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WV TAX DEPARTMENT

IN THE CIRCUIT COURT OF KANAWHA COUNTY, WEST VIRGINIA

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

Petitioners,

v.

DALE W. STEAGER<sup>1</sup>,  
STATE TAX COMMISSIONER of  
WEST VIRGINIA,

Respondent.

### FINAL ORDER

This matter comes before the Court upon the appeal of Kang M. Zheng and Mei D. Zheng, and Asian Grill, ("Petitioners" or "Taxpayers") from the Final Decision of the West Virginia Office of Tax Appeals ("OTA"), entered December 4, 2013, which found in favor of the Respondent State Tax Commissioner of the State of West Virginia, and assessed nearly \$50,000.00 in taxes: personal income tax of \$17,139.21 for individuals Kang M. Zheng and Mei D. Zheng; consumer sales and service taxes of \$24,650.95; and a business franchise tax of \$7,956.28 against Asian Grill, a partnership consisting of Mr. and Mrs. Zheng.

By scheduling order entered January 31, 2014, the parties timely submitted briefs to the Court. However, the Respondent filed a motion to dismiss based upon the Petitioners' failure to post an appeal bond on April 7, 2014. The Petitioners filed a response to the motion to dismiss on April 10, 2014. Over the remainder of the year, the parties filed memoranda of law in support of their motions and responses, and on November 20, 2014, the Petitioners filed their Response to Respondent's Supplemental Brief and Motion to Certify Question to Supreme Court of Appeals.

<sup>1</sup> On January 16, 2017, Governor Jim Justice appointed Dale W. Steager, Esquire, to be the State Tax Commissioner succeeding the previous Tax Commissioner, Mark W. Matkovich. Tax Commissioner Steager is automatically substituted as a party in this matter pursuant to Rule 25(d)(1) of the WV Rules of Civil Procedure.

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KANAWHA COUNTY CIRCUIT COURT



Case No. 14-AA-1  
Judge Jennifer F. Bailey

A status conference was held on August 18, 2017, at which time the Respondent agreed to withdraw its motion to dismiss and the Petitioners agreed to withdraw their motion to certify question. Accordingly, the matter is ripe for decision upon the merits.

The Court has reviewed the lengthy administrative record from the OTA, examined the *Petition for Appeal*, all other pleadings, reviewed the briefs, examined the relevant statutes, and applicable legislative rules related to the West Virginia consumer's sales tax. The Court concludes that the OTA committed error in these matters based upon the relevant facts which are set forth in detail in the administrative record, and further, that the Final Decision fails to comply with the applicable state law. Therefore, the Final Decision of the OTA is **REVERSED**.

#### STANDARD OF REVIEW

The West Virginia Supreme Court of Appeals has frequently addressed the standard of review to be employed by a circuit court in reviewing administrative decisions issued by State agencies. Factual findings made by the OTA or any other administrative agency receive deference, unless clearly erroneous. *See* Syl. pt. 2, *CB&T Operations Co., Inc. v. Tax Commissioner of State*, 211 W.Va. 198, 564 S.E.2d 408 (2002); *Noble v. W. Virginia Dept. of Motor Vehicles*, 223 W. Va. 818, 821 (W.Va. 2009). On the other hand, questions of law are subject to *de novo* review. *See* Syl. pt. 1, *Davis Memorial Hospital v. West Virginia State Tax Commissioner*, 222 W.Va. 677, 671 S.E.2d 682 (2008); *see also* Syl. pt.1, *CB&T supra*; *Muscatell v. Cline*, 196 W. Va. 588, 474 S.E.2d 518 (1996).

This Court may affirm the OTA decision based upon the evidentiary record from below. In the alternative, this Court may reverse, vacate or modify the administrative decision 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 of

law, clearly wrong in view of the reliable, probative and substantial evidence on the whole record, or arbitrary or capricious or characterized by an abuse of discretion or by a clearly unwarranted exercise of discretion. *See* W. Va. Code §§ 11-10A-19(f) and 29A-5-4(g).

### **FINDINGS OF FACT**

The underlying hearing in this case involved 2 days of testimony by eight 8 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.

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' 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 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. In February of 2011, the respondent attempted to continue the audit by sending an out-of-state selection letter to the petitioner's New York accountants. The Tax Department auditor assigned to conduct the audit in this matter did not actually begin work on the audit until early in 2012. This delay was due to problems with getting a response from the New York accountants and confusion about whether the audit would be conducted in New York or West Virginia.

Additionally, there is a six month to one-year lag time at the Tax Department between assigning an audit and an auditor actually being available to begin work.

5. Once the delays were over and the representative of Asian Grill was clarified, the auditor requested and reviewed certain financial documents, including state and federal tax returns, and some credit card and cash receipts for the period 2008-2010. Additionally, the auditor requested cash register tapes for the period January through March 2011; however, when the purported cash register tapes were provided, the auditor found them lacking, in that they appeared to be adding machine tapes, as opposed to actual cash register tapes. Moreover, during one of the days of surveillance, January 20, 2011, a Tax Department employee entered the restaurant and ordered food. During this visit, she observed orders being taken over the phone. A review of the purported cash register tape for January 20, 2011, showed that it did not include the food ordered by the Tax Department employee, nor some of the phone orders overheard by the employee.

6. As a result of these omissions, the auditor determined that the Petitioners' records were insufficient to accurately reflect its business operations, and as a result, used other information to complete the audit.

7. 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).<sup>2</sup> 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%).

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<sup>2</sup> 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.

8. 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.

9. 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. Further, the audit revealed that for all of the years in question, Asian Grill failed to show on its Federal Schedule K-1 a distribution into the partners' capital accounts. Therefore, the auditor applied the restaurant's attributed increased sales to the partnership's West Virginia taxable capital based upon her determination that the partnership's Schedule Cs from their Federal 1065 returns, did not show distribution of that taxable capital.

10. Lastly, the auditor applied the amount of under-reported sales from Asian Grill to the Zheng's personal income. Specifically, for tax years 2009-2011 she added the attributed sales from the restaurant to the income the Zhengs reported on their federal tax returns. She then recalculated the Asian Grill's self-employment deduction and arrived at a new federal adjusted gross income amount. This amount was then carried over to the first line of the Zheng's West Virginia personal income tax return. The increased income obviously led to additional income tax due resulting in the issuance of the personal income tax assessment.

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.

### **DISCUSSION** **The Statistical Evidence**

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..."

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 not be considered arbitrary.

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 evaluated and weighed in light of its reliability.

There was discussion at the hearing below of use of confidence levels in statistical sampling methodology.

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 different 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.)

However, when presented graphically, confidence intervals can be shown at several confidence levels, for example 50%, 95% and 99%. The Petitioner'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 chances 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.

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. The lower tribunal was on point when it noted that many may have a "visceral reaction . . . to taking one day's business and extrapolating that out over three years." (W. Va. Officer of Tax Appeals Final Order p. 18). Indeed, such an arbitrary methodology employed by a State agency is enough to shock the conscience. However, while the taxpayers in this present case argue for this Court to adopt the 95% percent confidence level for statistical sample projection methodology used by the Tax Commissioner, this Court will not go so far. 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.

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. For instance, if there was a taxpayer who has allegedly underreported revenue for ten years. Extrapolating from the Petitioners' expert's testimony that it



would take 36 days of observation in a 3 year period to yield a sample that would fall within a 95% confidence interval, it would then take 4 months (120 days) of observation to have a sample projection with a 95% confidence interval in such a situation. The time and manpower required for such a feat would be enormous and would no doubt hinder the Tax Commissioner in performing other mandated duties.

However, lack of resources is not a whole sale license to arbitrarily assess taxpayers who are suspected of underreporting. Using one day's observation as the primary consideration when determining taxes for a 3 year period is absurd. But if the same information generated from the one day of observation was used in conjunction with more definite and complete information such as valid and complete credit card sales records over the 3 year period, which, according to the undisputed testimony of Petitioner's expert, typically account for around 80% of the revenue generated for a business like Asian Grill during that 3 year period, the sample projection method would not be arbitrary as the effects of the uncertainty of such a method would be largely minimized.

Another factor that lends itself to finding the Tax Commissioner's methodology arbitrary is the lack of training. 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." The supervisor 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. 78-79). When asked how Auditor Warner elected two days for the audit, she 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." (Day 2 Tr. p. 79).

The Tax Commissioner's lead auditor on the Asian Grill assessment, Shannon Marie Hockensmith, testified that she received on-the-job training when she started at the Tax Commissioner, which consists of going out and doing an audit one-on-one with another auditor and does not include classroom training. (Day 2 Tr. p. 154-155). There is no classroom training programs at the State Tax Commission, nor any annual continuing education courses, no seminars that auditors are asked to attend or required to attend, no training manuals, and they do not take a course in the West Virginia Code. The auditors have no training other than the on-the-job training and the education she received in college (Auditor Hockensmith did take two statistical analysis classes in college). She does not consider herself an accountant. (Day 2 Tr. p. 155). 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). Auditor Hockensmith had not taken any training in auditing standards for taxes. The State Tax Commissioner does not issue any guidelines, manuals, or documents about how to audit different industries. (Day 2 Tr. p. 157). The State Tax Commissioner does not give any courses, procedure, methods or training in statistical analysis or sampling or procedures, nor any manual on how to perform those type of procedures. (Day 2 Tr. p. 158). The paper produced by the State Tax Commissioner since this audit is only a form sheet used for the purpose of note taking with columns and not for purposes of the statistical analysis and not an attempt at a manual or guidance in statistical sampling itself. (Day 2 Tr. p. 159).

By each of the three tax auditors own admissions, there are no training manuals, they were given no meaningful training, there is no course, no authoritative papers on how to conduct such a technique, or how to calculate the sample size. In fact, they were going to use two days, but could not due to the weather, so they just “decided” to go with one day.

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.

#### **Error in Grossing Up Credit Card Sales**

The lower tribunal erred in affirming the State Tax Commissioner’s assessment in relation to grossing up both cash and credit card sales, when it was acknowledged by the Tax Department that all the credit card sales were fully reported, as those sales receipts go directly into the bank account, and all the receipts deposited in the bank were reported and the full amount of consumer sales tax paid on those credit card sales.

The Tax Department’s auditors acknowledged in their testimony that Asian Grill’s credit card sales were fully reported on the bank statements, since the sales go directly from the credit card machine to the bank for credit to the restaurant’s account. (Day 2 Tr. p. 196). However, even though the Tax Department’s auditor agreed that all of the credit card sales had been reported, the auditors applied their calculated underreporting percentage of 66 percent to the entire amount of sales which Asian Grill did report, not just to the cash sales. (Day 2 Tr. p. 197-198).

In effect, these are direct deposits of customer funds at the time of sale. These were fully reported on Asian Grill’s consumer sales tax returns and the taxes paid. Asian Grill’s expert

witness, D. Patrick Donahoe, C.P.A., testified regarding the credit card sales that the 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 Tax Department did in simply grossing up sales. The supposed "phantom credit card sales" that the Tax Department grossed up would show up on bank statements. (Tr. p. 110).

The testimony of the Tax Department's auditors was that they took Asian Grill'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. In effect, the Tax Department's assessment multiplied all sales, credit card and cash sales, by the underreported rate generated by the single day of observation despite the fact that only cash sales were allegedly underreported. This mistake is more egregious when you consider the undisputed testimony of the Asian Grill's expert who stated that credit card sales on average are equivalent to approximately 80% of the revenue generated by a business of the type in question here. (Tr. p. 123). Even if you accept everything about the Tax Department's sample and projection technique then the Tax Department simply cannot apply the underreported sales percentage to the admittedly reported credit card sales. For this reason alone, the Tax Department's assessments are arbitrary, capricious, and unjust. The alleged under-reported gross cash sales percentage should be applied only to the cash sales that were actually reported, and the tax assessments recalculated.

#### **Duplication of Business Franchise and Personal Income Taxes**

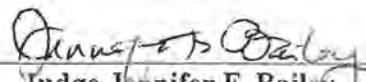
The Petitioners allege that the Tax Department assessments erred in assessing both business franchise tax on capital retained in the business, and taxing personal income tax on the income which would be distributed to the Zhengs, in that it would be assessing two taxes on the same amount of allegedly underreported income. As noted by the lower tribunal in its Final Order,


there simply was not enough development of this issue below. The briefings on this appeal did little to further illuminate this issue for this Court. Accordingly, further fact finding is desirable to clarify the application of the law on this topic.

### RULING

**THEREFORE**, based on the foregoing findings of fact and conclusions of law, the Administrative Decision of the West Virginia OTA against Appellants Kang M. and Mei D. Zheng and Asian Grill is hereby **REVERSED** and the assessments of consumer sales and use tax, business franchise tax, and personal income tax by the State Tax Commissioner at issue here are set aside. Further, the matter is **REMANDED** for new assessments which are to be computed in a manner consistent with this Order as well as further fact finding in regard to the Business Franchise Tax issue.

ENTERED this 13<sup>th</sup> day of February, 2020.

  
Judge Jennifer F. Bailey  
Kanawha County Circuit Court

STATE OF WEST VIRGINIA  
COUNTY OF KANAWHA, SS  
I, CATHY S. GATSON, CLERK OF CIRCUIT COURT OF SAID COUNTY  
AND IN SAID STATE, DO HEREBY CERTIFY THAT THE FOREGOING  
IS A TRUE COPY FROM THE RECORDS OF SAID COURT.  
GIVEN UNDER MY HAND AND SEAL OF SAID COURT THIS 20  
DAY OF February, 2020  
 CLERK  
COURT OF KANAWHA COUNTY, WEST VIRGINIA