period itself.⁵

Similarly, the questionnaire asked “What *are* your hours of operation?,” Ex. J46 (emphasis added), rather than “What *were* your hours of operation between June 1, 2007, and

⁴ Eventually, the audit was limited to the period September 1, 2007, to February 28, 2011.

⁵ Nor does it appear that the auditor solicited any information from the taxpayer concerning drink prices during the audit period in any other way. On March 16, 2011, for example, the auditor’s log notes indicate she inquired “about price levels during happy hour,” but there is no indication that her inquiries were directed to price levels during the audit period. Ex. J42. Similarly, on March 22, 2011, the auditor called the bar directly and spoke with someone named “Marta,” who told her “the prices of regular and premium beer at non promotional times and happy hour.” Ex. J42. It appears that the auditor used those prices in the bar audit spreadsheet, Ex. J1, even though there is no indication (1) that the auditor inquired about historical prices, or (2) that “Marta” was even employed by the establishment during the audit period. Indeed, the auditor refused to believe Mr. Mulrooney that the information she had received from “Marta” was incorrect, insisting that he provide “evidence” of different prices. Ex. J42, at 4/5/2011.

October 31, 2010?”⁶ The auditor noted the bar’s hours of operation on the Bar Audit Questionnaire and that “happy hour” ran from 3:30 to 7:00 p.m, Ex. J46, but did not note that (and apparently did not inquire whether) drinks were discounted at any other times. Question 7 asked for “the percentage of non-promotional and happy hour sales by drink size or price.” Ex. J46. This section of the questionnaire is blank; a handwritten note on the bottom of the questionnaire notes that the bar did “most business” between 12 midnight and 2:00 a.m. but does not indicate that most of the bar’s sales between midnight and 2:00 a.m. were discounted. Ex. J46.

As we have indicated, Blarney’s offered different discounts on different beers and drinks on different days throughout the audit period. Question 8 asked for a table of “drink prices,” which assumed single and consistent prices for all domestic and foreign tap beers; for rail, call, and premium liquors, and for wine. Ex. J46. Question 8 also assumed single and consistent prices for all domestic and foreign tap beers, for liquors, and for wine during “happy hour.” Ex. J46. Next to the table of wine prices, the auditor wrote “I have the list (I averaged the list),” Ex. J46, but the list used by the auditor is not part of our record.

The auditor’s log notes indicate that she “examined” the point-of-sale terminal on the bar during the December 1, 2010 meeting. Ex. J42; Tr. 196 (the auditor testifying that she “looked at the hardware that [the taxpayer] had for [its] point of sale system,” “[i]t looked like it was operating,” and “[t]he light was on”). According to the auditor, neither Mr. Mulrooney nor Mr. Pitzl “show[ed] [her] how the point of sale system operated” or even offered to do so. Tr. 196. According to Mr. Mulrooney, he offered the auditor access to the point-of-sale system and to the

⁶ There is no indication on this record that Blarney’s hours of operation changed during the audit period. A change in operations during the audit period, such as shortened or lengthened hours of operation could, however, invalidate an assessment that assumed no such change.

vendor's help line "in case she needed help in accessing the system." Tr. 286. We credit Mr. Mulrooney's testimony.

Question 20 on the questionnaire asked whether the establishment "retain[ed] register Z-tapes or a daily sales register." Ex. J46. On this point, accounts of the conversation also differ. It appears undisputed that the bar's point-of-sale system (called XYNG) does not generate a traditional z-tape, that is, a printed record of each item sold and its sale price. According to the auditor, Mr. Mulrooney stated that there *were* z-tapes, but he saved them for only 30 days and then destroyed them. Tr. 194 ("I asked him if he retained the Z-tapes and he said he did not. He shredded them at the end of 30 days."). The auditor noted essentially the same thing in the Bar Audit Questionnaire: "Yes only for 30 days then shredded. Run reports from his [point-of-sale] computer system for sales tax returns." Ex. J46.

Mr. Mulrooney testified that what he told the auditor were saved for 30 days and then shredded were credit card receipts. Tr. 285-86. We see no reason for Mr. Mulrooney to have dissembled on this point, so easily disproven. Moreover, the auditor's log notes for the December 1 meeting recite something closer to Mr. Mulrooney's version: Mr. Mulrooney "saves all *receipt copies* from his 5 registers then runs a tape at the end of the month. He saves the tape for 30 days then he shreds them." Ex. J42 (emphasis added). But Mr. Mulrooney nevertheless initialed the questionnaire—stating that he shredded z-tapes after 30 days—as "true and correct." Ex. J46. We credit Mr. Mulrooney's testimony that the system did not generate traditional z-tapes, and that what was shredded after 30 days were credit card receipts.⁷

⁷ According to the Commissioner, the auditor requested "sales receipts" "at the outset of the audit." Appellee's Post-Trial Br. 12. For this proposition, the Commissioner cites Ex. J44, the auditor's November 2010 letter, but there is no mention of "sales receipts" in the auditor's November 2010 letter. The Commissioner also cites the auditor's trial testimony, Tr. 191. The auditor testified that at the initial December 1 meeting with Mr. Mulrooney and his accountant,

On December 13, the auditor met with accountant Pitzl “to go through the information requested in the audit confirmation letter.” Ex. J42. Because Mr. Pitzl did not testify, we have only the auditor’s version of the meeting in our record. According to the auditor, Mr. Pitzl had copies of the taxpayer’s bank statements, chart of accounts, general ledger, credit card statements (for both the business and Mr. Mulrooney personally), and some invoices of liquor purchases. Ex. J42. The auditor’s log notes repeat the assertion that Mr. Mulrooney “throws away all of the z-tapes at the end of the month.” Ex. J42. The auditor’s log notes also state that “[c]ash sales were not disclosed” and “[c]ash deposits were not made to the bank accounts provided to [her].” Ex. J42.

After the December 13 meeting, the auditor wrote in the log: “I will need to do an indirect audit using the invoices from the liquor distributors. We do not have hard copies of the sales information. [Taxpayer] does not make cash deposits. [Taxpayer] pays sales tax based on unverifiable information.” Ex. J42. At trial, the auditor denied that these were the reasons she decided to conduct an indirect audit, calling the log note merely “a notation.” Tr. 214-15. After trial, though, the Commissioner conceded that the auditor decided to conduct an indirect audit “based on her determination that [the taxpayer] did not provide copies of sales information and did not make cash deposits.” Appellee’s Post-Trial Br. 6.

she “talked about obtaining documents, certain documents to verify sales and use tax returns. And we talked about the next appointment getting set up.” Tr. 191. In response to a question from the Commissioner’s attorney, the auditor testified that she had “requested documents” before the December 1 meeting, “at least in the confirmation letter if not over the phone as well.” Tr. 191. But in response to a request from the Commissioner’s attorney to list the “topics” she discussed with the taxpayer during her initial call, the auditor testified only that Mr. Mulrooney “wanted [her] to get in contact with his accountant.” Tr. 189-90. At no time did the auditor testify that she asked the taxpayer to produce “sales receipts,” either before or at the December 1 meeting, and the Commissioner’s representation that she did is unsupported by the record.

One of the auditor's proffered reasons was based on her inexplicable failure to understand the taxpayer's bank statements. These statements show that the taxpayer *did* make cash deposits and in substantial amounts. *See, e.g.,* Ex. J22, at T00122 (bank statement for January 2009 showing a service charge of \$29.88 for "coin and currency services"), T00125 (bank statement for February 2009 showing a service charge of \$42.48 for "coin and currency services"); Ex. J26 (bank statement for January 2009 showing both "customer deposits" of \$64,748.42 and electronic deposits of \$77,076.82), (bank statement for February 2009 showing both "customer deposits" of \$47,278.40 and electronic deposits of \$92,591.89). Indeed, the taxpayer's total deposits of cash and credit card receipts during the audit period differ from total sales during the entire audit period, according to its point-of-sale system, by only \$2,801. Ex. J28 (showing total bank deposits of \$4,094,243.96 for the period September 2007 through October 2010 and \$4,091,442.98 in total sales for the same period).

2. Indirect audit procedure - overview

We understand the auditor to have begun the indirect audit by entering the taxpayer's 2009 liquor and beer purchases into a spreadsheet, using records obtained directly from the taxpayer's alcohol suppliers. Ex. J1, at Worksheet 1 (Purchase Detail). The spreadsheet automatically calculated the number of cans of beer purchased, the number of ounces of tap beer purchased, the number of ounces of liquor purchased, and the number of ounces of wine purchased. Ex. J1, at Worksheet 1 – Purchase Detail. The auditor's next steps demonstrate the immense importance of the Bar Audit Questionnaire and of the need to ensure that the taxpayer appreciates that importance.

From the number of ounces of beer purchased, the auditor estimated the total amount of revenues generated from tap beer sales, making assumptions about such things as the proportion

of beer sales made at promotional (happy hour) and non-promotional prices, serving sizes, and drink prices, and making allowances for spillage, giveaways, and personal use. Ex. J1, at Worksheet 2. In making these assumptions, the auditor relied in part on information found on the Bar Audit Questionnaire, Ex. J46.

Similarly, the auditor estimated the total amount of revenues generated from sales of canned and bottled beer, again making assumptions about such things as the proportion of beer sales made at promotional and non-promotional prices, and making allowances for spillage, giveaways, and personal use. Ex. J1, at Worksheet 3. In making these assumptions, the auditor again relied at least in part on information found on the Bar Audit Questionnaire, Ex. J46.

From the number of ounces of liquor purchased, the auditor estimated the total amount of revenues generated from liquor sales, making assumptions about the proportion of liquor sold at promotional and non-promotional prices, drink prices, and allowing for spillage, giveaways, and personal use. Ex. J1, at Worksheet 4. In making these assumptions, the auditor similarly relied at least in part on information found on the Bar Audit Questionnaire, Ex. J46.

Finally, from the number of ounces of wine purchased, the auditor estimated the total amount of revenues generated from wine sales, again making assumptions about the proportion of wine sold at promotional and non-promotional prices, serving sizes, prices, and making allowances for spillage, giveaways, and personal use. Ex. J1, at Worksheet 5. In making these assumptions, the auditor again turned, at least in part, to information found on the Bar Audit Questionnaire, Ex. J46.

Having thus estimated the total amount of revenue the auditor believed were generated from alcohol purchases, the auditor compared that total to the amount actually reported by the business during 2009, and divided that total by 12 to arrive at allegedly unreported sales per month

during the sample period. Ex. J1, at Worksheet 6. The auditor then multiplied the monthly estimate by the number of months in the audit period to arrive at her calculation of the total amount of unreported sales during the audit period. Ex. J1, at Schedule A. The auditor applied relevant taxes to these totals. Ex. J1, at Schs. B (Minneapolis sales tax on liquor), C (Hennepin County sales tax on liquor), D (transit improvement tax on liquor sales), E (gross receipts tax on liquor sales).

Finally, the auditor divided by 12 the total amount of liquor assumed to have been given away or consumed for personal use during 2009 to arrive at a monthly amount she assumed had been given away or consumed for personal use during each month of the audit period. Ex. J1, at Schs. F (Minnesota use tax on liquor purchases), G (Minneapolis use tax on liquor purchases), H (Hennepin County use tax on liquor purchases), I (transit improvement tax on liquor purchases), J (gross receipts tax on liquor purchases). She then multiplied this amount by the number of months in the audit period to arrive at total use tax owed.

3. Analysis of the indirect audit

With this overview of the indirect audit process, we turn to our “proper, thorough analysis” of the auditor’s work, *Conga*, 868 N.W.2d at 53-54, starting with the Bar Audit Questionnaire (Ex. J46). We note that each question on the December 2010 Bar Audit Questionnaire asked about the establishment’s then-current operations, even though the audit period extended back to September 1, 2007. For example, the questionnaire asked “What *are* your drink prices?” rather than “What *were* your drink prices during the audit period?” Ex. J46, at 2. Although the questionnaire asked for the date of the most recent price increase (January 2010, according to the Bar Audit Questionnaire), it did not ask what prices were *before* that price increase. Ex. J46.

Simply put, the questionnaire solicited no information about drink prices during the bulk of the audit period itself.

Nor does it appear that the auditor solicited any information from the taxpayer concerning drink prices during the entire audit period in any other way. On March 16, 2011, for example, the auditor's log notes indicate she inquired "about price levels during happy hour," but there is no indication that her inquiries were directed to happy hour prices during the audit period itself. Ex. J42. Similarly, on March 22, 2011, the auditor called the bar directly and spoke with someone named "Marta," who told her "the prices of regular and premium beer at non promotional times and happy hour." Ex. J42. It appears that the auditor used those prices in the bar audit spreadsheet, *see* Ex. J46, even though there is no indication (1) that the auditor inquired about historical prices or (2) that "Marta" was even employed by the establishment during the audit period. Indeed, the auditor refused to believe Mr. Mulrooney that the information she had received from "Marta" was not correct, insisting that he provide "evidence" of different prices. Ex. J42.

To construct the spreadsheet, the auditor was required to categorize each purchase of alcohol as liquor, beer, or wine. Ex. J1, at Worksheet 1. According to the spreadsheet, the taxpayer purchased 55,560 cans and bottles of "regular" beer; 7,992 cans and bottles of "premium" beer, and 156 cans and bottles of "other " beer; 1,521,728 ounces of "regular" tap beer; 948,826 ounces of "premium" tap beer; 296,113 ounces of liquor, and 11,721 ounces of wine during 2009. Ex. J1, at Worksheets 2-5.

But our analysis of Worksheet 1 shows the auditor miscategorized purchases. For example, the auditor inconsistently categorized purchases of "Two Vines" (a wine) as both "wine" and "liquor." Ex. J1, at Worksheet 1 – Purchase Detail, p. 11. The effect of this miscategorization was to overstate the amount of liquor purchased, and understate the amount of wine purchased,

by 607.2 ounces. Similarly, the auditor inconsistently categorized “Cooks Spumante” (a sparkling wine) as both “wine” and “liquor.” Ex. J1, at Worksheet 1 – Purchase Detail, p. 11. The effect of this miscategorization was to overstate the amount of liquor purchased, and understate the amount of wine purchased, by 303.6 ounces. The auditor also miscategorized “Dek Curacao Blue” (a liqueur) as “wine.” Ex. J1, at Worksheet 1 – Purchase Detail, p. 16. The effect of this miscategorization was to overstate the amount of wine purchased, and understate the amount of liquor purchased, by 32.5 ounces. The auditor further miscategorized “Stanford Brut” (a champagne) as “liquor.” Ex. J1, at Worksheet 1 – Purchase Detail, p. 51. The effect of this miscategorization was to overstate the amount of liquor purchased, and understate the amount of wine purchased, by 405.8 ounces. The auditor categorized “Trapiche Oak Cask Malbec” (a wine) as both “wine” and “liquor.” Ex. J1, at Worksheet 1 – Purchase Detail, p. 54. The effect of this error was to overstate the amount of liquor purchased, and understate the amount of wine purchased, by 607.2 ounces.

The auditor’s errors in categorizing purchases necessarily affected her estimate of unreported retail liquor sales (Worksheet 4). To estimate the number of ounces of liquor actually sold, the auditor began with her calculation of the number of ounces of liquor purchased. Ex. J1, at Worksheet 4. By overstating the number of ounces of liquor purchased, the auditor necessarily overstated the number of ounces of liquor sold. The auditor’s errors in categorizing purchases also affected her estimate of unreported wine sales (Worksheet 5). To estimate the number of ounces of wine actually sold, the auditor began with her calculation of the number of ounces of wine purchased. Ex. J1, at Worksheet 5. By understating the number of ounces of wine purchased, the auditor necessarily understated the number of ounces of wine sold. Significantly, because the auditor assumed an average retail price of about \$2.95 per ounce of liquor, but only \$1.00 per

ounce of wine, overstating the amount of liquor sold (and understating the amount of wine sold) resulted in an overstatement of the taxpayer's total revenues from sales of liquor and wine. Any one of these miscategorizations constitutes the substantial evidence required to overcome the prima facie validity of the assessment.

Within the category of beer, the auditor was also required to categorize each brand of beer purchased as either "premium" or "regular." In at least one instance, the auditor categorized the same brand of tap beer—Coors Light—as both "premium" and "regular." Ex. J1, at Worksheet 1, p. 13. The effect of the miscategorization was to overstate the amount of premium tap beer purchased, and understate the amount of regular tap beer purchased, by 9,920 ounces. By overstating the number of ounces of "premium" tap beer purchased, the auditor necessarily overstated the number of ounces of "premium" tap beer sold and underestimated the number of ounces of "regular" tap beer sold. Because the auditor assumed that "premium" tap beers sold at a higher price than "regular" beer (\$6.50 per pint of "premium" beer versus \$4.25 per pint of "regular" beer), the auditor's miscategorization overstated revenues from the sale of "premium" tap beer. Ex. J1, at Worksheet 2. This miscategorization constitutes the substantial evidence required to overcome the prima facie validity of the assessment.

Overall, the bar audit spreadsheet arrived at 2009 purchases of liquor and wine totaling \$995,823.40 and purchases of beer (both canned/bottled and tap) totaling \$985,541.70, for total 2009 purchases of \$1,981,365.10. Ex. J1, at Worksheet 1. Several aspects of this calculation are apparent on its face. First, it implies an average *cost* of liquor and wine of a whopping \$3.235 *per ounce* and an average *cost* of beer of \$0.305 *per ounce*, or more than \$3.60 for a 12-ounce can. Second, as Grant Thornton noted, Ex. J8 at p. 8, the auditor estimated total alcohol *sales* during all of 2009 of only \$1,808,357.32. Ex. J1, at Worksheet 6. In other words, the auditor estimated

the bar's 2009 alcohol purchases *at cost* were nearly \$200,000 more than the revenues those purchases generated *at retail*. The Commissioner did not acknowledge this error, either before or during trial. Not until her post-trial brief did the Commissioner agree "that the purchase amount for 2009 should be changed to \$277,971.00," Appellee's Post-Trial Br. 22, the amount shown on the taxpayer's general ledger for 2009.⁸

The auditor's erroneous calculation of total purchases affected other aspects of the Commissioner's assessment. The auditor estimated unpaid state, county, and municipal use tax on alcohol giveaways as a percentage of alcohol purchases. Ex. J1, at Schs. F, G, and H. Having grossly overstated alcohol purchases, the auditor's calculation of unpaid state, county, and municipal use tax was also grossly overstated.

Despite having based her assessment of use tax on alcohol giveaways on an admittedly wildly overstated estimate of purchases, the Commissioner continues to maintain that the taxpayer "has not demonstrated that the Commissioner's assessment is incorrect." Appellee's Post-Trial Br. 23. We disagree. The conceded error in the calculation of alcohol purchases is sufficient evidence to overcome the *prima facie* validity of the assessment.

We turn to the auditor's revenue estimates. The auditor's estimate of revenues from tap beer sales assumed that only 10% of tap beer sales occurred during "happy hour." Ex. J1, at Worksheet 2. According to the Bar Audit Questionnaire, Mr. Mulrooney estimated that only 2% of sales occurred during the time period denominated as "happy hour," that is, specifically between 3:30 and 7:00 p.m. Ex. J46. But Worksheet 2 instructs the auditor that "happy hour" "refers to

⁸ The taxpayer's general ledger for 2009 shows total alcohol purchases of \$277,971 and total food purchases of \$188,345. Ex. J31, at 36, 38. Because the bar audit spreadsheet (Ex. J1, at Worksheet 1 – Purchase Detail) does not include purchase prices, on this record we cannot determine the precise cause of the auditor's seven-fold error.

any promotional pricing.” Ex. J1, at Worksheet 2. Mr. Mulrooney testified credibly—and the Bar Audit Questionnaire indicates—that the bar did most of its business between midnight and closing time (2:00 a.m.). Tr. 15; Ex. J46. Mr. Mulrooney further testified credibly that the bar’s clientele—“about 80 percent student driven”—virtually always buys the “special.” Tr. 49-50. It is therefore clear that far more than 10% of tap beer sales were made at promotional prices. The auditor’s underestimate of the percentage of tap beer sales made at promotional prices constitutes the substantial evidence required to overcome the prima facie validity of the assessment.⁹

The auditor’s estimate of revenues from tap beer sales also assumed that all beer sold during “happy hour”—that is, between 3:30 and 7:00 p.m.—was “regular” (as opposed to “premium”) beer. Ex. J1, at Worksheet 2. As we have explained, the auditor erred in using “happy hour” to refer only to the period between 3:30 and 7:00 p.m., as opposed to times during which any discounts applied. The auditor’s notes on the Bar Audit Questionnaire indicate a discounted price of \$3.00 for foreign or “premium” beers. Ex. J46. The auditor therefore erred in assuming that Blarney’s never discounted foreign or “premium” beers during the audit period. This error constitutes substantial evidence that overcomes the prima facie validity of the assessment.

In estimating potential revenues from sales of canned and bottled beer, the auditor assumed that all sales were at non-promotional prices, that is, that there were no sales of canned or bottled beer during “happy hour.” Ex. J1, at Worksheet 3. But the auditor herself indicated on the Bar Audit Questionnaire that 2% of canned and bottled beer sales occurred during “happy hour.” Ex. J46. Moreover, Mr. Mulrooney credibly testified that on busy nights, the bar offered bottled

⁹ According to the auditor’s log notes, Mr. Mulrooney later revised his estimate of sales during “happy hour” to 10%, with the caveat that it was only an estimate and he had “no idea” what the actual percentage of sales during “happy hour” was. Ex. J46. It is apparent that Mr. Mulrooney’s estimate still referred only to the time period denominated as “happy hour.”

beer at the front door at \$3.00 per bottle, Tr. 36-38, a discount from the regular price of \$4.25 each, *see* Ex. J1, at Worksheet 3. The auditor's erroneous assumption that canned and bottled beer were never sold at a discount constitutes substantial evidence to overturn the prima facie validity of the assessment.

In estimating potential revenues from sales of liquor, the auditor assumed 90% of liquor was sold at non-promotional prices and only 10% during "happy hour." Ex. J1, at Worksheet 4. As we have explained, the auditor mistakenly limited "happy hour" pricing to the period between 3:30 and 7:00 p.m., when the bar audit spreadsheet uses the term "happy hour" to refer to any period of promotional pricing. Mr. Mulrooney testified credibly that the bar regularly sold Long Island ice tea (a mix of vodka, gin, tequila, rum, and Triple Sec) on Thursday nights at a discounted price of \$2.50. Tr. 50. An understatement of the proportion of liquor sold at promotional prices results in an overstatement of the potential revenues generated by a given amount of liquor purchases. The auditor's underestimate of the percentage of liquor sold at promotional prices constitutes substantial evidence sufficient to overcome the prima facie validity of the assessment.

The auditor totaled her estimates of revenues from sales of tap beer, canned and bottled beer, liquor, and wine and, after subtracting 10.01% for sales tax, arrived at her estimate of the bar's total alcohol sales in 2009 of \$1,643,830.44 net of sales tax. Ex. J1, at Worksheet 6. From this, the auditor subtracted total reported sales of \$707,654.00, to arrive at her estimate of unreported sales of \$936,176.44 in 2009. Ex. J1, at Worksheet 6. The auditor divided that by 12 to arrive at her estimate of monthly unreported sales of \$78,014.70 per month during the sample

period. Ex. J1, at Worksheet 6.¹⁰ Multiplied across the entire audit period, the auditor estimated unreported sales of \$3,276,617.40, and unpaid state sales tax of \$218,831.32. Ex. J1, at Sch. A. The same estimate of unreported sales resulted in an estimate of unpaid Minneapolis sales tax of \$16,382.94 (Ex. J1, at Sch. B), unpaid Hennepin County sales tax of \$4,914.84 (Ex. J1, at Sch. C), unpaid transit improvement tax of \$6,241.28 (Ex. J1, at Sch. D),¹¹ and unpaid gross receipts tax of \$81,915.54 (Ex. J1, at Sch. E). There is substantial evidence in our record that the auditor's estimates of unreported sales, and therefore of unpaid state sales tax, unpaid Minneapolis sales tax, unpaid Hennepin County sales tax, unpaid transit improvement tax, and unpaid gross receipts tax, are erroneous and therefore no longer prima facie valid.

To estimate the amount of use tax owed, the auditor multiplied her admittedly vastly overstated calculation of total purchases of liquor, wine, and beer (\$1,981,365.10) by 2%, her assumed giveaway percentage, resulting in total liquor giveaways of \$39,627.30 during 2009. The auditor divided this sum by 12 to arrive at the amount of liquor given away (\$3,302.28) during each month of 2009, and then multiplied this amount by the number of months in the audit period. This estimate of liquor given away resulted in an estimate of unpaid use tax of \$9,262.90 (Ex. J1, at Sch. F), unpaid Minneapolis use tax of \$693.42 (Ex. J1, at Sch. G), unpaid Hennepin County use tax of \$207.90 (Ex. J1, at Sch. H), unpaid transit improvement use tax of \$264.32 (Ex. J1, at Sch. I), and unpaid gross receipts tax of \$3,467.52 (Ex. J1, at Sch. J). There is substantial evidence in our record that the auditor's estimate of unpaid use tax, unpaid Minneapolis use tax, unpaid

¹⁰ By the auditor's estimate, the taxpayer reported only 43% of its sales during the sample period. See Ex. J1, at Worksheet 6.

¹¹ Transit improvement tax was assessed beginning July 1, 2008. Ex. J1, at Sch. D.

Hennepin County use tax, unpaid transit improvement use tax, and unpaid gross receipts tax are erroneous and therefore no longer prima facie valid.

The auditor reviewed the taxpayer's general ledger for purchases of goods and services during 2009 on which it appeared no sales tax had been paid. Ex. J42, at 3/3/11; *see* Ex. J1 at Sch. K. These purchases totaled \$5,525.99 during 2009. *See* Ex. J1, at Sch. K. The auditor divided this sum by 12 to arrive at her estimate (\$460.50) of purchases of goods and services during each month of the audit period, on which no sales tax had been paid. *See* Ex. J1, at Sch. K. The auditor projected these purchases across the audit period, arriving at an estimate of total state use tax unpaid of \$1,297.81 (Ex. J1, at Sch. K); total Minneapolis use tax unpaid of \$96.65 (Ex. J1, at Sch. L); total Hennepin County use tax unpaid of \$28.99 (Ex. J1, at Sch. M); and total transit improvement use tax unpaid of \$36.82 (Ex. J1, at Sch. N).

The auditor also reviewed the taxpayer's general ledger for purchases of fixed assets on which it appeared no sales tax had been paid. Ex. J42, at 3/3/11; *see* Ex. J1, at Sch. O. These purchases totaled \$49,790, resulting in Minnesota use tax of \$3,303.38 (Ex. J1, at Sch. O); Minneapolis use tax of \$248.97 (Ex. J1, at Sch. P), Hennepin County use tax of \$74.69 (Ex. J1, at Sch. Q), and transit improvement use tax of \$96.41 (Ex. J1, at Sch. R).

Finally, the auditor estimated the amount of sales made during periods when live entertainment was offered, and which are subject to Minneapolis entertainment tax. *See* Ex. J1, at Sch. S. According to Mr. Mulrooney, live entertainment was offered only on Friday nights between 10 p.m. and 2 a.m. Ex. J42, at 6/2/11. Mr. Mulrooney reported that on Friday, January 30, 2009, the bar had done \$4,000 of business during those hours. Ex. J42.

The auditor used that information and "extrapolate[d] [it] using an adjustment factor." Ex. J42, at 6/14/11. According to the auditor's log notes, she "multiplied [the taxpayer's] Friday

night sales amount between 10 pm and 2 am of \$4,000.00,” Ex. J42, but the log notes do not indicate what she multiplied those sales by. The log notes indicate the auditor “then multiplied that by the number of weeks in a month.” Ex. J42. “The adjustment factor was then calculated for the remaining months in the audit period.” Ex. J42. The order on appeal describes the process somewhat more obliquely:

An adjustment factor was determined by dividing the dollar amount of sample adjustments by the total dollar amount of all sampled items (sample period totals). The adjustment factor was then multiplied by the total dollar amount of the population (period totals) being audited to determine the additional taxable amount.

Ex. J1, at Explanation of Sampling Method. We understand the auditor to have applied an “adjustment factor” of 0.13617530 to the taxpayer’s reported total taxable sales, to arrive at her estimate of sales subject to Minneapolis entertainment tax, that is, sales made during periods in which live entertainment was offered. *Compare, e.g.*, Ex. J3 (sales and use tax return for the period ended Sept. 30, 2007, showing total sales of \$88,726) *with* Ex. J1, at Sch. S, Part 3 (multiplying “period total” for September 2007 of \$88,726 by an “adjustment factor” of 0.13617530). To arrive at an “adjustment factor” of 0.13617530, the auditor divided the taxpayer’s reported sales during the month of January 2009 (\$127,189, *see* Ex. J5) by \$17,320. Ex. J1, at Sch. S, part 2.

In sum, the taxpayer has overcome the prima facie validity of the June 2011 assessment.

2. The Bevinco reports.

In addition to challenging the methodology used to conducting the indirect audit, the taxpayer introduced reports prepared by the beverage control inventory company Bevinco during the audit period and called its local franchisee, Kamee Swanum Cole, to testify. Bevinco’s estimate of lost revenues differs significantly from the auditor’s estimate of unreported sales.

Ms. Cole testified that Bevinco took a weekly physical inventory of all alcohol in the bar, weighing each of the open bottles using a scale accurate to one-thirtieth of an ounce, counting all

full bottles of beer, wine, and liquor, and weighing the kegs of beer to “know exactly what is on hand currently.” Tr. 91-92. Bevinco then added purchases during the week, using invoices provided by the taxpayer. Tr. 92. By comparing inventory levels from week to week, Bevinco determined the number of ounces of each brand of liquor, wine, and beer used during the week. Tr. 93. Bevinco then compared the amount of alcohol used during the week to the amount reported as sold according to the taxpayer’s point-of-sale system, based on the taxpayer’s recipe for each particular drink. Tr. 93.

Bevinco produced a variety of reports for the taxpayer, which were introduced at the hearing. One series of reports calculated the amount of each brand of alcohol presumably used (or, at least, missing from inventory) during the week and its cost to the taxpayer. *See, e.g.*, Ex. J36 (reporting that during the week of March 23-30, 2009, 107.62 ounces of Crown Royal was used but only 85.56 ounces were reported sold), Ex. J38 (reporting that during the week of December 29, 2009 – January 4, 2010, 70.38 ounces of Crown Royal were used but 85.62 ounces were reported sold); Ex. J40 (reporting that during the week of December 28, 2010 – January 3, 2011, 236.02 ounces of Crown Royal were used but 280.64 ounces were reported sold). In making these calculations, Bevinco relies on the taxpayer’s actual “recipes.” *See* Tr. 102.

A second series of reports also calculated the amount of each type of alcohol presumably used (or, at least, missing from inventory) during the week but included total sales of that type according to the taxpayer’s point-of-sale system. *See, e.g.* Ex. J37 (reporting that during the week of March 23-30, 2009, 309.73 ounces of wine were used, 264 ounces were reported sold (at a total of \$187.46), and wine on-hand as of March 30 had a cost of \$119.75), Ex. J39 (reporting that during the week of December 29, 2009 – January 4, 2010, 1433.49 ounces of wine were used, 1333.61 ounces of wine were reported sold (at a total of \$877.26), and wine on-hand as of

January 4 had a cost of \$464.08), Ex. J41 (reporting that during the week of December 28, 2010 – January 3, 2011, 1132.29 ounces of wine were used, 1114.24 ounces of wine were reported sold (at a total of \$814.01), and wine on-hand as of January 3 had a cost of \$915.32). This second series of reports also roughly estimated “revenue potential” for each category of alcohol, that is, the additional revenues that could have been generated had all alcohol reported to have been “used” been recorded as sold. Tr. 95-96. For example, for the week of March 23 – 30, 2009, Bevinco estimated that the bar could have generated another \$5,309.92 in liquor sales, another \$31.19 in wine sales, another \$129.60 in canned and bottled beer sales, and another \$1,832.54 in sales of tap beer, had all alcohol reported to have been “used” been sold.¹² Ex. J37.

A comparison of the Bevinco reports and the Commissioner’s assessment reveals significant differences. For example, the Commissioner assumed that the taxpayer had unreported sales for each month of the audit period of \$78,104.70. Ex. J1, at Sch. A. By comparison, Bevinco reported (for example) lost revenues for the month of April 2009 of only \$21,197.25 (Ex. J37) and lost revenues for the month of February 2010 of only \$4,271.97 (Ex. J39). The Bevinco reports do not distinguish among alcohol spilled, stolen, given away, or overpoured—not all of which have a use tax impact.¹³ But even if we assume that all alcohol unaccounted for in the Bevinco inventories from week to week is subject to sales and use tax, the Bevinco reports call into substantial question the validity of the assessment.

The Bevinco reports are substantial evidence that overcome the prima facie validity of the assessment.

¹² Ms. Cole testified that in estimating revenue potential, Bevinco uses an average retail price per ounce of each category of alcohol (liquor, wine, canned/bottled beer, and tap beer). Tr. 95-96.

¹³ For example, alcohol given away is subject to use tax, but overpouring merely reduces the revenue generated by a given amount of alcohol.

3. The Grant Thornton report.

Finally, the taxpayer retained the accounting firm of Grant Thornton

to determine whether the direct audit methodology using the books and records of Blarney was sufficient to: 1) conduct a sales and use tax audit to determine the sales subject to the Minnesota sales tax for the periods from September 2007 through February 2011; and 2) determine if the books and records, including Blarney's point of sale ("POS") system, properly reflected taxable sales of liquor and food for Minnesota sales and use tax purposes.

Ex. J8, at 2. Grant Thornton observed that the taxpayer "had a more complex pricing structure than the two levels of pricing used by [the Commissioner] (i.e. full prices for 90% of tap beer and around 1/2 price [sic] 10% of the time as well as no discount at any time for bottled beer, wine, and most liquor)." Ex. J8, at p. 7. According to Grant Thornton, the Commissioner's simplistic two-tiered pricing structure "may be suited for certain types of bars that have a pricing structure whereby the full price is charged all of the time except during 'happy hour,' " but it "failed to account for the daily drink specials that are heavily used by University of Minnesota students."

Ex. J8, at p. 7.¹⁴

Grant Thornton further opined that the assessment produced an unrealistic sales multiple. Ex. J8, at 10. To explain, a sales multiple is computed by dividing sales by the cost of purchases. See Ex. J8, at 10. The industry standard for bars and nightclubs is 2.3—that is, a dollar spent on alcohol should generate \$2.30 in revenues; for single location full-service restaurants, the industry standard is 4.5—that is, a dollar spent on alcohol should generate \$4.50 in revenues. In this case, the auditor estimated total alcohol sales during 2009 of \$1,808,357.32 (both reported and

¹⁴ Grant Thornton reported numerous drink specials found on an archive of Blarney's website. Ex. J8, at p.3. For example, during the week of July 16, 2011, according to Grant Thornton, Blarney's website advertised "anything behind the bar" at 2-for-1, rail drinks for \$2.50, and shots for \$3.00. Ex. J8, at pp. 3-4. We have not considered this information because it is outside of the audit period, which ends February 28, 2011.

unreported, *see* Ex. J1, at Worksheet 6) on total purchases erroneously calculated to be \$1,981,365.10 (Ex. J1, at Worksheet 1). The assessment therefore implies that a dollar spent by this taxpayer on alcohol in 2009 generated only \$0.91 in revenues. In other words, the assessment implies that Blarney's lost money on every alcohol sale, even before considering any other costs. Yet the taxpayer reported net income for federal income tax purposes in 2009 of more than \$111,000. Ex. J33.

As a further check on the validity of the assessment, Grant Thornton divided the auditor's calculation of total alcohol sales by \$277,971, the taxpayer's total alcohol purchases according to its general ledger (and a figure the Commissioner now concedes is correct), to arrive at a sales multiple of 6.95. Ex. J8, at 10. In other words, the assessment implies that a dollar of alcohol generated approximately \$7.00 in revenues. As Grant Thornton points out, this far exceeds the industry standard of 2.3 for bars and nightclubs, and even the 4.5 standard for single-location full-service restaurants. Ex. J8, at 10. That the assessment produces a sales multiple so far removed from industry averages—particularly considering Blarney's significant discounting—is substantial evidence that overcomes the *prima facie* validity of the assessment.

B. The choice of an indirect audit.

The taxpayer also challenges the Commissioner's decision to conduct an indirect audit in the first place, arguing that because the Commissioner erred in choosing an indirect audit, the assessment should be reversed in its entirety. We review the Commissioner's decision to conduct an indirect audit *de novo*, without deference to the Commissioner. *Conga*, 868 N.W.2d at 47; Minn. Stat. § 271.06, subd. 6 (2014) (describing an appeal "from an order or determination of the commissioner" as "an original proceeding in the nature of a suit to set aside or modify the order or determination").

In this case, we decline to address the taxpayer's challenge to the decision to conduct an indirect audit. We have already concluded that the taxpayer has overcome the prima facie validity of the assessment. And as the supreme court's decision in *Conga* makes clear, even if the Commissioner erred in conducting an indirect audit, the taxpayer still bears the burden to prove the amount of its tax liability, if any. *Conga*, 868 N.W.2d at 53. In other words, even if the Commissioner erred in conducting an indirect audit in the first place, the taxpayer in this case is not entitled to outright reversal of the assessment.

C. Order for further hearing

The record thus far establishes that the taxpayer underreported sales during the audit period, and that the Commissioner's assessment is incorrect. Based on the foregoing, we order a further evidentiary hearing to determine the amount, if any, of the taxpayer's liability for sales and use tax. The tax court administrator will contact counsel to schedule a further evidentiary hearing, during which the parties will be entitled to present evidence on the amount of the taxpayer's liability, if any.¹⁵

¹⁵ Throughout her post-trial briefs, the Commissioner argued that we had barred her from presenting evidence during the first phase of trial. *See, e.g.*, Appellee's Post-Trial Br. 19 n.12 ("The Court ordered that the Commissioner could not present the Commissioner's evidence regarding miscategorized items."), 21 n.14 ("The Court ordered that the Commissioner could not present the Commissioner's evidence regarding variance between the volume of liquor purchased and the volume of liquor sold."). The Commissioner misapprehends her August 2014 "recalculation" and, in the process, misstates our order on the taxpayer's motion in limine.

As recited in our January 8, 2015 order on the parties' motions in limine, in June 2011 the Commissioner issued the order on appeal in these proceedings, which assessed appellant an additional \$366,358.31 in sales and use tax for the audit period. In August 2014, after the deadline for completion of discovery and after the case was to have been trial-ready, the Commissioner sent the taxpayer a "recomputation" of the taxpayer's ostensible liability, based on the auditor's review of Blarney's books and records.

As we noted in our January 2015 order, the Commissioner's August 2014 "recomputation" arrived at substantially lower amounts of sales and use tax allegedly due. *Compare, e.g.*, Order

Sch. A (June 30, 2011) (assessing \$218,831.32 in liquor sales tax) *with* Pridgeon Aff. Ex. 4, at Sch. A (Aug. 28, 2014) (showing only \$41,396.03 in liquor sales tax due); Order Sch. F (June 30, 2011) (assessing \$9,262.90 in liquor use tax) *with* Pridgeon Aff. Ex. 4, at Sch. F (Aug. 28, 2014) (showing only \$1,270.48 in liquor use tax due).

Although the Commissioner's "recomputation" reduced by more than half the overall amount of sales and use tax allegedly due, it included additional sales and use tax not part of the June 2011 order. Most significantly, the Commissioner's recomputation included, for the first time, Minneapolis sales tax on sales *as actually reported by the taxpayer to the Commissioner in the taxpayer's sales and use tax returns*. Pridgeon Aff. Ex. 4, at Sch. Z (Aug. 28, 2014).

In response, the taxpayer sought an order barring the Commissioner "from asserting that any additional sales and use tax is due from Appellant" and barring the Commissioner "from introducing evidence relating to" certain months of the audit period, which the taxpayer argued were beyond the statute of limitations. Appellant's Not. Mot. Mot. Limine 1-2 (filed Sept. 12, 2014). We excluded Schedules T, U, V, W, X, Y, and Z of the August 2014 recalculation, and we excluded evidence of the negligence penalty calculated and imposed by the Commissioner only after the June 2011 order on appeal. But we did not grant the taxpayer's request to bar the Commissioner from introducing evidence altogether.

In this respect, the Commissioner misapprehends her August 2014 recalculation as "evidence," either of miscategorized items or of a difference between the volume of liquor purchased and the volume of liquor sold. The August 2014 recalculation includes the Commissioner's calculation, month-by-month, of total sales of "liquor" that the taxpayer's point-of-sale system categorized as "food" but provides no *evidence* of particular items that were allegedly misclassified. The actual *evidence* of misclassifications came through the Commissioner's cross-examination of the Grant Thornton auditors and from the testimony of a Department of Revenue employee. Tr. 136-37 (Mr. Lunka agreeing that the taxpayer's point-of-sale misclassified Pinot Grigio—a wine—as "food"); Tr. 249-253 (Ms. Lencowski testifying that the taxpayer's point-of-sale misclassified Gnarlyhead Pinot Grigio (a wine), Large Black and Tan (a beer), Guinness (a beer), Malbec (a wine), Harp (a beer), "Smithwicks (a beer), Riesling (a wine), Bass (a beer), Bud Light (a beer), and Coors Light (a beer) all as "food").

The August 2014 recalculation also includes the Commissioner's calculation, month-by-month, of allegedly unreported sales attributed to the "average discrepancy between volume of liquor sold per POS and volume of liquor purchased per distributor records." But the August 2014 recalculation provides no *evidence* of specific liquor purchases allegedly unrecorded in the taxpayer's books and records. If such evidence exists, the Commissioner chose not to introduce it during the hearing.