

IN THE WEST VIRGINIA SUPREME COURT OF APPEALS

NO. 20-0226

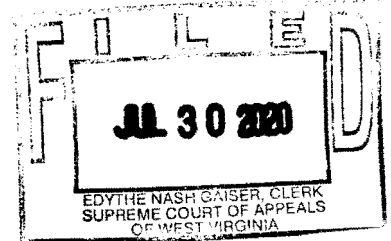
**DALE W. STEAGER, WEST VIRGINIA
STATE TAX COMMISSIONER,**

Respondent below, Petitioner

vs.

**KANG N. ZHENG, MEI D. ZHENG, and
ASIAN GRILL,**

Petitioners below, Respondents.



**REPLY BRIEF OF THE
WEST VIRGINIA STATE TAX DEPARTMENT**

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State Tax Commissioner**

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BEFORE THE WEST VIRGINIA SUPREME COURT OF APPEALS

Appeal No. 20-0226

**DALE W. STEAGER,
STATE TAX COMMISSIONER OF WEST VIRGINIA,
RESPONDENT BELOW, PETITIONER,**

v.

**ZHENG, KANG M. and MEI D., and
ASIAN GRILL,
PETITIONERS BELOW, RESPONDENTS.**

**REPLY BRIEF
OF THE
WEST VIRGINIA STATE TAX DEPARTMENT**

I. ARGUMENT

**A. ASIAN GRILL'S DEMAND FOR A 95% CONFIDENCE INTERVAL BASED ON
STATISTICAL ANALYSIS IS WRONG UNDER THE LAW.**

Facts matter. The law matters. Every tax case is dependent on the facts before the Court and the applicable law of the particular tax statutes at issue. Asian Grill raised four primary arguments in its response brief filed before this Court. The Taxpayer argues that the assessment is incorrect based on statistical analysis, that Asian Grill maintained very good business records, that the Tax Department applied "phantom credit card sales" in the tax assessment, and that the business franchise tax and personal income tax assessments are wrong. None of those arguments are persuasive based on the facts of this case and the applicable statutory framework.

1. A 95% confidence interval is not applicable.

Asian Grills argues that the tax assessment is wrong because the Tax Department relied on undercover surveillance for one full day plus two partial days in conducting the audit and issuing the estimated assessment. The Taxpayer argues that the number of days of used in the surveillance supporting the estimated assessment must obtain a 95% confidence interval based on statistical analysis in order to be valid. *See Supreme Court Brief of the Respondents Kang M. Zheng, Mei D. Zheng, and Asian Grill* at 5-10, 19-32 (hereinafter, *Asian Grill's Brief*). Specifically, Asian Grill argues that the Tax Department must conduct twelve (12) days of surveillance per year or thirty-six (36) days of surveillance for a three-year audit period in order to have a valid statistical sample on which to base the tax assessment. *See Asian Grill's Brief* at 8, 23-24, and 30.

Asian Grill's statistical analysis argument fails for three reasons. First, the Circuit Court specifically rejected the argument that a 95% confidence interval was required in order to issue a tax assessment. While the Circuit Court ruled that the Tax Commissioner's assessment was "completely arbitrary" the Court also stated "...this Court will not draw a bright line percentage for confidence intervals." Furthermore, Judge Bailey ruled, "It would be unreasonable to require the Tax Commissioner to perform enough surveillance to fall within a 95% confidence interval in every circumstance where records are lacking or are too voluminous to do a standard audit." Circuit Court Decision at AR 0008. The Circuit Court refused to adopt the evidentiary standard of a 95% confidence interval as advocated by Asian Grill.

In addition, Asian Grill has not designated statistical analysis and the requirement of a 95% confidence interval as a cross-assignment of error before this Court as required. According to Rule 10(f) of the Rules of Appellate Procedure, the respondent is required to conspicuously raise a cross assignment of error in its brief and to designate the cross-assignment of error on the cover page of

the brief. Asian Grill has failed to raise the issue of statistical analysis and the 95% confidence interval as a cross-assignment of error and to designate it as such.

Second, Asian Grill has based the requirement of a 95% confidence interval on the evidentiary requirements for the admission of statistical data at trial. For example, Asian Grill relied on *Corpus Juris Secundum*, Evidence § 318, "Survey and statistical evidence." See *Asian Grill's Brief* at 27-28. However, *CJS* § 318, addresses the admissibility of statistical evidence at trial. Similarly, Asian Grill relies on the West Virginia Supreme Court decision in *State v. Woodall*, 182 W. Va. 15, 385 S.E.2d 253 (1989), and argues that sampling methodology has been considered and is admissible in this State. See *Asian Grill's Brief* at 30. However, *State v. Woodall* is not applicable to the case before this Court. In *State v. Woodall*, this Court reviewed the conviction of Mr. Woodall for nineteen criminal counts based on two attacks on women in the Huntington area. *Id.*, at 20, 258. This Court stated that the primary issue on appeal was the admissibility of DNA print analysis tests into evidence at trial. *Id.*, 21, 259. In Syl. Pt. 1 of *State v. Woodall*, the Court ruled that expert testimony concerning generally recognized tests is presumptively admissible under Rule 702 of the West Virginia Rules of Evidence. *Id.*, at 21, 259.

The Supreme Court's ruling that generally recognized tests are presumptively admissible under Rule 702 of the Rules of Evidence is not applicable to the case on appeal. According to statute, the WV Office of Tax Appeals is *not* bound by the rules of evidence as applied in circuit courts of this State. The Office of Tax Appeals is authorized to give probative effect to the type of evidence that is commonly relied on by a reasonably prudent person in the conduct of his affairs. See W. Va. Code § 11-10A-10(c).

Furthermore, the Taxpayer argues that the auditors' testimony should not have been admissible evidence because scientific matters must be within the purview of the testifying witness

and the auditors are not expert witnesses. *See Asian Grill's Brief* at 31. While Rule 702(a) of the West Virginia Rules of Evidence would prevent a lay witness from testifying about a scientific issue in the circuit courts, the rules of evidence do not apply at the Office of Tax Appeals. *See W. Va. Code § 11-10A-10(c)*. Asian Grill is arguing that the Court should adopt an evidentiary standard for administrative hearings that was expressly rejected by the West Virginia Legislature when it created the Office of Tax Appeals in 2002.

In addition, Asian Grill has failed to point to any West Virginia authority which requires the Tax Department to issue an assessment based on a 95% confidence interval derived from statistical analysis. Argued below at AR 0034-0035, 0314. No such requirement exists under West Virginia law.

Contrary to Asian Grill's argument, the legislative rule specifically authorizes the Tax Department to base an assessment on the best information available when a vendor's books and records do not adequately reflect the business operations.

If records are inadequate to accurately reflect the business operations of the taxpayer, the auditor will determine the best information available and will base the audit report on that information.

W. Va. Code R. § 110-15-14b.4. As argued previously, the Tax Department utilized the customer count from the January 20 surveillance, the percentage of underreported sales, Asian Grill's consumers sales tax returns that were filed, an examination of the adding machine tapes provided by Asian Grill, and all other records that were provided by the Taxpayer. *See Tax Department's Initial Brief* at 29-30; referencing testimony of Auditor Hockensmith from OTA Transcript at AR 0780-0782, 0786, 1708-0712, 1735-1736, and 1745-1746. Importantly, Judge Bailey ruled that Asian Grill failed to maintain adequate business records and specifically criticized the failure to

provide cash register z-tapes and reliance on handwritten ledgers. See Circuit Court Decision at AR 0005-0006.

Third, Asian Grill relies on a handful of state and federal cases for the importance of obtaining a 95% confidence interval based on statistical analysis. For example, in *Maidenbaum v. Bally's Park Place, Inc.*, 870 F. Supp. 1254 at 1259 (D. N.J. 1994), the federal court ruled that a proffered sample size used in statistical analysis was insufficient to establish a cause of action in a claim of age discrimination under the Age Discrimination Employment Act. Asian Grill also relies on *Shutt v. Sandoz Crop Protection Corp.*, 944 F.2d 1431, 1434 (9th Cir. 1999), another Age Discrimination Employment Act case. The Court ruled in *Shutt* that the class was too small to establish the age discrimination claim. In the case of *Faust v. BNSF Railway Co.*, 337 S.W. 3d 325, 328 (Tax. Crt. of App., Fort Worth 2011), the court addressed personal injury claims based on exposure to chemicals from a wood treatment plant located on BNSF Railway property. The Texas Appellate Court ruled that to be reliable scientific evidence regarding general causation, an epidemiological study must be statistically significant at the 95% confidence level. *Id.* at 337. See *Asian Grill's Brief* at 29-30. Argued below at AR 0118-0119 and AR 0033-0034.¹

However, Asian Grill has provided no case law from any jurisdiction applying a 95% confidence interval based on statistical analysis to a tax assessment. Argued below at AR 0034-0035, 0314. Asian Grill is attempting to impose a limitation on issuing tax assessments that the WV Legislature has not chosen to impose. It is well settled that tax law is the exclusive province of the legislature. See W. Va. Constitution, Art. X, 1. By statute, the Tax Commissioner is authorized to issue assessments when he believes that a tax has not been properly reported and

¹ At the Circuit Court, the Tax Department argued that the cases on which Asian Grill relies are not applicable to a tax audit. Counsel for the Tax Department failed to direct the Court's attention to the proper evidentiary standard for administrative hearings before the Office of Tax Appeals as set forth in W. Va. Code § 11-10A-10(c). Nevertheless, the Circuit Court rejected the 95% confidence interval requirement proposed by Asian Grill.

paid by any taxpayer. The Tax Commissioner is authorized to investigate and determine the tax liability or to *estimate* the tax liability at issue. *See* W. Va. Code § 11-10-7(a). As argued *supra*, the legislative rule states that the tax assessment will be based on the best information available when the books and records do not reflect the business operations. *See* W. Va. Code R. § 110-15-14b.4. If the Legislature had wanted to restrict tax assessments to a 95% confidence interval, then the Legislature would have done so and would *not* have authorized the use of estimated assessments. The plain language of the statute authorizes the Tax Commissioner to issue estimated assessments if necessary and does not include a 95% confidence interval based on statistical analysis. Argued below at AR 0034-0035 and 0314.

The Tax Department has argued before the Supreme Court that the lower court decision has reversed the burden of proof by directing the Tax Department to re-calculate the assessment based on the reported cash sales that were actually reported by Asian Grill. *See Tax Department's Brief* at 32-36. Asian Grill has failed to address this issue in its brief.

The Taxpayer simply made one conclusory statement on the matter.

3. Further, there is nothing in the Circuit Court's well reasoned opinion that remotely changes the burden of proof in such cases. The auditors had the taxpayer's records and completely ignored them in their entirety and relied solely on its flawed statistical sampling technique, a gross and clear error.

Asian Grill's Brief at p. 21. The Taxpayer makes no other response to the assignment of error raised on appeal.

As argued in the Tax Department's previous brief before this Court, the Circuit Court's direction to the Tax Department is a *non sequitur*. The problem is that Asian Grill did **not** report all of its sales on the consumers sales tax returns and could not provide cash register z-tapes substantiating the returns it filed. Therefore, neither the Tax Department nor the Circuit Court can determine the exact amount of unreported cash sales. Asian Grill has failed to comply with its

statutory obligation to keep complete and accurate books and records of its retail sales under W. Va. Code § 11-15-23. The legislative rule specifically requires every retail business to keep original source documents supporting its books and records such as cash register z-tapes. *See* W. Va. Code R. § 110-15-14a.2. By overlooking Asian Grill's failure to create basic records for a retail business, the Court has effectively repealed the statute and the legislative rule. In addition, W. Va. Code § 11-10A-10(a) places the burden of proof on the taxpayer at a hearing before the Office of Tax Appeals. The Circuit Court has erroneously reversed the burden of proof which was placed squarely on the retail vendor by the West Virginia Legislature. Argued below at AR 0120-0121 and AR 0312, 3016.

2. The Tax Department did not conduct a sample and projection audit.

In addition, Asian Grill argues that the Tax Department performed a sample and projection audit incorrectly; therefore, the assessment should be reduced. *See Asian Grill's Brief* at 6, 9, 16, 17, 19-20, 22, 25, 30-32. Asian Grill's argument is simply wrong.

The legislative rule outlines the procedures the Tax Department must utilize when conducting an audit of taxpayers. The rule provides three options for the Tax Department to choose. The Tax Department *may* utilize a detailed audit or a sample and projection audit. *See* W. Va. Code R. § 110-15-14b.2. While the word "shall" connotes a mandatory obligation, the word "may" means that the Tax Department has the option to choose the proper methodology for each audit based on the particular facts surrounding the audit. *See, e.g.,* Syl . Pt. 1, *State ex rel. Coats v. Means*, 188 W. Va. 233, 423 S.E.2d 636 (1992) (the word "shall" is generally afforded a mandatory construction); *see also e.g., State v. Hedrick*, 204 W.Va. 547, 552, 514 S.E.2d 397, 402, (1999) (use of the word "may" means a discretionary choice).

The legislative rule states that a sample and projection audit is appropriate if the records are so detailed, complex or voluminous, that a detailed audit would not be practical; the records are inadequate or insufficient so that a competent audit for the period in questions is not possible; or the costs of a detailed audit would not be practical. *See* W. Va. Code R. § 110-15-14b.3. Significantly, the legislative rule does **not** state that a sample and projection audit must achieve a 95% confidence interval based on statistical analysis. Asian Grill's arguments to the contrary are clearly not supported by the plain language of the legislative rule and West Virginia Code § 11-10-7(a) which authorizes the use of estimated assessments when necessary. Argued below at AR 0034-0035, 0314.

More importantly, the legislative rule includes a third option from which the Tax Department may choose. If the taxpayers books and records are inadequate and do not reflect the business operations, then the Tax Department will base the tax assessment on the best information available. *See* W. Va. Code R. § 110-15-14b.4., quoted *supra*. It is important to note that the OTA Decision expressly ruled that the Tax Department chose this option and used the best information available to estimate tax liability. *See* OTA Decision at 11-12, AR 0283-0287.

In fact, the Office of Tax Appeals noted the fundamental criteria. Chief Administrative Law Judge Pollack ruled that there is a difference between a taxpayer who keeps generally good records but has a few or even several missing records versus a taxpayer whose records do not provide an adequate picture of the business operations. In the former situation, a sample and projection audit would be a valid choice rather than a detailed audit while in the latter situation the audit must be based on the best information available. *See* OTA Decision at 0286-0287. Argued below at AR 0120-0121. As argued previously, this audit was initiated after Auditors Hockensmith and Mills ate dinner at the restaurant in 2010; the two auditors observed that Asian

Grill did not enter their meals into the cash register. *See WV State Tax Department's Supreme Brief* at p.2. In addition, the auditors observed several other transactions that were not entered in the books and records of Asian Grill while conducting the surveillance in 2011. *Id.* at 3-5. If Asian Grill had provided the fundamental business record of cash register z-tapes, then this case would not be before the Court. Since Asian Grill failed to keep adequate business records and the proffered records did not adequately the business operations, the Tax Department chose to base the estimated assessment on the best information available. Argued below at AR 0107-0114, 0116-0118, 0120-0122 and 0314.

Finally, the Taxpayer argues that the Tax Department tried to conduct a sample and projection audit, did so improperly, and attempted to hide the facts. *See Asian Grill's Brief* at 16-17, 30-31. Asian Grill has misstated the testimony in the record.

Attorney Rodak.

Q: Thank you. Did you use a sample-and-projection technique during this audit?

Auditor Hockensmith.

A: Well, we'll call it that. I took a sample, and I projected it to the whole audit period. I took a sample, and due to the records that were clear to me, not necessarily manufactured for audit purposes, but just in general, they're not accurate and they're not complete. And being unreliable, I had no other way to determine actual sales because there was [*sic*] no other records provided.

Attorney Rodak.

Q: Would you say it is fair to characterize this audit as you used the best information available to you, due to inadequate records?

Auditor Hockensmith.

A: I do feel that I used the best information available for this specific taxpayer.

Transcript, Day 2, AR 0800-0801. A fair reading of Auditor Hockensmith's testimony is that she based the audit on the best information available due to the inadequate business records provided by Asian Grill. Assuming *arguendo*, this Court chooses to characterize the audit process employed

as a sample and projection audit, Asian Grill has provided no authority imposing a 95% confidence interval on the Tax Department to issue an estimated assessment.

The Circuit Court decision should be reversed and the Tax Department's assessment should be affirmed since it was based on the best information available as authorized by the legislative rule.

B. ASIAN GRILL FAILED TO MAINTAIN ADEQUATE BOOKS AND RECORDS AS REQUIRED BY LAW.

The Taxpayer has argued before this Court that it kept good books and records. *See Asian Grill's Brief* at 10, 12-13, & 32. Asian Grill argues that its expert witness testified that the restaurant kept adequate records, that the records were very good, and that the records were typical records that a restaurant business would keep. Asian Grill's witness testified the records were "...better than most restaurants that I've been around." *See Asian Grill's Brief* at 33.

However, the evidence in the record clearly demonstrates that Asian Grill failed to keep the most fundamental records for a retail vendor—cash register z-tapes. Auditor Hockensmith testified that Asian Grill failed to produce cash register z-tapes and provided adding machine tapes instead. *See* Testimony of Auditor Hockensmith, OTA Tr. 2, 119-120, AR 0783-0784 and OTA Tr. 2, 201, AR 0864. The Office of Tax Appeals found that Asian Grill failed to produce the mandatory cash register z-tapes and only provided adding machine tapes. *See* OTA Decision at Footnote 4, AR 0284. The Office of Tax Appeals ruled that Asian Grill failed to maintain adequate and accurate business records and that the records did not accurately reflect the business operations. *Id.*, Conclusion of Law 11 at AR 0295. The Circuit Court specifically ruled that Asian Grill failed to maintain proper business records and further ruled, "...this Court will not disturb the factual finding that Asian Grill's business records were inadequate as to the cash register tapes

and hand written ledgers of Asian Grill, as this evidence is credible and undisputed; ..." AR 0006. Argued below at AR 0121-0122, 0315-0316.

The Circuit Court's ruling that Asian Grill's books and records were inadequate should be affirmed by the Court based on the clear evidence in the administrative record.

C. THE TAX DEPARTMENT DID NOT BASE THE ASSESSMENT ON "PHANTOM CREDIT CARD SALES" CONTRARY TO ASIAN GRILL'S ARGUMENT.

Asian Grill argues that the Tax Department's estimated assessment is overstated because it includes "phantom credit card sales" that were not processed through the restaurant's bank and were not properly reported. The Taxpayer argues that the Tax Department erroneously "grossed up" total reported sales which would include credit card sales that leave a digital trail; the Taxpayer argues that only reported cash sales should be grossed up. *See Asian Grill's Brief* at 34-35.

The Taxpayer's argument is simply wrong. The tax assessment represents the unreported cash sales and not "phantom credit card sales" as argued by Asian Grill. As argued previously, without cash register z-tapes or the digital equivalent, the Tax Department cannot determine the total dollar amount of sales on any particular day. On January 28, 2011, the auditors observed 87 customers; but, Asian Grill only reported 30 customers for that day. *See Tax Department's Initial Brief* at p. 7, referencing AR 1817-1818. Therefore, the Tax Department cannot determine the actual dollar amount of the unreported 57 cash sales on January 28, based on the records provided by the Taxpayer. The average dollar amount of unreported sales could be \$8.25 per sale or \$11.15 per sale or \$15.82 per sale. Without cash register z-tapes, the Tax Department cannot determine whether credit card sales constituted 22% of sales, 41% of sales or 87% of sales. Cash register z-tapes would provide the exact sales total for January 28 and the exact ratio of credit card to cash sales; but, Asian Grill failed to provide cash register z-tapes.

As a result, the auditors grossed up reported sales (which included both *reported cash* and all credit card sales), calculated the sales tax liability, and gave Asian Grill full credit for all sales tax that was remitted. Therefore, Asian Grill received full credit for *reported sales*. The outstanding tax liability on the assessment represents *unreported cash sales* only. There are no "phantom credit card sales" as claimed by Asian Grill.

D. THE TAX DEPARTMENT CORRECTLY CALCULATED THE BUSINESS FRANCHISE TAX LIABILITY AND PERSONAL INCOME TAX LIABILITY.

Finally, Asian Grill argues that the Tax Department erroneously calculated the business franchise tax liability and personal income tax liability on the assessments. Contrary to Asian Grill's arguments, the Tax Department did not proceed pell-mell and pile on undue tax liabilities simply to run a tab. *See Asian Grill's Brief* at 35-37.

Auditor Hockensmith's testimony was clear. Asian Grill did not file the mandatory business franchise tax returns for the years 2005 through 2009. See OTA Tr., Day 2, 145-146, AR 0809-0810. The assessments were based on the failure to file tax returns. Similarly, the unreported consumers sales tax liability impacted the personal income tax liability for the Zhengs.

West Virginia imposes a business franchise tax on corporations and partnerships. W. Va. Code § 11-23-1. The tax base for the business franchise tax is the capital of the business entity. W. Va. Code § 11-23-4. For a partnership, the capital is specifically defined as:

Partnerships. -- In the case of a partnership, the average of the beginning and ending year balances of the value of partner's capital accounts from Schedule L of Federal Form 1065, prepared following accepted accounting principles and as filed by the taxpayer with the Internal Revenue Service for the taxable year.

W. Va. Code § 11-23-3(b)(2)(C).

According to Petitioner's Exhibit 12, AR 1549-1649, Kang M. and Mei D. Zheng operated Asian Grill as a partnership for federal income tax purposes for the years 2007 through 2011. The

auditor testified that Asian Grill did not file a West Virginia business franchise tax return for the years 2005 through 2009. *See* OTA Tr., Day 2, 145-146, AR 0809-0810. Auditor Hockensmith created a business franchise return for the Zhengs for the years 2005 through 2011 based upon the information on the Zheng's federal income tax returns. Since the federal returns did not indicate a distribution to the partners, the increased sales were classified as partners' equity. *Id.*, *see also* OTA Tr., Day 2, 220, AR 0880.

Similarly, the unreported sales by Asian Grill affected the personal income tax returns filed by the Zhengs for the years 2009, 2010 and 2011. Auditor Hockensmith added the unreported sales to the federal adjusted gross income of the Zhengs. *See* Tax Department's Exhibit 15, AR 1849-1887 and Exhibit 16, AR 1889. Federal adjusted gross income is the starting point in calculating West Virginia taxable income. W. Va. Code § 11-21-12(a). The unreported sales by Asian Grill had the net effect of increasing federal adjusted gross income which, in turn, increased the West Virginia taxable income for the Zhengs. *See* W. Va. Code § 11-21-12g(d). Argued below at AR 0121-0122; 0315-0316.

The business franchise tax assessments and the personal income tax assessments were calculated correctly under the law. The ruling of the Circuit Court remanding these two assessments for further proceedings should be reversed and the two tax assessments should be affirmed.

II. CONCLUSION

The audit of a restaurant should be a simple matter if the Taxpayer can provide basic business records. However, Asian Grill could not provide cash register z-tapes or the digital equivalent from its computerized point-of-sale system. In addition, the auditors ate dinner at the restaurant twice and observed that their meals were not entered into the cash register. Since Asian

Grill could not provide basic business records for a retail vendor and the proffered records were incomplete, the Tax Department estimated the consumers sales tax liability based on the best information available. The Circuit Court decision has erroneously reversed the burden of proof contrary to law and the legislative rule. Asian Grill's choice to disregard its statutory obligation to maintain complete and accurate business records should not be rewarded by limiting the "gross up" to the cash sales that Asian Grill chose to report.

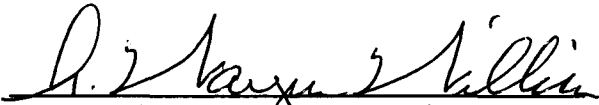
The Circuit Court decision should be reversed, the decision from the Office of Tax Appeals should be affirmed, and the estimated assessments should be affirmed by this Court.

Respectfully submitted,

**DALE W. STEAGER,
STATE TAX COMMISSIONER
OF WEST VIRGINIA,**

By counsel,

**PATRICK MORRISEY
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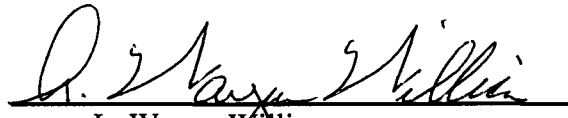
**KANG N. ZHENG, MEI D. ZHENG, and
ASIAN GRILL,**

Petitioners below, Respondents.

CERTIFICATE OF SERVICE

I, L. Wayne Williams, counsel for Dale W. Steager, State Tax Commissioner of West Virginia, do hereby certify that the following *Reply Brief of the West Virginia State Tax Department* was served upon counsel of record by depositing a true copy thereof, in the United States mail, first class, postage prepaid, on this the 30th day of July, 2020 addressed as follows:

C. Page Hamrick
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Charleston, WV 25329


L. Wayne Williams