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IN THE WEST VIRGINIA SUPREME COURT OF APPEALS

NO. 20-0226

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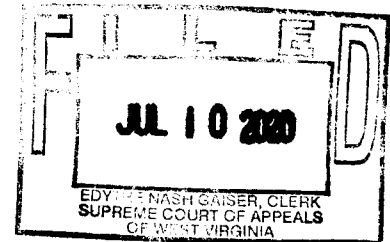
**DALE W. STEAGER, WEST VIRGINIA
STATE TAX COMMISSIONER**

Respondent Below, Petitioner

v.

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

Petitioners Below, Respondents



**SUPREME COURT BRIEF OF THE
RESPONDENTS KANG M. ZHENG, MEI D. ZHENG AND ASIAN GRILL**

C. Page Hamrick, State Bar # 1566
1550 Kanawha Blvd, East
PO Box 2521
Charleston, WV 25329-2521
304-345-8283; FAX 304-342-5925
page_hamrick@hotmail.com

Counsel for Respondents

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**SUPREME COURT BRIEF OF THE
RESPONDENTS KANG M. ZHENG, MEI D. ZHENG AND ASIAN GRILL**

I. Statement of the Case

The case was instituted as an appeal to the West Virginia Office of Tax Appeals from Notice of Assessments issued by the State Tax Commissioner for three separate taxes, one for personal income tax against Appellants, the individuals Kang M. Zheng and Mei D. Zheng, husband and wife, and one for consumer sales and service tax and one for business franchise tax each against Petitioner Asian Grill, supposedly a partnership consisting of Mr. and Mrs. Zheng.

An administrative hearing was held on April 30, 2013 and May 1, 2013, evidence and testimony taken, and a large number of exhibits introduced into evidence. The West Virginia Office of Tax Appeals issued its Administrative Decision on December 4, 2013, affirming the imposition of the sales and use tax assessment against Asian Grill in the amount of \$24,650.95, business franchise tax against Asian Grill in the amount of \$7,956.28, and personal income tax against Kang M. and Mei D. Zheng in the amount of \$17,139.21. (A.R. 0239).

Kang M. and Mei D. Zheng and Asian Grill petitioned for appeal from the administrative decision of the West Virginia Office of Tax Appeals to the Circuit Court of Kanawha County, West Virginia.

The Circuit Court of Kanawha County, West Virginia, Judge Jennifer F. Bailey presiding, issued its Final Order, filed February 14, 2020. (A.R. 0001). The Final Order reversed the Administrative Decision of the Office of Tax Appeals and set aside the assessments of consumer sales and use tax, business franchise tax, and personal income tax made by the State Tax Commissioner. Further, the Circuit Court remanded for new assessments, which are to be computed

in a manner consistent with the Final Order of the Circuit Court of Kanawha County, West Virginia, as well as further fact finding in regard to the Business Franchise Tax issue.

This matter is now on appeal to the Supreme Court of Appeals of West Virginia, on the appeal of the State Tax Commissioner from the Circuit Court's Final Order.

FINDINGS OF FACT BY CIRCUIT COURT

The underlying hearing in this case involved two days of testimony by eight witnesses and generated over 500 pages of transcript. Numerous documents admitted into evidence at the hearing were attached as exhibits. The record included 84 entries, covering 1,561 pages, which, including the transcript, totaled 2,074 pages. The Circuit Court found as follows: (A.R. 0003).

1. Asian Grill is a partnership operated by the Kang M. Zheng and Mei D. Zheng, in Charleston, Kanawha County, West Virginia.
2. On more than one occasion, employees of the West Virginia State Tax Department ("Tax Department") visited the Petitioners' [Below - Respondent/taxpayer herein] restaurant and allegedly observed transactions that were not processed through the cash register. These observations led to an investigation of the Petitioners' business.
3. The audit began with Tax Department employees conducting surveillance of the Petitioner's [(Below) Respondent/taxpayer herein] restaurant from the parking lot over the course of three days. These employees conducted the surveillance from 9 a.m. to 3 p.m. on January 20, 2011, from 3 p.m. to 10:20 p.m. on January 27, 2011, and from approximately 10:45 a.m. to 10:15 p.m. on January 28, 2011.
4. The auditor completed the audit by a ratio analysis by taking the number of customers that the Asian Grill records showed were served on January 28, 2011, (30 people) and dividing that

number by the number of customers she actually observed being served, (87 people).

5. That calculation resulted in a purported finding that Asian Grill was underreporting sales by 66 percent (30 divided by 87 = 34.5; $100-34=66\%$). (A.R. 0004).

6. The restaurant is primarily a take-out establishment and few customers dine in. (Tr. p. 54). The Tax Department observers reached the number of 87 customers by a combination of counting actual customers and attributing each bag being delivered by restaurant employees as one order and each box being delivered as two orders. This calculation was done when the observers could not see inside the bags. At certain times during the observation, they were actually able to count how many orders were in a bag or box.

7. The auditor further increased Asian Grill's reported sales by 66 percent to arrive at an "accurate" calculated amount of daily, monthly and yearly sales. Finally, the auditor calculated Asian Grill's unremitted sales taxes based upon the extrapolated sales results, and issued the tax customer sales tax assessments under review in this matter.

8. The audit also found that Asian Grill, as a partnership, had not filed West Virginia business franchise tax returns for tax years 2005-2009. Additionally, for tax years 2010 and 2011, Asian Grill filed business franchise tax returns, but only paid the minimum \$50 franchise tax. (A.R. 0005).

9. Lastly, the auditor applied the amount of under-reported sales from Asian Grill to the Zheng's personal income.

10. This Court finds that there is substantial evidence in the record to support the above listed factual findings which largely mirror the findings of the lower tribunal. Since the lower tribunal was in a better position to assess the records put forth into evidence and the credibility of the witnesses called, 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; however, this Court does not accept the Tax Department's decision to disregard all of Asian Grill's other financial records when determining "other information" to use to complete the audit, namely the credit card sales reports, which, as acknowledged by the Tax Department below, are accurate. (A.R. 0005).

The following additional facts were presented by testimony and documents admitted into evidence:

1. Yuan Zheng, the son of Mei Ding and Kang Ming Zheng, the Appellants, who works in the Asian Grill restaurant, testified on behalf of the Appellants. (Tr. p.24). (A.R. 0429). He resides with his parents. He has worked there about 3 years, as cashier and answers the phone as he speaks some English. (Tr. p.24- 25) (A.R. 0429-0430). . Sales of food are entered into the cash register which has a tape; there are two types of sales, cash and credit cards. Sales paid with checks are also entered. (Tr. p. 26) (A.R. 0431). Two boxes full of credit card receipts and cash register tapes were identified by the witness as the taxpayer's cash register sales records, one for 2008, 2009, 2010, and one for 2011 and 2012. (Tr. p. 27-28). (A.R. 0432-0433).
2. Although, Appellants tendered the entire two boxes of records, THE HEARING EXAMINER PERMITTED ONLY a sample of one month, for January 2011, of the voluminous records to be marked as Appellants Exhibit One and received in evidence. (Tr. p. 32) (A.R. 0437). The witness testified that the other months records were similar. The records were kept in the ordinary course of business of Asian Grill. The records were kept in storage at the restaurant.(Tr. p. 32) (A.R. 0437). The records were available when the State Tax Commissioner came to look at the records and investigate Asian Grill. (Tr. p. 33) (A.R. 0438). The witness helps his parents with

translation, and paying bills owed. (Tr. p. 33-34) (A.R. 0438-09439). They keep receipts for bills paid, bank records, monthly records of sales, and a daily total of sales. (Tr. p. 34) (A.R. 0439). The cash register receipts are totaled daily and written down on handwritten sheets. Mei Ding writes them down, but the witness deals with the accountant in New York who handles their tax returns. (Tr. p. 34) (A.R. 0439).

3. Bank statements are kept, showing credit card sales, and the records are available for each day showing the amount of credit card sales. (Tr. p. 38) (A.R. 0443). The State Tax Commissioner auditors did not ask for and did not review the bank statements. (Tr. p. 39) (A.R. 0444). The State Tax Commissioner auditors did not request to look at cash register records contained in the two boxes of records tendered by the Appellants, one month of which was received in evidence. (Tr. p. 47) (A.R. 0452). The Asian Grill is mostly a take out type of restaurant, few customers eat in. (Tr. p. 54) (A.R. 0459).

4. D. Patrick Donahoe, C.P.A., of Charleston, West Virginia, testified as an expert witness on behalf of the Appellants. (Tr. p. 66) (A.R. 0471). His written report was received in evidence as Petitioner's [Respondent/taxpayer herein] Exhibit Two, and contains his Curriculum Vitae (Tr. p. 68) (A.R. 0473). He is a graduate of West Virginia University, earned a Master of Science in Taxation degree from Robert Morris University, Pittsburgh, Pa, and is a licensed Certified Public Accountant, has some teaching experience at the university level, and about 20 years experience. (Tr. p. 68) (A.R. 0473). He has been recognized as an expert witness in other court proceedings. (Tr. p. 69) (A.R. 0474). He was recognized as an expert witness in this case. (Tr. p. 70) (A.R. 0475).

5. The expert witness reviewed the Asian Grill and Zheng financial records and assessment and

audit records. (Tr. p. 70-71) (A.R. 0475-0476). **The observations made by the State Tax Commissioner were what the expert witness said could be “loosely say that that was a statistical analysis, but it’s very inadequate as a statistical analysis.”** (Tr. p. 77) (A.R. 0482). The State Tax Commissioner took those two days of observations and expanded that to three and one-half years. (Tr. p. 78) (A.R. 0483).

6. **The witness testified that in his expert witness opinion the two-day analysis was an attempt to perform a sample-and-projection auditing methodology, an attempt at a statistical analysis.** (Tr. p.78-79) (A.R. 0483-0484). A statistical analysis is a method of taking a small sample and applying the results of that sample to a larger population. (Tr. p. 79) (A.R. 0484). In this case the State Tax Commissioner took two days samples of sales at Asian Grill and applied that two days to over three years, which would be well over 1,050 days. (Tr. p. 79-80) (A.R. 0484-0485). **In effect the audit methodology attempts to say that the two day sample applies to all of the 1,050 days that the Asian Grill restaurant are open per year.** (Tr. p. 80) (A.R. 0485).

7. In the restaurant business, the expert witness testified that there are variations in sales on different days of the week, for example many restaurants close on Mondays as a slow day. But, in the State Tax Commissioner methodology there was no variation for days of the week. (Tr. p.80) (A.R. 0485). The expert witness testified that in the restaurant business there are variations in sales in different months and different seasons of the year. (Tr. p. 81) (A.R. 0486). **The State Tax Commissioner audit assessments made no variations for differences in days of the month, or in months or seasons.** The State Tax Commissioner audit applied the month of January, 2007, a winter month, to all the months of the year and to all of the years. (Tr. p. 82) (A.R. 0487). The State Tax Commissioner audit did not take into account any variations in daily, monthly, weekly, seasonal

and annual variations in business in the restaurant industry. (Tr. p. 83) (A.R. 0488). **The State Tax Commissioner audit assumes that the same number of customers come into the restaurant every day of the years in all of the three years of the audit period.** (Tr. p. 83) (A.R. 0488). The witness testified and issued his report based on his investigation, experience, education, and knowledge of the restaurant business. (Tr. p. 84) (A.R. 0489).

8. The expert witness testified as to his professional opinions as follows. **It's my opinion that the assessments against these Appellants grossly overstates the number of Petitioner's [Respondent/taxpayer herein] sales transactions which are realized in a typical business day, and fails to account for groups of customers visiting restaurant facilities at the same time.** (Tr. p. 85) (A.R. 0490).

9. The second opinion of the expert witness is that **the assessments against the Appellants grossly overstates the average dollar amount of Petitioner sales per customer per visit.** (Tr. p.86-87) (A.R. 0491-0492). **A proper statistical analysis would include an analysis of the number of customers, an analysis of the average number of meals eaten by customers, and an analysis of the average amount paid for various meals.** (Tr. p. 87) (A.R. 0492). The State Tax Commissioner audit simply applied an average price throughout the three years by applying the same price that was assumed paid before. (Tr. p. 88) (A.R. 0493). In effect, the audit assumes that the additional customers they included would have eaten the same things that the reported people ate, and grossed up the sales based on the proportion the State Tax Commissioner audit determined versus the reported sales. (Tr. p. 89) (A.R. 0494). **In the expert witness' expert opinion that is not a statistically valid methodology of estimating sales.** (Tr. p. 89) (A.R. 0494).

10. The expert witness expressed a third opinion. The Respondent **State Tax Commissioner's**

tax assessments of Appellants' restaurant business are not based on statistically valid methodology of analysis of customer sales in the counts of two days out of an audit period of three calendar days, during which Petitioner would have been open for business for 1,095 days, and this is not a statistically valid sample size for a statistical analysis and prediction of a population of customer visits. (Tr. p. 89) (A.R. 0494).

11. The expert witness attached an attachment to his report showing what would be a statistically valid count, taken from a recognized reference manual, being Statistics for Management and Economics, basically a university textbook on statistics, by Keller and Warwick. (Tr. p. 90) (A.R. 0495). The textbook gives the statistical methodology for selecting sample sizes out of a large population. The theory is that the sample size must be sufficiently large that the probability of being correct, to for example 95 percent in this situation. In the expert witness' opinion, the sample size of two days out of 1,095 was not sufficient. (Tr. p. 91) (A.R. 0496). **The statistician desires to be confident to some confidence level, in this case 95 percent, a typical statistical percentage of confidence.** (Tr. p.91-92) (A.R. 0496-0497). In other words, the statistician would be confident that the real number was within 5 percent, or from 95% to 105% of the real number. (Tr. p. 92) (A.R. 0497). **If one does not use the formula to calculate the sample size to a certain confidence level, then the chances of being correct are less. 95 percent is a typical confidence level for business-type operations.** (Tr. p. 93) (A.R. 0498). **The expert witness made the calculation to determine the number of observations necessary for the 95 percent confidence level and determined that to be 12 days per year, which would be 36 days for three years. Two days is not an adequate sample size and the two days of observations for the Asian Grill analysis was not adequate sample size to perform a statistical sampling methodology.** (Tr. p. 94 (A.R. 0499).

; 153).

12. The expert witness testified that what the State Tax Commissioner was doing fits the definition of a statistical analysis or sampling and projection methodology, but what they did was not an adequate statistical analysis because they did not use a proper sample. Therefore, the sampling technique could not have produced a correct tax assessment. (Tr. p. 96) (A.R. 0501). **The audit methodology therefore would not have produced the best records available, nor the best evidence available.** (Tr. p. 97) (A.R. 0502). **West Virginia law recognizes statistical-sampling methodology, but the auditor using the techniques must use it in a professional manner, and comply with standards in the financial analysis industry.** If the sample size, for example, is not correct, then the statistical-sampling methodology does not produce a correct result, to a recognizable confidence level. (Tr. p. 183-185) (A.R. 0588-0590). **The sample size used by the State Tax Commissioner in this case did not comply with established standards in statistical sampling methodology, or sample-and-projection auditing method.** (Tr. p. 185) (A.R. 0590). Further, the State Tax Commissioner took an inconsistent position on the question of sample-and-projection; on the one hand the State Tax Commissioner denied performing a sample-and-projection audit, and on the other hand, said that the taxpayers' records were inadequate that the quasi-statistical sampling was the best information available, and use it to "project" the taxpayer's gross income. (Tr. p. 186) (A.R. 0591)

13. The expert witness testified as to his fourth opinion. The **Respondent's tax assessments of Appellants' restaurant business are not based on statistically valid methodology of Petitioner, Asian Grill's, customer visits per day. By sampling only two days of customer visits and extrapolating to three years of customer visits, the State Tax Commissioner has used an invalid**

statistical method of estimation. To be statistically valid to a confidence level of 95 percent, i.e. plus or minus five percent, of the statistically accurate number of customer visits in each of three years of operation, the sample size would be an average of at least 12 days per year. By utilizing the sample size of only two days, the resulting number of customer visits per day calculated by the State Tax Commissioner cannot be an accurate estimation of the statistically accurate number of customer visits. The tax assessments in this case are based upon a statistical sampling methodology which is inaccurate and fatally flawed. (Tr. p. 97) (A.R. 0502).

14. Mr. Donahoe noted that the taxpayers' kept tax and financial records, which he reviewed, including cash register receipts, credit card receipts, income tax returns which he characterized as good original source documents, Pennsylvania tax returns (Tr. p. 98) (A.R. 0503). partnership tax returns, bank statements showing credit card charges and expense payments, records of daily sales, handwritten, sales records, tax returns filed, ledgers and handwritten ledgers (Tr. p. 99) (A.R. 0504).

The taxpayers have consistent records day-today, and for months and years and could not have been fabricated. (Tr. p. 179-180) (A.R. 0584-0585). There are records for every month of each of the audit years, none are missing. (Tr. p. 180) (A.R. 0585).

15. The C.P.A. compared the sales records with the tax returns filed and the return records comported with the cash receipts and the cash and credit card records. (Tr. p. 99 (A.R. 0504); 165 (A.R. 0570). He was of the opinion that the taxpayers kept adequate records, that the records were very good, and that they were the typical records that restaurant businesses kept. (Tr. p.100 (A.R. 0505); 161 (A.R. 0566). He characterized these taxpayers' records as "better than most restaurants that I've been around." (Tr. p. 101) (A.R. 0506).

16. He was of the opinion that the records adequately reflected the gross sales of Asian Grill,

(Tr. p. 101-102) (A.R. 050 (A.R. 0). 6-0507). , and that he felt confident that the tax returns were properly prepared and reflected the income of the taxpayers, and that the taxpayers paid the correct amount of tax. (Tr. p. 102) (A.R. 0507).

17. **After reviewing the taxpayer's records, the C.P.A. was of the opinion that the State Tax Commissioner could have performed a typical transaction audit of these taxpayers.** (Tr. p. 107) (A.R. 0512). However, the State Tax Commissioner auditors did not look at the original source documents and did not compare those with the other records such as bank statements, showing cash deposits and credit card charges. (Tr. p. 108) (A.R. 0513). **The C.P.A. did not believe taxpayers' records were so detailed, complex or voluminous that an audit of the detailed records would have been impractical.** (Tr. p. 111 (A.R. 0516); 138 (A.R. 0543). **It would not have been unreasonable for the State Tax Commissioner to audit the taxpayers' records.** (Tr. 111) (A.R. 0516). **The records were not inadequate or insufficient, so that a competent audit could not have been performed by the State Tax Commissioner. Additionally, the cost of such an audit would not have been unreasonable in relation to the benefits thereof. The C.P.A. was of the opinion that the State Tax Commissioner auditors did not use the best information available.** (Tr. p. 112 (A.R. 0512); 143 (A.R. 0548). A detailed audit, as referenced in the State Tax Commissioner's Regulations, is a regular audit procedure, where the auditor reviews the original source documents, reviews bank records, reviews the tax returns, looks for consistency, looks for adequacy, correctness of totals, verifies expenses, audits expenses receipts. (Tr. p. 181-182) (A.R. -0586-0587).

18. **Regarding the credit card sales, the State Tax Commissioner audit did not compare the sales records with the bank statements, which show each and every credit card sale.** (Tr. p.

109-110) (A.R. 0514-0515). These records are more accurate than what the State Tax Commissioner did in simply grossing up sales. **The supposed “phantom credit card sales” that the State Tax Commissioner grossed up would show up on bank statements.** (Tr. p. 110) (A.R. 0515). The expert witness was of the opinion that the job performed by the State Tax Commissioner was inadequate auditing (Tr. p. 110-111) (A.R. 0515-0516).

19. **D. Patrick Donahoe, C.P.A., the expert witness testified that all his opinions were to a reasonable degree of certainty in the profession in which he is engaged.** (Tr. p. 119) (A.R. 0524).

20. On cross-examination by Respondent’s counsel and asked about whether he was aware if the State Tax Commissioner had reviewed the taxpayer’s books and records in performing the audit, the witness stated that if those had been reviewed an indication of such would have been in the State Tax Commissioner audit report, and the audit report did not contain any such references. (Tr. p. 121) (A.R. 0526). Further, States Exhibit 4, the Notice of Assessment, states that the audit findings and audit work papers are enclosed with the Notice of Assessment. Both are incorporated by reference. (Tr. p. 175) (A.R. 0580). Nothing other than the State Tax Commissioner’s calculation of tax and the three-day surveillance records are enclosed with the Notice of Assessment. There are no other audit work papers. There are no other work papers, no bank statements references, no references to tax returns, in any of the Notices of Assessment. (Tr. p. 178) (A.R. 0583). The State Tax Commissioner did not perform an audit at all in this instance. (Tr. p. 179) (A.R. 0584).

21. Mei Ding Zheng, one of the owners of Asian Grill testified on her own behalf. (Tr. p. 195) (A.R. 0600). These daily records are kept every day, and these are the normal records of the business. (Tr. p. 206) (A.R. 0611). She checks the bank statements when received and checks the

balances with their credit card sales records, sales receipts. (Tr. p. 209-210) (A.R. 0614-0615). She believes that they have paid all the taxes they owe. (Tr. p. 209) (A.R. 0614).

22. Kang Ming Zheng, one of the owners of Asian Grill testified on his own behalf. Peter Corbett helps them with various matters, helps them read English documents and business records. (Tr. p. 216-217) (A.R. 0621-0622). He does not speak or read English. (Tr. p. 217-218) (A.R. 0622-0623). Mr. Zheng communicates with the New York accountants, gives them the monthly totals, and the NY accountants prepare the tax returns and send them back to be signed and filed. (Tr. p. 219) (A.R. 0624). They keep the daily cash register receipts each day and retain credit card receipts. Most customers use credit cards for purchases and records are kept of each days sales. (Tr. 219-220) (A.R. 0624-0625).

23. Appellants Exhibit Five, tax returns for 2007, 2008, 2009, 2010, 2011, were received in evidence. (Tr. p. 223) (A.R. 0628). Appellants Exhibit Six, bank statements for 2006, 2007, 2008, 2009, 2010, 2011, and 2012 were received in evidence. (Tr. p. 226) (A.R. 0631). Appellants Exhibit Seven, the menu for the restaurant was received in evidence. (Tr. p. 228) (A.R. 0633).

24. Jean Warner testified for the Respondent, State Tax Commissioner. (Day 2 Tr. p. 64) (A.R. 0728). Ms. Warner is an Auditor II with the State Tax Commissioner. She stated that she is not an accountant, has taken college courses in accounting, but does not have a degree. (Day 2 Tr. p. 73) (A.R. 0737). **There is no training program for the surveillance audits, nor on-the-job training, nor manual.** (Day 2 Tr. p. 75-76) (A.R. 0739-0740). Surveillance audits were started probably two or three years ago, she testified. **There is no manual to show how to do the surveillance audits.** (Day 2 Tr. p. 76) (A.R. 0740). **There is no direction sheet, nor any documents whatsoever, other than a legal pad.** (Day 2 Tr. p. 77) (A.R. 0741). The supervisor assigns the audits and the

auditor is told to perform an audit on the taxpayer. She testified that "He does not tell me how to do the audit." **He does not tell the auditor how many days to observe, nor any direction as to an estimate of what it will take to do the surveillance audit.** (Day 2 Tr. p. 77-78) (A.R. 0741-0742). When asked how she selected two days for the audit, Ms. Warner answered: **"Shannon [Hockensmith] and I, we just decided to use two days, a weekday and a Friday to possibly determine weekend activity. We don't work on Saturday and Sunday."** Friday is the weekend day. The three auditors, the witness, Shannon Hockensmith, and Cathy Mills all just decided among the three of them to select two days. (Day 2 Tr. p. 79) (A.R. 0743). The witness did not recall if there was any direction from higher-up supervisors that they did not need to go more than 2 full days. There is no printed document that tells the auditor to use any particular number of days for the surveillance audit. They only take a legal pad. (Day 2 Tr. p. 81) (A.R. 0745).

25. On cross-examination by Judge Pollack about a particular phone order which came into the restaurant and how did they "know that that order wasn't for five people and that somebody didn't come in later and pick up a bag with five orders", the witness testified that: "We don't know..." (Day 2 Tr. p. 84) (A.R. 0748).

26. On cross-examination, when asked about a particular order, **"So you don't know that that may have been the phone order that someone came in to get, which you've already counted as one, do you?"**, the witness testified: **"No, I do not know that."** When asked if they were counting transactions when the order was made and again when it was picked up, the witness testified: "I did not count them when they made the order. Auditor Mills counted them inside when they made the phone order." (Day 2 Tr. p. 89-90) (A.R. 0753-0754). **On another particular transaction, the witness/auditor stated that she put down eight transactions, but only saw eight**

bags of food, and she did not know how many cash register transactions there were for those eight bags. She acknowledged that there could have been one charge for the eight bags, not eight separate transactions as the audit specified. (Day 2 Tr. p. 90) (A.R. 0754). The witness/auditor testified that she had no idea what was in the bags that were being carried out of the restaurant, nor the number of means or transactions, or whether the bags contained a full meal or only an appetizer or just soup or what was in the bag. (Day 2 Tr. p. 91-92) (A.R. 0755-0756). Further, she testified that she did not see drinks and that its possible that drinks could have been in the bags. (Day 2 Tr. p. 92) (A.R. 0756).

27. Cathy Mills testified for the Respondent. She is a Tax and Revenue Auditor III. (Day 2 Tr. p. 93) (A.R. 0757). **She testified that she had no specific training in surveillance techniques. There is no training program in the State Tax Commissioner in surveillance techniques. There is no document or direction or directive or memorandum on surveillance techniques, but they take directions from their supervisors. But there was nothing written at the time of this audit, nor any explanatory document or program or paper, or anything explaining what to do or how to do it. (Day 2 Tr. p. 101) (A.R. 0765). The witness did not take any training program in surveillance. (Day 2 Tr. p.102) (A.R. 0766).**

28. The three auditors discussed and decided to do the surveillance on two days. **There was no direction from anybody at the State Tax Commissioner as to how to select the number of days of surveillance. The three discussed it and it was only her opinion. (Day 2 Tr. p.103) (A.R. 0767). There was no calculation to come up with the number of days of surveillance, two days. (Day 2 Tr. p.104) (A.R. 0768).**

29. The witness/auditor testified that she did not know what was in the bags that were

being carried out of the restaurant, nor the number of means or transactions, or whether the bags contained a full meal or only an appetizer or just drinks or what was in the bag. (Day 2 Tr. p.107; 108) (A.R. 0771-0772).

30. The witness could not explain why there were two orders exactly the same amounts, at exactly the same time on the handwritten surveillance sheets the auditors used to take notes. (Day 2 Tr. p. 109) (A.R. 0773). She acknowledged that one eat-in for a bottle of Coke for \$1.48, was counted as one transaction. (Day 2 Tr. p. 109-110) (A.R. 0773-0774). She acknowledged that the full extent of her input was taking down the number of people that came in and out of the restaurant, and that she had no idea of what they purchased, how much they spent, what type of meal it was. (Day 2 Tr. p. 110-111) (A.R. 0774-0775).

31. Shannon Marie Hockensmith testified for the Respondent. (Day 2 Tr. p. 113) (A.R. 0777). **The witness reviewed the documents supplied by Peter Corbett for the Asian Grill and Zhengs. She testified: "I don't think they were necessarily manufactured for audit purposes."** (Day 2 Tr. p. 119) (A.R. 0783). **She testified that she discussed the records with the State Tax Commissioner legal department and management, and the decision was made to use only one full day of surveillance and to solely base the calculations on January 28 for the audit findings.** (Day 2 Tr. p. 123) (A.R. 0787).

32. The witness testified that she purchased meals at Asian Grill and acknowledged that the credit card charge was actually reported in the taxpayer's records on their credit card machine. (Day 2 Tr. p. 126) (A.R. 0790).

33. **When asked "Did you use a sample-and-projection technique during this audit?", the witness replied: "Well, we'll call it that. I took a sample, and I projected it to the whole audit**

period.” (Day 2 Tr.p. 136) (A.R. 0800). [NOTE: This is the first time the State Tax Commissioner acknowledged using the sampling technique, and had to that time adamantly denied using such an audit technique. This is a wholesale reversal of the representations of the State Tax Commissioner during this entire appeal procedure.]

34. The auditor admitted that she and the State Tax Commissioner had no books or manuals which they relied upon to perform the analysis, nor any authors or treatises or books that would support the Commissioner’s methodology used in this sample-and projection method. (Day 2 Tr. p. 183) (A.R. 0846).

35. Using a one day observation was a management decision, by their Director, Dana Angell, that one day was sufficient. [NOTE: The Director did not testify.] (Day 2 Tr. p. 174) (A.R. 0837). There was no legal or other authority for using the one day observation. (Day 2 Tr. p. 175) (A.R. 0838).

36. The counts of bags and boxes observed in the surveillance were the assumptions of the auditor. She stated “I assumed they had different meals in them.” “It’s based on my assumptions.” (Day 2 Tr. p. 178) (A.R. 0841).

37. Again, on cross-examination, when asked whether the best information available was based upon a sampling technique, the State Tax Commissioner witness, Shannon Hockensmith, testified: “It was a sample.” And, she agreed that it was a sample of one day. And, she agreed that the one day was projected to three years, which is over 1,065 days. (Day 2 Tr. p. 189) (A.R. 0852).

38. When asked about the credit card sales, the witness testified that she agreed that all the credit card sales were reported. (Day 2 Tr. p. 196, 197) (A.R. 0859-0860). However, even though she agreed that all of the credit card sales had been reported, they auditors applied

their calculated underreporting percentage of 66 percent to the entire amount of sales which the taxpayers did report, not just to the cash sales. (Day 2 Tr. p. 197-198) (A.R. 0860-0861).

39. After protracted wrangling, (Day 2, Tr. p. 227 to 237) (A.R. 0887-0897). **the witness reluctantly, and finally, responded, that the tax returns did not show any assets remaining in the so-called partnership. “Q. Don’t all of them show zero? A. “..Are zero.” (Day 2 Tr. p. 235) (A.R. 0895).** [NOTE: this is important, since if there were no assets left in the partnership, then the Business Franchise Tax could not apply, since that is a tax on retained earnings. The State Tax Commissioner representative’s refusal to respond to questioning in this regard, shows a callous lack of regard for the law, for the facts, and for justice and truth in assessing taxes against these taxpayers and taxpayers in general.]

II. STATEMENT REGARDING ORAL ARGUMENT

The Respondents Zheng and Asian Grill request a Rule 20 Oral Argument pursuant to Rules of Appellate Procedure as involving issues of fundamental public importance in the administration of the State tax laws.

III. STANDARD OF REVIEW

The Circuit Court has the authority to reverse, vacate, or modify an administrative decision of a state agency if the decision issued was in violation of constitutional or statutory provisions, in excess of the statutory authority or jurisdiction of the agency, made upon unlawful procedures, affected by other error, clearly wrong in view of the reliable, probative and substantial evidence in the whole record, or **arbitrary or capricious** or characterized by an abuse of discretion or by a clearly unwarranted exercise of discretion. W.Va. Code Sections 11-10-A-19(f) and 29A-5-4(g).

Legal issues are subject to de novo review. *Mayhew v. Mayhew*, 197 W.Va. 290, 475 S.E.2d

382 (1996)(Albright, J.); *Chrystal R.M. v. Charlie A.L.*, 194 W.Va. 138, 459 S.E.2d 416 (1995); *Solution One Mortg. LLC v. Helton*, 216 W.Va. 740, 613 S.E.2d 601 (2005). Syl.Pt. 1, *Davis Memorial Hosp. v. W.Va. State Tax Comm'r.*, 222 W.Va. 677, 671 S.E.2d 682 (2008); Syl.Pt. 1. *CB&T Operations Co., Inc. v. Tax Comm'r. of State of W.Va.*, 211 W.Va. 198, 564 S.E.2d 401 (2002); *Muscatell v. Cline*, 196 W.Va. 588, 474 S.E.2d 518 (1996).

Underlying factual findings are reviewed under a clearly erroneous standard. See Syl. Pt. 2, *CB&T Operations Co., Inc. v. Tax Comm'r. of State of W.Va.*, 211 W.Va. 198, 564 S.E.2d 401 (2002); *Noble v. W.Va. Dept. Motor Vehicles*, 223 W.Va. 818, 821 (W.Va. 2009).

IV. SUMMARY OF THE ARGUMENT

The Circuit Court's extensive and complete findings and determinations set out in its well-reasoned Final Order entered February 14, 2020, clearly point out the incredible and embarrassing number of errors committed by the State Tax Department in its audit procedures in this case, and ignored in the Administrative Decision of the Office of Tax Appeals. The State Tax Department auditors clearly and admittedly performed a wholly inadequate statistical analysis technique termed sampling and projection. The auditors took a sample of one day's observations of customers at taxpayer's restaurant and expanded that over three years, claiming that the same number of customers, same amount of food served, same amount of drinks, same amount of money received was received by the taxpayers on each day of the three years. The taxpayer's expert witness's opinions point out the inadequacy of the statistical analysis and invalidity of the statistical analysis utilized by the State Tax Department. The Circuit Court found that the procedures and methodology resulted in an **arbitrary** method used to impose a tax assessment on the Respondents/Taxpayers. The result propounded by the State Tax Department's auditors (and approved by the Administrative

Decision) are “clearly **arbitrary, capricious and unreasonable.**” (Final Order p. 11) (A.R. 0011).

The State Tax Department’s audit procedures and the Office of Tax Appeals upholding of this fatally flawed methodology were both clearly erroneous. For this reason, the Circuit Court’s decision should be affirmed.

The Circuit Court’s further found that even if you accept the sampling and projection technique used by the STD, the Administrative Decision applied the allegedly under-reported gross case sales percentage not only to the cash sales which the Department claimed were not reported on consumer tax returns, but also to the admittedly reported credit card sales, in effect doubling the Respondent’s tax liability on the credit card sales income, a **clearly erroneous** decision, which the Circuit Court found to be **arbitrary, capricious and unjust.** (Final Order p. 12 (A.R. 0012). For this reason alone the Circuit Court’s decision must be affirmed.

In the Circuit Court’s analysis of the business franchise tax issue (a tax that has long since been repealed), the Circuit Court found that the administrative decision did not adequately develop the issue and remanded this issue for further development. Final Order p.12-13 (A.R. 0012-0013). For this reason, the Circuit Court’s decision should be affirmed.

V. ARGUMENT

STATISTICAL ANALYSIS FATALY FLAWED

1. The Circuit Court found that the State Tax Department’s incredible and embarrassing number of errors committed in its audit procedures in this case, and ignored in the administrative decision of the Office of Tax Appeals, were not based on the best available information, ignored the taxpayer’s complete and quite adequate books and records, utilized a fatally flawed statistical sampling methodology, and resulted in an arbitrary result.
2. Further, by applying its flawed sampling and projection technique increased percentages both to the allegedly unreported cash sales and to the admittedly reported credit card sales, the State Tax Department grossly overstated the amount of taxpayer’s sales and grossly

overstated the tax assessments against these taxpayer. The Circuit Court properly ordered the State Tax Department to recalculate its erroneous tax assessments.

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.

The auditor completed the audit by a ratio analysis by taking the number of customers that the Asian Grill records showed were served on January 28, 2011, (30 people) and dividing that number by the number of customers she actually observed being served, (87 people). That calculation resulted in a purported finding that Asian Grill was underreporting sales by 66 percent (30 divided by 87 = 34.5; $100 - 34 = 66\%$). The restaurant is primarily a take-out establishment and few customers dine in. The Tax Department observers reached the number of 87 customers by a combination of counting actual customers and attributing each bag being delivered by restaurant employees as one order and each box being delivered as two orders. The auditor further increased Asian Grill's reported sales by 66 percent to arrive at an "accurate" calculated amount of daily, monthly and yearly sales. Finally, the auditor calculated Asian Grill's unremitted sales taxes based upon the extrapolated sales results, and issued the tax customer sales tax assessments under review in this matter. The auditors then extended the same amounts to the Business Franchise Tax and Personal Income Tax, resulting in three assessments of taxes based on the flawed reasoning.

D. Patrick Donahoe, C.P.A., of Charleston, West Virginia, testified as an expert witness on behalf of the Appellants. He is a graduate of West Virginia University, earned a Master of Science in Taxation degree from Robert Morris University, Pittsburgh, Pa, and is a licensed Certified Public Accountant, has teaching experience at the university level, and about 20 years experience. He has been recognized as an expert witness in other court proceedings. He was recognized as an expert

witness in this case. The expert witness reviewed the Asian Grill and Zheng financial records and assessment and audit records.

Mr. Donahoe testified that the State Tax Commissioner staked out the Asian Grill restaurant and counted the number of people coming and going from the restaurant and made a computation to come up with a number, which they then increased sales by that number. **The observations made by the State Tax Commissioner were what the expert witness said could be “loosely say that that was a statistical analysis, but it’s very inadequate as a statistical analysis.** (Tr. p. 77) (A.R. 0482). The State Tax Commissioner took those two days of observations and expanded that to three and one-half years. (Tr. p. 78) (A.R. 0483). **The witness testified that in his expert witness opinion the two-day analysis was an attempt to perform a sample-and-projection auditing methodology, an attempt at a statistical analysis.** (Tr. p.78-79) (A.R. 0483-0484). A statistical analysis is a method of taking a small sample and applying the results of that sample to a larger population. (Tr. p. 79) (A.R. 0484). **In effect the audit methodology attempts to say that the two day sample applies to all of the 1,050 days that the Asian Grill restaurant are open per year.** (Tr. p. 80) (A.R. 0485).

In the restaurant business, the expert witness testified that there are variations in sales on different days of the week. But, in the State Tax Commissioner methodology there was no variation for days of the week. (Tr. p.81) (A.R. 0486). The expert witness testified that in the restaurant business there are variations in sales in different months and different seasons of the year. (Tr. p. 81). **The State Tax Commissioner audit assessments made no variations for differences in days of the month, or in months or seasons.** The State Tax Commissioner audit applied the month of January, 2007, a winter month, to all the months of the year and to all of the years. (Tr. p. 82) (A.R.

0487). The State Tax Commissioner audit did not take into account any variations in daily, monthly, weekly, seasonal and annual variations in business in the restaurant industry. (Tr. p. 83) (A.R. 0488).

The State Tax Commissioner audit assumes that the same number of customers come into the restaurant every day of the years in all of the three years of the audit period. (Tr. p. 83) (A.R. 0488). The witness testified and issued his report based on his investigation, experience, education, and knowledge of the restaurant business. (Tr. p. 84-85) (A.R. 0489-0480).

The expert witness testified as to his professional opinions as follows. **It's my opinion that the assessments against these Appellants grossly overstates the number of Petitioner's [Respondent/taxpayer herein] sales transactions which are realized in a typical business day, and fails to account for groups of customers visiting restaurant facilities at the same time.** (Tr. p. 85) (A.R. 0490). The second opinion of the expert witness is that **the assessments against the Appellants grossly overstates the average dollar amount of Petitioner sales per customer per visit. In the expert witness' expert opinion that is not a statistically valid methodology of estimating sales.** (Tr. p. 86-87) (A.R. 0491-491). The expert witness expressed a third opinion. **The counts of two days out of an audit period of three calendar days, during which Petitioner would have been open for business for 1,095 days, and this is not a statistically valid sample size for a statistical analysis and prediction of a population of customer visits.** (Tr. p. 89) (A.R. 0494). **The statistician desires to be confident to some confidence level, in this case 95 percent, a typical statistical percentage of confidence.** (Tr. p.91-92) (A.R. 0496-497). In other words, the statistician would be confident that the real number was within 5 percent, or from 95% to 105% of the real number. (Tr. p. 92) (A.R. 0497). **The expert witness made the calculation to determine the number of observations necessary for the 95 percent confidence level and determined that**

to be 12 days per year, which would be 36 days for three years. Two days is not an adequate sample size and the two days of observations for the Asian Grill analysis was not adequate sample size to perform a statistical sampling methodology. (Tr. p. 94 (A.R. 0499).

The audit methodology therefore would not have produced the best records available, nor the best evidence available. (Tr. p. 97) (A.R. 0502).

West Virginia law recognizes statistical-sampling methodology, but the auditor using the techniques must use it in a professional manner, and comply with standards in the financial analysis industry. The tax assessments in this case are based upon a statistical sampling methodology which is inaccurate and fatally flawed.

The pertinent portion of the Internal Revenue Service Audit Technique Guide for Bars and Restaurants was received in evidence as Appellants' Exhibit Three. (Tr. p. 114) (A.R. 0519). The Guide recommends a percentage-markup method of auditing when the taxpayer's records are not adequate or nonexistent. (Tr. p. 115) (A.R. 0520). And, in addition, the IRS Guide recommends that normal audit procedures should also be followed, including tracing gross receipts to bank deposits, analyzing bank deposits of all business and personal accounts of the owner/manager, review the responses regarding internal control, look at the supervision habits in the restaurant to evaluate how sales might be understated or how easily theft may occur and by whom. (Tr. p. 118) (A.R. 0523). However, the audit report in this particular case of Asian Grill does not indicate that the State Tax Commissioner performed any of those analyses. The State Tax Commissioner did not comply with the IRS recommended guidelines and recommendations. (Tr. p. 119) (A.R. 0524). The IRS Guidelines provide that if a quasi-statistical analysis is performed with regard to a taxpayer, then the auditor must still perform a regular audit of the taxpayer's books and records. (Tr. p. 191-192) (A.R.

0596-0597).

Three auditors testified for the State Tax Commissioner. One auditor stated that she is not an accountant, has taken college courses in accounting, but does not have a degree. (Day 2 Tr. p. 73-74) (A.R. 0737-0738). **There is no training program for the surveillance audits, nor on-the-job training. There is no manual to show how to do the surveillance audits. (Day 2 Tr. p. 75-76) (A.R. 0739-740). There is no direction sheet, nor any documents whatsoever, other than a legal pad. (Day 2 Tr. p. 77-78) (A.R. 0741-742).** There is no printed document that tells the auditor to use any particular number of days for the surveillance audit. They only take a legal pad. (Day 2 Tr. p. 81) (A.R. 0745). Another auditor testified that she had no specific training in surveillance techniques. **There is no training program in the State Tax Commissioner in surveillance techniques. There is no document or direction or directive or memorandum on surveillance techniques, but they take directions from their supervisors. But there was nothing written at the time of this audit, nor any explanatory document or program or paper, or anything explaining what to do or how to do it. (Day 2 Tr. p. 101) (A.R. 0765).** The witness did not take any training program in surveillance. (Day 2 Tr. p.102) (A.R. 0766). A third auditor testified and when asked **"Did you use a sample-and-projection technique during this audit?"**, the witness replied: **"Well, we'll call it that. I took a sample, and I projected it to the whole audit period."** (Day 2 Tr.p. 136) (A.R. 0800). The Circuit Court's discussion of this issue is particularly enlightening and Judge Bailey showed a keen understanding of statistical analysis. Judge Bailey states: (A.R. 0006).

"The general statement regarding statistical evidence is found in Corpus Juris Secundum, Evidence, Sec. 318, "Survey and statistical evidence", where the rule is stated: -'Statistical evidence should be reviewed carefully by the trial court, comparing prejudice

against the relevancy and quality of proof. The proponent is required to establish relevancy to the issues and an adequate foundation by showing that the evidence involves comparable circumstances...'

* * *

Although the confidence level or significance of a statistical analysis is only a part of a meaningful evaluation of its reliability, **statistical evidence is admissible only if the evidence is statistically significant.** [Emphasis supplied.] Statistical significance can be determined merely by calculating the standard deviation or some other test statistic. However, statistical significance and practical significance are two completely different concepts. In order to determine the practical significance of statistical results, the court must look at theories and assumptions underlying the analysis and apply common sense."

* * *

"In the present case before this Court, the Tax Commissioner's sample size of only one day, out of 1,095, is not only small, but **practically non-existent**... Indeed, such an arbitrary methodology employed by a State agency is enough to shock the conscience... Although this Court finds that the method used by the Tax Commissioner is **completely arbitrary**, this Court will not draw a bright line percentage for confidence intervals. If the sampling methodology used in the present case is the basis of an audit and subsequent assessment, then the sample must be large enough so as to reasonably relate to reality and not be arbitrary....Using one day's observation as the primary consideration when determining taxes for a 3 year period is **absurd**." (A.R. 0008).

Judge Bailey then turned to another factor in reversing the Administrative Decision, something not even considered by the Office of Tax Appeals' Decision: (A.R. 0009).

"Another factor that lends itself to finding the Tax Commissioner's methodology arbitrary is the lack of training. [Emphasis supplied.] The Tax Commission auditor Jean Warner testified that there is no training program for the surveillance audits, nor on-the-job training. (Day 2 Tr. p. 75-76). Auditor Warner testified that the surveillance audits employed in this case were started probably two or three years prior to the surveillance of Asian Grill. There is no manual to show how to do the surveillance audits. (Day 2 Tr. p. 76). There is no direction sheet, nor any documents whatsoever, other than a legal pad. (Day 2 Tr. p. 77). The supervisor assigns the audits and the auditor is told to perform an audit on the taxpayer. Auditor Warner testified that "[h]e does not tell me how to do the audit."

* * *

Audits prepared at the State Tax Commissioner are not prepared in accordance with any auditing standards, nor do they follow generally-accepted accounting principles in tax audits. (Day 2 Tr. p. 156-157).

* * *

The result is an arbitrary method used to impose a tax assessment on the Petitioners. **The method chosen is not reliable. The assessment is not accurate.** Tax assessments demand accuracy; the State is subjecting its citizens to one of the most onerous burdens it

can impose, and it must do so in a lawful manner. In this case, the result propounded by the tax auditor is clearly **arbitrary, capricious, and unreasonable.**" [Emphasis supplied.]

Statistical sampling is defined as:

"In statistics, quality assurance, and survey methodology, **sampling is concerned with the selection of a subset of individuals from within a statistical population.** Acceptance sampling is used to determine if a production lot of material meets the governing specifications. Two advantages of sampling are that the cost is lower and data collection is faster than measuring the entire population.

Further, "Survey methodology" is defined as:

"A hybrid field made up of statistics and social sciences, **survey methodology studies the sampling of individuals from a population and data collection techniques** (e.g. questionnaire design) with a view towards making statistical inferences about the population represented by the sample and the constructs represented by the measures (i.e., survey questions used."

The general law regarding statistical evidence is found in Corpus Juris Secundum, Evidence, Sec. 318, "Survey and statistical evidence" , where the rule is stated:

"Statistical evidence should be reviewed carefully by the trial court, comparing prejudice against the relevancy and quality of proof. **The proponent is required to establish relevancy to the issues and an adequate foundation by showing that the evidence involves comparable circumstances...**

The court must guard against the use of data that has been segmented, particularized, and fashioned to achieve the desired result. The usefulness of statistical evidence depends to a large extent on the existence of proper supportive facts and the absence of variables which would undermine the reasonableness of the inference drawn. Inaccuracies or variations in data may easily lead to different, contradictory, or even misleading conclusions by experts. **Courts therefore must carefully evaluate all assumptions and data underlying statistical analyses in order to determine whether they are sufficiently related to reality to provide any useful information to the court.**

Although the confidence level or significance of a statistical analysis is only a part of a meaningful evaluation of its reliability, **statistical evidence is admissible only if the evidence is statistically significant.** Statistical significance can be determined merely by calculating the standard deviation or some other test statistic. However, statistical significance and practical significance are two completely different concepts. In order to determine the practical significance of statistical results, the court must look at theories and assumptions underlying the analysis and apply common sense..."

While statistical evidence is generally admissible, as with any other scientific evidence, it must be tested in light of its reliability. Standard references discuss **confidence levels in statistics**.

See Wikipeda for example:

In statistics, a **confidence interval (CI)** is a type of interval estimate of a population parameter and **is used to indicate the reliability of an estimate**. It is an observed interval (i.e. it is calculated from the observations), in principle different from sample to sample, that frequently includes the parameter of interest if the experiment is repeated. How frequently the observed interval contains the parameter is determined by the **confidence level** or **confidence coefficient**. More specifically, the meaning of the term "confidence level" is that, if confidence intervals are constructed across many separate data analyses of repeated (and possibly different) experiments, **the proportion of such intervals that contain the true value of the parameter will match the confidence level**; this is guaranteed by the reasoning underlying the construction of confidence intervals.

Confidence intervals consist of a range of values (interval) that act as good estimates of the unknown population parameter. **The level of confidence of the confidence interval would indicate the probability that the confidence range captures this true population parameter given a distribution of samples**. It does not describe any single sample. This value is represented by a percentage, so when we say, "we are 99% confident that the true value of the parameter is in our confidence interval", we express that 99% of the observed confidence intervals will hold the true value of the parameter. After a sample is taken, the population parameter is either in the interval made or not, there is no chance. The desired level of confidence is set by the researcher (not determined by data). If a corresponding hypothesis test is performed, the confidence level is the complement of respective level of significance, i.e. a 95% confidence interval reflects a significance level of 0.05. The confidence interval contains the parameter values that, when tested, should not be rejected with the same sample. Greater levels of variance yield larger confidence intervals, and hence less precise estimates of the parameter. Confidence intervals of difference parameters not containing 0 imply that there is a statistically significant difference between the populations.

In applied practice, confidence intervals are typically stated at the 95% confidence level. (See Zar, J.H., Biostatistical Analysis. Prentice Hall International, New Jersey, (1984), p. 43-45.) Respondent's expert witness D. Patrick Donahoe, C.P.A. testified as follows: **"If one does not use the formula to calculate the sample size to a certain confidence level, then the changes of being correct are less. 95 percent is a typical confidence level for business-type operations."** (Tr. p. 93).

Certain factors may affect the confidence interval size including size of sample, level of confidence, and population variability. **A larger sample size normally will lead to a better estimate of the population parameter.** There are several other **cases which have considered this type of evidence.**

In *Maidenbaum v. Bally's Park Place, Inc.*, 870 F.Supp 1254, 68 Fair Empl. Prac. Cas. (BNA) 1245 (D.N.J. 1994), judgment summarily aff'd 67 F.3d 291, 69 Fair Empl.Prac.Cas. (BNA) 3210 (3rd Cir. 1995), the Federal court held that statistical sample was of insufficient size to establish cause of action. The Court observed that the **Supreme Court of the United States** in *Int'l. Broth. of Teamsters v. U.S.*, 432 U.S. 324, 97 S.Ct. 1843, 52 L.Ed.2d 396, 14 Fair Empl. Prac. Cas (BNA) 1514, 14 Empl. Prac. Dec. (CCH) Para. 7579 (1977), and others have **held that considerations of very small sample sizes detracts from the probative value of statistical evidence and is of little or no use in establishing a claim.**

See also *Shutt v. Sandoz Crop Protection Corp*, 944 F.2d. 1431, 57 Fair.Empl.Prac.Cas. (BNA) 144, 57 Empl.Prac. Dec. (CH) para. 41095 (9th Cir. 1991), where the Federal Court ruled that the statistical evidence was insufficient to show a cause of action, noting that while a small sample size is not "per se" insufficient to establish a cause of action, such small sample sizes should not be used.

For admissibility of statistical evidence, the 95% confidence level was mandated in *Faust v. BNSF Railway Co.*, 337 S.W.3d 325 (Tex.App. Fort Worth 2011), reh'g. overruled (Mar. 10, 2011) and petition for review filed (May 23, 2011).

In *Hogan v. General Elec. Co.*, 109 F.Supp.2d 99 (NDNY 2000), the Federal court held that the plaintiff's statistical analysis was sufficient. The court ruled that the plaintiff's statistical analysis

showing a **variance of two standard deviations** from the expected result, though not automatically statistically significant, is generally sufficient to warrant an inference of correctness. **The court noted that such a variation is only 5% attributable to chance.**

The Faust and *Hogan* cases are of particular applicability to the Asian Grill case, since the taxpayer's expert witness testified that he had calculated the 12-day sample size to this same 95% confidence level, which is 100-95 or 5% left to chance. The Tax Commissioner's level of confidence from using 1 day instead of 12 days observations would be very small, and not within two standard deviations, as was the 12-day requirement calculated by Mr. Donahoe, Asian Grill's expert witness.

Tax assessments demand accuracy; the State is subjecting its citizens to the most onerous burden it can impose, and it must do so in a Constitutional manner, with due process. Due process demands that the result not be arbitrary or capricious, nor unreasonable. In this case, the result propounded by the tax auditor is clearly arbitrary, capricious, and unreasonable as the Circuit Court found. And, since the methodology was unreliable, the result would necessarily be unreliable and not representative of the situation. Clearly, the auditor's position cannot be upheld.

Statistical sampling methodology has been considered and is admissible in West Virginia. See *State v. Woodall*, 182 W.Va. 15, 385 S.E.2d 253 (1989).

For an explanation of the formula for determining sample size in statistical sampling see *Statistics for Management and Economics*, 4th Ed., Gerald Keller and Brian Warrack, 1999 Brooks/Cole Publishing Company, Chapter 5, Data Collection and Sampling, a portion of which was attached to Mr. Donahoe's Report, received in evidence as Petitioner's [(Below) Respondent/taxpayer herein] Exhibit No. 2.

The State Tax Commissioner first asserted that a sampling and projection methodology was

not used in the Asian Grill case. **That was specifically refuted** by the Tax Commissioner's own witness, the supervising auditor in the Asian Grill matter. When asked "Did you use a sample-and-projection technique during this audit?", the witness replied: "Well, we'll call it that. I took a sample, and I projected it to the whole audit period." (Day 2 Tr.p. 136).

The West Virginia Supreme Court of Appeals has considered the admissibility of an expert witness's testimony on scientific matters in a large number of cases, including *State v. Lockhart*, 208 W.Va. 622, 542 S.E.2d 443 (2000). The same principles would apply to the underlying scientific evidence. The West Virginia cases held that an assessment should be made in regard to the expert testimony's reliability by considering its underlying scientific methodology and reasoning, and this includes assessment of whether:

- * scientific theory and its conclusion can be and have been tested;
- * **scientific theory has been subjected to peer review and publication;**
- * **scientific theory's actual or potential rate of error is known;** and
- * scientific theory is generally accepted within the scientific community.

The taxpayer/Asian Grill presented expert witness testimony which complies with the Supreme Court of Appeals' rules in all respects, however, the Tax Department presented NO expert witness testimony, and tendered evidence of an underlying methodology which does not meet ANY of the requirements set down by the scientific and legal authorities. The tax auditors were questioned closely about the basis for their surveillance techniques. First, their evidence was not presented by an expert witness, so there is a question whether the scientific evidence should even have been admissible, as generally scientific matters must be in the purview of the witness testifying to the same. The Tax Department's tax auditors had no training in statistical or sampling methodology, there were no manuals on the subject, there were no publications authenticating their theories, no

peer review of their methodology; there is nothing to validate their methodology whatsoever. And the “actual or potential rate of error” was NOT known by the Tax Department’s auditors. That alone puts the Department’s entire case in jeopardy. Additionally, the taxpayer proved by its expert witness that the rate of error in the one-day sampling would be extremely high, since to be 95% confident (5% rate of error), there would have to have been 12 observations per year, or 36 days of observation in all. It is clear that the Tax Department’s methodology is fatally flawed, and does not stand the tests required.

It is clear that in considering the Asian Grill assessments of consumer sales, business franchise and personal income taxes, that the Tax Department’s entire case is based on sampling and projection auditing, a statistical sampling technique, and which methodology must comply with the rules governing the admissibility and consideration of scientific evidence. The Tax Department used the smallest sample size that could be used, one day, simply because the Department’s auditors did not want to do anymore. The Tax Department presented no evidence whatsoever to bolster its methodology, presented no expert witness opinion as to the validity of its methodology, presented no scientific publication supporting its methodology, presented no assessment of whether its scientific theory and its conclusion can be and have been tested; **whether its methodology has been subjected to peer review and publication; whether its scientific theory’s actual or potential rate of error is known;** and whether its methodology is generally accepted within the scientific community.

Appellant/Tax Commissioner’s brief makes much reference to the books and records of the taxpayer’s in this case. The facts show exactly the opposite of what the Tax Department’s auditors claimed. Although, taxpayer’s tendered the entire two boxes of records, the hearing examiner

permitted only a sample of one month, for January 2011, of the voluminous records to be marked as taxpayers Exhibit One and received in evidence. (Tr. p. 31). The witness testified that the other months records were similar. **The records were kept in the ordinary course of business of Asian Grill.** The records were kept in storage at the restaurant.(Tr. p. 32). **The records were available when the State Tax Commissioner came to look at the records and investigate Asian Grill.** (Tr. p. 33). Bank statements are kept, showing credit card sales, and the records are available for each day showing the amount of credit card sales. (Tr. p. 38). **The State Tax Commissioner auditors did not ask for and did not review the bank statements.** (Tr. p. 39). **The State Tax Commissioner auditors did not request to look at cash register records contained in the two boxes of records tendered by the Appellants, one month of which was received in evidence.** (Tr. p. 47).47. The taxpayer's expert witness, a C.P.A. compared the sales records with the tax returns filed and the return records comported with the cash receipts and the cash and credit card records. (Tr. p. 99; 167). He was of the opinion that the taxpayers kept adequate records, that the records were very good, and that they were the typical records that restaurant businesses kept. (Tr. p.100; 161). He characterized these taxpayers' records as "better than most restaurants that I've been around." (Tr. p. 101). On cross-examination by the Department's counsel and asked about whether he was aware if the State Tax Commissioner had reviewed the taxpayer's books and records in performing the audit, the witness stated that if those had been reviewed an indication of such would have been in the State Tax Commissioner audit report, and **the audit report did not contain any such references.** (Tr. p. 121).

From all this, it is clear that the Tax Department's tax assessments against Asian Grill and the Zhengs were justifiably set aside by the Circuit Court. For these reasons alone, the Final Order

of the Circuit Court should be affirmed.

ERROR IN DUPLICATING CREDIT CARD SALES

2. The Circuit Court's found that even if you accept the sampling and projection technique used by the STD, the Administrative Decision applied the allegedly under-reported gross case sales percentage to the admittedly reported credit card sales, in effect doubling the Respondent's tax liability on the credit card sales income, a clearly erroneous decision. (A.R. 0012).

Further, the State Tax Department grossly overstated the amount of taxpayer's sales and grossly overstated the tax assessments against these taxpayer. The Circuit Court properly ordered the State Tax Department to recalculate its erroneous tax assessments. There is nothing contradictory nor contrary to the evidence in the lower court's decision.

The taxpayer's expert witness D. Patrick Donahoe, CPA, testified regarding the credit card sales, stating that the State Tax Department audit did not compare the sales records with the bank statements, which show each and every credit card sale. (Tr. p. 109-110). These records are more accurate than what the State Tax Department did in simply grossing up sales. **The supposed "phantom credit card sales" that the State Tax Commissioner grossed up would show up on bank statements.** (Tr. p. 110). The expert witness was of the opinion that the job performed by the State Tax Commissioner was inadequate auditing (Tr. p. 110-111).

State Tax Department auditor was **asked about the credit card sales, the witness testified that she agreed that all the credit card sales were reported. (Day 2 Tr. p. 196). However, even though she agreed that all of the credit card sales had been reported, they auditors applied their calculated underreporting percentage of 66 percent to the entire amount of sales which the taxpayers did report, not just to the cash sales. (Day 2 Tr. p. 197-198).**

The tax auditors made a enormous error in their assessment procedure against these taxpayers. The auditor testified that they took the taxpayer's reported sales (which of course include

credit card sales and cash sales) and grossed them up by the auditor's calculated under reported percentage of sales, which in this case was 3 times the total sales. In effect, the Tax Department's assessment multiplied all sales, credit card and cash sales, by 3 and then applied the consumer sales tax rate to the multiplied sales figure. Even if you accept everything about the Tax Department's sample and projection technique (which taxpayer adamantly disputes) then you simply cannot apply the underreported sales percentage to the admittedly reported credit card sales. It is wanton and unwarranted duplication (in this case triplication). For this reason alone, the Tax Department's assessments should have been thrown out in its entirety. The taxpayers feel that the errors are so gross as to warrant only one result, total reversal of the tax assessments.

For this reason alone the Circuit Court's decision should be affirmed.

BUSINESS FRANCHISE TAX ISSUE

3. In the Circuit Court's analysis of the business franchise tax issue (a tax that has long since been repealed), the Circuit Court found that the administrative decision did not adequately develop the issue and remanded this issue for further development. (A.R. 0012).

After determining that the taxpayer had underreported its gross sales and applying the consumer sales tax, the Tax Department went two steps further. First, applying the same amount of underreported sales to Asian Grill, the Tax Department assessed the West Virginia Business Franchise Tax against Asian Grill as if the entire amount of those sales had been retained in the company as *retained capital*. It must be remembered that the BFT, WV Code 11-23-1 et seq., for partnerships, was [it has long since been repealed] assessed against:

“[t]he 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.” WV Code Sec. 11-23-3(b)(2)(C). “

The State Tax Department auditor, after protracted wrangling, **reluctantly, and finally, responded, that the tax returns did not show any assets remaining in the so-called partnership.**

“Q. Don’t all of them show zero? A. “..Are zero.” (Day 2 Tr. p. 235) (A.R. 0895). This is important, since if there were no assets left in the partnership, then the Business Franchise Tax could not apply, since that is a tax on retained earnings.

In the case of Asian Grill, it was uncontroverted from the Partnership tax returns, in evidence as exhibits, that there were no assets, no capital accounts, everything was zero, written off as expenses. Without partner’s capital accounts there can be NO BFT whatsoever.

D. Patrick Donahoe, CPA, the taxpayer’s expert witness testified that the taxpayers filed partnership tax returns, but since the taxpayers and owners were husband and wife, they are not partners and should have filed a Schedule C as a proprietorship of both husband and wife. The business was not a true partnership. Schedule C businesses do not pay business franchise tax. And the taxpayers should not have been paying or assessed business franchise taxes. (Tr. p. 103-104; 170-171; 173) (A.R. 0575-0576, 0578).

Then to further assess and pile additional taxes on these taxpayers, the Tax Department takes the same amount of supposedly under-reported income that it had used to assess consumer sales tax and to assess Business Franchise Tax, and assesses that same amount of income for purposes of the West Virginia Personal Income Tax. This is real double taxation, (actually triple). For these reasons alone, the BFT assessment should have been thrown out in its entirety.

Administrative decisions and sanctions which are in violation of constitutional or statutory provisions, or which are clearly wrong in view of the reliable, probative and substantial evidence on the whole record, or are arbitrary or capricious or characterized by abuse of discretion or clearly

unwarranted exercise of discretion, must be reversed and set aside. See *Hinerman v. WV Dept. of Motor Vehicles*, 189 W.Va. 353, 431 S.E.2d 692 (1993); *Muscatell v. Cline*, 196 W.Va. 588, 474 S.E.2d 518 (1996); and *Surratt v. Rutledge*, 167 W.Va. 903, 280 S.E.2d 726 (1981).

The taxpayers believe that the facts regarding this issue are clear and convincing. The State Tax Department simply **got it wrong**. In its pell-mell intent to assess these taxpayer's for as much tax as they court, the State Tax Department took its erroneously determined amount of income it claimed to be unreported, assessed that amount for Consumer Sales Tax, then claimed that the taxpayer's must have retained that amount in their business and assessed Business Franchise Tax for the SAME amount, then claiming that the taxpayer's took that income, the Department assessed Personal Income Tax in the SAME amount. Clearly this is over-reaching on the part of the State Tax Department. These taxes should ALL have been tossed out.

On the other hand the Circuit Court felt that the matter needed further exploration. If the consumer sales tax assessments are wrong, then the Business Franchise Tax assessments must also be wrong, and the Personal Income Tax assessments likewise wrong. This the Circuit Court remanded for further findings. For this reason, the Circuit Court's decision should be affirmed.

VIII. CONCLUSIONS

The Circuit Court's extensive and complete findings and determinations set out in its well-reasoned Final Order entered February 14, 2020, clearly point out the incredible and embarrassing number of errors committed by the state tax department in its audit procedures in this case, and ignored in the administrative decision of the Office of Tax Appeals.

The Circuit Court found that the procedures and methodology resulted in an arbitrary method used to impose a tax assessment on the Respondents. The result propounded by the State Tax

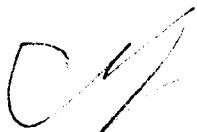
Department's auditors are "clearly arbitrary, capricious and unreasonable." The administrative decision of the Office of Tax Appeals upholding this fatally flawed methodology was clearly erroneous. For this reason, the Circuit Court's decision should be affirmed.

Even if you accept the flawed sampling and projection technique used by the State Tax Department, still the STD cannot apply the under-reported gross case sales percentage to the admittedly reported credit card sales, in effect doubling the tax liability on the credit card sales income and imposing a double-tax burden on these taxpayers. For this reason alone the Circuit Court's decision must be affirmed.

In the Circuit Court's analysis of the business franchise tax issue (a tax that has long since been repealed), the Circuit Court found that the administrative decision did not adequately develop the issue and remanded this issue for further development. For this reason, the Circuit Court's decision should be affirmed.

Respondent's request this Honorable Court to affirm the well-reasoned opinion and Final Order of the Circuit Court, and lay to rest the fatally flawed, clearly erroneous, arbitrary and capricious statistical sampling methodology utilized by the State Tax Department.

Respectfully submitted,
KANG M. ZHENG, MEI D. ZHENG, and ASIAN GRILL
Respondents, By Counsel



C. Page Hamrick, State Bar # 1566
1550 Kanawha Blvd, East
PO Box 2521
Charleston, WV 25329-2521
304-345-8283; FAX 304-342-5925
page_hamrick@hotmail.com
Counsel for Respondents

IN THE WEST VIRGINIA SUPREME COURT OF APPEALS

NO. 20-0226

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

Respondent Below, Petitioner

v.

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

Petitioners Below, Respondents

NOTICE OF CERTIFICATE OF SERVICE

I, C. Page Hamrick III, counsel for Appellants, do hereby certify that service of

SUPREME COURT BRIEF OF THE

RESPONDENTS KANG M. ZHENG, MEI D. ZHENG AND ASIAN GRILL

has been made upon the following interested parties of record by mailing a true and exact copy thereof and this Notice of Certificate addressed as follows, this 10th day of JULY, 2020:

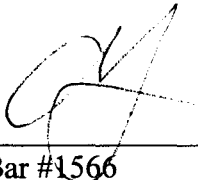
L. WAYNE WILLIAMS, ESQ.

ASSISTANT ATTORNEY GENERAL

1900 KANAWHA BLVD EAST

BLDG 1, RM W-435

CHARLESTON WV 25305



C. Page Hamrick III, State Bar #1566

Counsel for Respondents

P. O. Box 2521

Charleston, WV 25329-2521

304-345-8283; FAX 304-342-5925

page_hamrick@hotmail.com