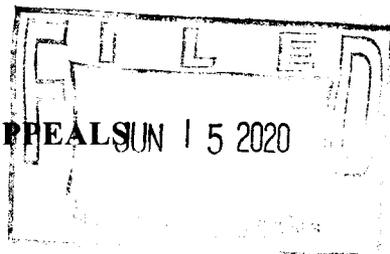


FILE COPY

IN THE WEST VIRGINIA SUPREME COURT OF APPEALS

NO. 20-0226



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

Respondent below, Petitioner

vs.

**DO NOT REMOVE
FROM FILE**

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

Petitioners below, Respondents.

**WEST VIRGINIA STATE TAX DEPARTMENT'S
SUPREME COURT BRIEF**

**PATRICK MORRISEY
ATTORNEY GENERAL**

**L. WAYNE WILLIAMS (WVSB #4370)
ASSIS0TANT ATTORNEY GENERAL
Office of the Attorney General
1900 Kanawha Boulevard, East
Building 1, Room W-435
Charleston, West Virginia 25305
Telephone: (304) 558-2522
Email: lwayne.williams@wvago.gov**

**Counsel for Petitioner Dale W. Steager,
State Tax Commissioner**

TABLE OF CONTENTS

I. ASSIGNMENTS OF ERROR.....	1
A. THE TAX DEPARTMENT BASED THE ESTIMATED ASSESSMENT ON THE BEST AVAILABLE INFORMATION CONTRARY TO THE CIRCUIT COURT'S DECISION.	
B. THE CIRCUIT COURT'S DIRECTIONS TO RECALCULATE THE ESTIMATED ASSESSMENT ARE CONTRADICTORY AND CONTRARY TO THE EVIDENCE IN THE ADMINISTRATIVE RECORD.	
C. THE CIRCUIT COURT ERRONEOUSLY REVERSED THE BURDEN OF PROOF REGARDING ESTIMATED ASSESSMENTS.	
D. THE BUSINESS FRANCHISE TAX ASSESSMENT AND PERSONAL INCOME TAX ASSESSMENT ARE CORRECT CONTRARY TO THE CIRCUIT COURT'S RULING.	
II. STATEMENT OF THE CASE.....	2
III. STATEMENT REGARDING ORAL ARGUMENT.....	11
IV. STANDARD OF REVIEW.....	11
V. SUMMARY OF ARGUMENT.....	11
VI. ARGUMENT.....	15
A. THE TAX DEPARTMENT BASED THE ESTIMATED ASSESSMENT ON THE BEST AVAILABLE INFORMATION CONTRARY TO THE CIRCUIT COURT'S DECISION.....	15
B. THE CIRCUIT COURT'S DIRECTIONS TO RECALCULATE THE ESTIMATED ASSESSMENT ARE CONTRADICTORY AND CONTRARY TO THE EVIDENCE IN THE ADMINISTRATIVE RECORD.....	24
C. THE CIRCUIT COURT ERRONEOUSLY REVERSED THE BURDEN OF PROOF REGARDING ESTIMATED ASSESSMENTS.....	32
D. THE BUSINESS FRANCHISE TAX ASSESSMENT AND PERSONAL INCOME TAX ASSESSMENT ARE CORRECT CONTRARY TO THE CIRCUIT COURT'S RULING.....	37
VI. CONCLUSION.....	38

TABLE OF AUTHORITIES

Cases

<i>Anderson v. Mt. Clemens Pottery Co.</i> , 328 U.S. 680 ___, 66 S. Ct. 1187 (1946).....	35
<i>Appalachian Power Company, et al., v. State Tax Department</i> , 195 W.Va. 573, 583, 466 S.E. 2d 424, 434 (1995).....	17
<i>CB&T Operations Co., Inc. v. Tax Commissioner of State</i> , 211 W. Va. 198, 564 S.E.2d 408 (2002).....	11
<i>Chico Dairy Company, Store No. 22, v. W.Va. Human Rights Commission</i> , 181 W.Va. 238, 382 S.E.2d 75 (1989).....	17
<i>Dale W. Steager, WV State Tax Commissioner, et al., v. CONSOL Energy, Inc., dba, CNX Gas Company, LLC, et al.</i> , 242 W.Va. 209, 832 S.E. 2d 135 (2019).....	17
<i>In re Tax Assessment Against American Bituminous Power Partners, L.P.</i> , 208 W. Va. 250, 539 S.E.2d 757 (2000).....	11
<i>United States Department of Labor v. Fire & Safety Investigation Consulting Services, LLC</i> , 915 F. 3d 277 at 286-287 (4 th Circ. 2019).....	35

Statutes

26 USC § 7491.....	34
W. Va. Code § 11-1-2.....	15
W. Va. Code § 11-10-3(a).....	15
W. Va. Code § 11-10-5a.....	16
W. Va. Code § 11-10-5j.....	15, 36
W. Va. Code § 11-10-7(a).....	16
W. Va. Code § 11-10A-10(e).....	14, 17, 24
W. Va. Code § 11-15-1, <i>et seq.</i>	15
W. Va. Code § 11-15-3.....	15, 36
W. Va. Code § 11-15-4a.....	15
W. Va. Code § 11-15-5.....	14, 15, 36
W. Va. Code § 11-15-6.....	14
W. Va. Code § 11-15-6(b).....	15
W. Va. Code § 11-15-23.....	<i>passim</i>
W. Va. Code § 11-21-12(a).....	38
W. Va. Code § 11-21-12g(d).....	38
W. Va. Code § 11-23-1.....	37
W. Va. Code § 11-23-3(b)(2)(C).....	37
W. Va. Code § 11-23-4.....	37
W. Va. Code § 29A-1-2(e).....	17

Rules

Rule 20, Rules of Appellate Procedure.....	11
--	----

TABLE OF AUTHORITIES- CONT.

W. Va. Code R. § 110-15-91.1.....15
W. Va. Code R. § 110-15-14a1.1.....16
W. Va. Code R. § 110.15-14a.2.....*passim*
W. Va. Code R. § 110-15-14b.4.....11, 19

Other

Allnutt v. Commissioner of Internal Revenue, T.C. Memo. 2004-239,
2014 WL 23398136.....34
Nkonoki v. Commissioner of Internal Revenue, T.C. Memo. 2016-93,
2016 WL 2763863.....34

BEFORE THE WEST VIRGINIA SUPREME COURT OF APPEALS

Appeal No. 20-0226

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

v.

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

**WEST VIRGINIA STATE TAX DEPARTMENT'S
SUPREME COURT BRIEF**

I. ASSIGNMENTS OF ERROR

- A. THE TAX DEPARTMENT BASED THE ESTIMATED ASSESSMENT ON THE BEST AVAILABLE INFORMATION CONTRARY TO THE CIRCUIT COURT'S DECISION.**
- B. THE CIRCUIT COURT'S DIRECTIONS TO RECALCULATE THE ESTIMATED ASSESSMENT ARE CONTRADICTORY AND CONTRARY TO THE EVIDENCE IN THE ADMINISTRATIVE RECORD.**
- C. THE CIRCUIT COURT ERRONEOUSLY REVERSED THE BURDEN OF PROOF REGARDING ESTIMATED ASSESSMENTS.**
- D. THE BUSINESS FRANCHISE TAX ASSESSMENT AND PERSONAL INCOME TAX ASSESSMENT ARE CORRECT CONTRARY TO THE CIRCUIT COURT'S RULING.**

II. STATEMENT OF THE CASE

When you make a purchase and the vendor does not run the sale through the cash register, you know you have a problem. The Tax Department cannot be sure that the vendor has reported all sales; more importantly, customers cannot be sure the sales tax they paid will be remitted to the state.

Asian Grill is a Chinese restaurant located in Charleston, WV. *See* Office of Tax Appeals Decision, Findings of Fact 1 & 2, (hereinafter, OTA Decision), AR 0279. Shannon Hockensmith and Cathy Mills, two Tax Department auditors, decided to eat dinner at Asian Grill in September and December of 2010. Auditor Hockensmith testified that on one occasion Auditor Mills paid with a credit card; the transaction was run through the credit card machine but was never entered in the cash register. Auditor Hockensmith paid with cash; the sale was written down on a piece of paper but was never entered into the cash register. She testified that the failure to enter all sales into the cash register is a red flag that sales are being grossly underreported. *See* OTA Transcript, Day 2¹ (hereinafter, Tr. 2,) 134, 11-19, AR 0798. Argued below AR 0308; 0104.

The two Auditors became suspicious that Asian Grill was not reporting all of its sales for consumers sales tax purposes. Therefore, the Auditing Division of the State Tax Department had reason to believe that Kang M. Zheng and Mei D. Zheng, d/b/a Asian Grill, were under reporting sales for combined sales and use tax purposes.

1. **Surveillance of Asian Grill.**

Subsequently, Auditors Shannon Hockensmith, Cathy Mills, and Jean Warner, conducted surveillance of Asian Grill to determine the number of customers served on three days. The

¹ All cites to the Transcript are to Day 2 of the administrative hearing unless otherwise noted.

purpose of surveillance is to obtain a customer count to compare with the Taxpayer's books and records to determine whether all sales are being reported on the tax return.

Initially, the Auditors Hockensmith and Warner decided to conduct surveillance for two full days covering all business hours on a weekday and a Friday. *See* TR. 2, 79, AR 0743.

However, the surveillance was actually conducted on:

January 20, 2011	9:00 a.m. - 3:00 p.m.
January 27, 2011	3:00 p.m. - 10:20 p.m.
January 28, 2011	10:45 a.m. - 10:15 p.m. ²

See OTA Decision, Finding 3, AR 0279; *see also*, Tr. 2, 69:20-23- 70:1, AR 07333-0734.

However, surveillance on January 20, 2011, was cut short due to a severe snowstorm in the Charleston area.³ *See* Tr., 2, 134, 20 – 135, 7, AR 0798-0799. The surveillance was continued on January 27, to obtain a customer count for the second half of a Thursday. *See* Tr. 2, 80, 17-23, AR 0744. Argued below at AR 0308. Auditor Warner testified that the auditors observed similar findings on all three days. *See* Tr. 2, 70: 7-9, AR 0734. As a result of the surveillance, the Tax Department collected one full-day of data and two partial-days of data.

2. Unreported transactions observed during the surveillance.

While conducting the surveillance, the auditors also purchased a few meals at the restaurant over the three-day period. Auditor Mills ate lunch at Asian Grill during the surveillance period and received a receipt for her meal on January 20, 2011, in the amount of \$9.86. *See* Tax Department's Exhibit 10, AR 1815; *see also* OTA Tr. 2, 95, AR 0759. Auditor

² The OTA Decision specifically listed surveillance on January 28, 2011, as a full day of observations from 10:45 a.m. until 10:15 p.m. Auditor Mills erroneously testified that the surveillance on January 28, 2011, was from 4:00 p.m. to 10:15 p.m. *See* Tr. 2, 69:20 – 70:1, AR 0733-0734. According to the observation notes from January 28, 2011, Auditors Hockensmith and Warner observed customers patronizing the restaurant from 10:52 a.m. until 10:09 p.m. *See* Tax Exhibit 8, AR 1741-1742. It is not disputed that the Tax Department conducted surveillance one full day and two partial days.

³ Counsel represents that January 28, 2011, was a Friday; the other two days were Thursdays.

Hockensmith testified that Auditor Mills' purchase of \$9.86 on January 20, 2011, was not included in Asian Grill's cash sales reported in Petitioners' Exhibit 1. *See* OTA Tr., Day 2, 120, 126, AR 0784, 0790. Before the Circuit Court, the Tax Department attached a photocopy of the adding machine tapes and credit card receipts in the record from January 20, and January 28, 2011, to its brief for easy reference since the Petitioner's Exhibit 1 is voluminous. The \$9.86 transaction is not included in Asian Grill's records for that day. Argued below at AR 0112-0113 and 0124-0144.

In addition, Asian Grill's records do not reflect additional sales known to have occurred on January 20, 2011. According to Tax Department's Exhibit 8, AR 1743-1744, Auditors Mills and Warner counted 44 transactions. Auditor Mills was able to identify six transactions by specific amount while eating lunch in the restaurant in less than thirty minutes.

<u>Time</u> ¹	<u>Amount</u>	<u>Recorded in Credit Card Receipts</u>	<u>Recorded on Adding Machine Tapes</u>
11:23 a.m.	\$44.68		No
11:36 a.m.	\$6.25	Transaction 2	
11:38 a.m.	\$4.98	Transaction 5	
11:39 a.m.	\$15.00		No
11:39 a.m.	\$4.98		No
11:44 a.m.	\$15.53	Transaction 3	

Three out of six known transactions during a thirty minute period were not recorded by Asian Grill in their sales records from January 20, 2011. *See* AR 1737 and AR 0124-0144. Argued below at AR 0113-0114.

¹Times and amounts for each transaction are listed on Tax Department's Exhibit 8, AR 1737 for January 20 and AR 1741 for January 28. Credit card receipts and cash sales are included in Petitioners' Exhibit 1, AR 0922 (174 pages). The adding machine tapes showing some cash sales for January 20, 2011, were attached as Exhibit 1 to the Tax Department's Circuit Court Brief; credit card sales receipts were attached as Exhibit 2. *See* AR 0124-0144.

Similarly, the Auditors observed Asian Grill for a full day on January 28, 2011. Auditors Hockensmith and Mills ate lunch in the restaurant and identified four transactions by specific amount in approximately five minutes.

<u>Time</u>	<u>Amount</u>	<u>Recorded in Credit Card Receipts</u>	<u>Recorded on Adding Machine Tapes</u>
12:25 p.m.	\$10.58		No
12:25 p.m.	\$10.58		No
12:13 p.m.	\$14.50	Possible	No
12:21 p.m.	\$1.48		No

At least three of the four identified transactions were not reported in Asian Grill's sales records for January 28, 2011. (It is possible that the sale identified as \$14.50 may have been a sale in the amount of \$14.15 reported as a credit card sale.) Auditor Hockensmith testified that two people ordered the same meal at 12:25 p.m., which accounts for the same transaction amounts. *See* OTA Tr. 2, 142, AR 0806. Neither transaction for \$10.58 appears in Asian Grill's reported sales records. Asian Grill did not even report the sale of a bottle of Coke for a \$1.48 in its daily sales records. Auditor Hockensmith reaffirmed on cross-examination that she found sales which occurred on January 20, 2011 and January 28, 2011, which were not recorded by Asian Grill in their calculator tapes and credit card sales records. *See* OTA Tr. 2, 190 at lines 16-23 & 196 at lines 14-21, AR 0853 & 0859. Finally, Auditor Hockensmith testified that her purchase of lunch on January 28, 2011, via credit card was reported by Asian Grill. *See* OTA Tr. 2, 126, AR 0790. *See* Tr. 2, 141, 15-16; 142, AR 0805-0806. Argued below, AR 0114.

3. Calculation of estimated assessment.

After completing the three days of surveillance of the restaurant, the Tax Department began the audit process for Asian Grill. The auditors requested the books and records for the

business on several occasions. However, Asian Grill was unable to provide a complete set of business records to support their reported sales. At the administrative hearing, Auditor Shannon Hockensmith, the lead auditor for this assessment, testified that Asian Grill did not provide numerous business records that were requested.

ATTORNEY RODAK: What documents did you request more than once that were never forthcoming?

MS. HOCKENSMITH: The actual point-of-sale receipts, the daily z-summaries, the daily reports from this machine [the Point-of-Sale computer terminal] that it provides, as well as the monthly report that this provides, I was never provided those records. I was told that this is all they had, this was their sales.

ATTORNEY RODAK: Just for purposes of clarification of anyone who ever may review this transcript, what is a daily z-tape summary?

MS. HOCKENSMITH: A daily z-tape is when all your sales are rung through a cash register, at the end of the day you total out your sales for the day so you're not running a running total for the week, so that Sunday [*sic*] actually has a date that has - - - it tells you how many transactions, tells you how much, actually tells you the sales tax that you collected. It'll even give you information, depending on how your register is set up, as to what items you sold, how many items you sold, how many drinks you sold. It can provide a whole vast information. And at the top of the z-tape, what they appear to have for later in 2012, they're actually printing a report from the machine that they weren't providing or printing prior to the audit.

OTA Tr. 2, 122, AR 0786.

During the surveillance days the auditors counted the number of purchases made by customers patronizing Asian Grill. Auditor Warner testified that they counted the number of customers who ate in the restaurant, picked up food for take-out, and the number of deliveries by a restaurant employee. *See* Tr. 2, 70-71, AR 0734-0735. When a customer left the restaurant with a bag of food, each bag was counted as one transaction. For example, if a customer left the restaurant with six bags it was counted as six transactions. The Auditors assumed that a bag only represented one transaction despite the fact that two or more meals could be inside the bag.

When a delivery was made by a restaurant employee, the same method of counting transactions was employed. *See* Tr., 2, 85-86, AR 0749-0750. Each box was counted as two transactions. *See* Tax Ex. 8, AR 1742. Chief Administrative Law Judge Pollack noted that the Auditors were being generous to the Taxpayer by counting a bag as a single transaction despite the fact that the bag could contain more than one meal. *See* Tr. 2, 87, 19 - 88, 11, AR 0751-0752.

The Auditors counted transactions for every day of surveillance. Once Asian Grill provided its books and records, Auditor Hockensmith concluded that Asian Grill was not reporting all of its sales.

	<u>Transactions Counted by Auditors</u>	<u>Transactions Reported by Taxpayer</u>
January 20	44	32
January 27	34	28
January 28	87	30

See Tax Ex. 11, AR1817-1818. The Auditors observed more sales for the partial days of January 20 and 27, than Asian Grill reported for those entire days. *See* also, Tr. 2, 133, 2-6, AR 0797.

However, Auditor Hockensmith was unable to utilize the observed transactions from the two partial days to calculate the estimated assessment for delinquent consumers sales tax because Asian Grill's records did not reflect which sales occurred at any particular time throughout the day. For example, Auditor Hockensmith was unable to determine which sales Asian Grill made between 11:00 a.m. and 3:00 p.m. on January 20 based upon a review of Asian Grill's records. *See* Tr. 2, 123, 1-10, AR 0787. If Asian Grill had provided cash register z-tapes, then you would not have this problem. Therefore, the Tax Department was unable to accurately compare the observed sales on those two days to the sales reported by Asian Grill.

As a result, the Tax Department based the estimate on the one full day of sales from January 28, 2011.

<u>Reported by Asian Grill</u>	<u>30</u>	=	34%
Observed by Auditors	87		

Since Asian Grill reported 34% of sales, the Tax Department concluded that 66% of sales were not reported on the consumers sales tax returns. Therefore, reported sales were increased by 66% to arrive at an estimated assessment. *See* Tr. 2, 133, 10-14 and Tr. 2, 137, 11-16, AR 0797 and 0801. Argued below at AR 0308–0310 and AR 0116-0117. The sales reported by Asian Grill included both credit card sales and cash sales.

In order to verify the estimated assessment based on total reported sales, Auditor Hockensmith calculated the assessment a second time independent of the reported credit card sales. The alternate calculation was based on the number of customers observed on January 28, 2011, the average size per household in Kanawha County (2.28 people), and the average menu price from Asian Grill. The second calculation yielded a calculated sales figure of \$1219.66 (audited figure) for January 28, 2001, versus reported sales of \$463.78 based upon Asian Grill’s records. Based on the second calculation, Auditor Hockensmith concluded that Asian Grill was reporting 38% of daily sales and not reporting 62% of daily sales. *See* OTA Tr. 2, 148-149, AR 0812-0813 and Tax Department’s Exhibit 14, AR 1839-1843, especially 1841. Argued below, AR 0117-0118.

Chief ALJ Pollack noted in the administrative decision that the auditor calculated the percentage of unreported sales using two different methodologies and arrived at remarkably similar percentages; the two estimated liabilities were within approximately \$1,000 of each other. *See* OTA Decision at pp. 19-20, AR 0291-0292. Argued below at AR 0117-0118. Even though the underreported sales were calculated in two very different methodologies, they provided similar percentages—underreporting of 34% and 38%. The second calculation is based

on the average menu price and was calculated independent of the credit card and debit card sales which were reported by Asian Grill. Argued below at AR 0117-0118.

Asian Grill was given full credit for the consumers sales tax remitted to the Tax Department with the returns. *See* Tr. 2, 138, 5-7, AR 0802 and AR 1708-1712. As a result, Asian Grill received a consumers sales tax Assessment of \$17,413 plus interest and additions to tax for the audit period of January 1, 2009 through June 30, 2012. *See* Tr. 2, 138, 14-16, AR 0802. *See* also Tax Department's Ex. 8, AR 1705 and OTA Decision at p. 6, AR 0278.

4. Estimated assessments.

The Tax Department issued three assessments based upon the audit. First, the Tax Department issued a combined sales and use tax assessment covering the period of January 1, 2009 through June 30, 2012, for \$17,413.11 in tax, plus interest of \$2,953.55, plus additions to tax of \$4,284.29 for a total assessment of \$24,650.95. *See* Tax Department's Exhibit 8, AR 1705. Second, the Tax Department issued a business franchise tax assessment based upon operating the business as a partnership or a pass-through entity covering the period of October 26, 2005 through December 31, 2011, for tax in the amount of \$5,424.00 plus interest of \$1,176.28, and additions to tax of \$1,356.00 for a total assessment of \$7,956.28. *See* Tax Department's Exhibit 9, AR 1748. Third, the Tax Department issued an assessment covering the period of January 1, 2009 through December 31, 2011, for unpaid personal income tax of \$12,398.00, plus interest of \$1,641.71, plus additions to tax of \$3,099.50, for a total assessment of \$17,139.21. *See* Tax Department's Exhibit 15, AR 1845.

Kang M. Zheng and Mei D. Zheng challenged the assessments at the Office of Tax Appeals. After conducting a two-day hearing and reviewing the legal briefs filed by both parties,

the Office of Tax Appeals affirmed the full amount of all three assessments. *See* OTA decision, AR 0297-0298.

The Office of Tax Appeals ruled that Asian Grill's books and records "... were not complete and accurate enough to determine the Petitioner's liability for consumers sales and use tax purposes." OTA Decision, Conclusion of Law 11, AR 0295. OTA also ruled that the Tax Commissioner did not abuse his discretion by basing the estimated assessment on the single full day of surveillance conducted on January 28, 2011. *See* OTA Decision, Conclusion of Law 9, 12 & 13, AR 0295-0296. In addition, OTA ruled that despite the shortcomings of basing an estimated assessment on a single full day of surveillance, the fact that Auditor Hockensmith performed a second estimate using a different methodology confirms the validity of the underreported sales calculation. When the estimate was made using an alternate methodology, the alternate estimate was within approximately \$1,000 of the total based on the ratio estimate originally calculated by Auditor Hockensmith. *See* OTA Decision at pp. 19-20, AR 0291-0292; Argued below at AR 0117-0118.

Asian Grill appealed the OTA Decision to the Circuit Court of Kanawha County before the Honorable Jennifer Bailey. Subsequently, after reviewing the voluminous administrative record, the Circuit Court of Kanawha County issued a decision which reversed the OTA Decision on the key element. The Court, essentially, adopted the findings of fact from the OTA decision. *See* AR 003-006. First the Circuit Court ruled that Asian Grill failed to maintain adequate business records which are required by statute and the legislative rule, then Court also ruled that the best information available on which to base an estimated assessment would be the cash sales actually reported by Asian Grill.

Therefore, the Tax Department timely appealed this matter to the West Virginia Supreme Court of Appeals for judicial review.

IV. STATEMENT REGARDING ORAL ARGUMENT

The Tax Department requests a Rule 20 Oral Argument, pursuant to the Rules of Appellate Procedure, in this case because it involves fundamental issues regarding the ability of the Tax Department to issue an estimated assessment when a business fails to maintain adequate business records. In addition, the Circuit Court has reversed the burden of proof on an estimated assessment contrary to statute.

V. STANDARD OF REVIEW

The standard of review on appeal is well-settled. Legal questions before the Supreme Court are subject to *de novo* review. See Syl. pt. 1, *In re Tax Assessment Against American Bituminous Power Partners, L.P.*, 208 W. Va. 250, 539 S.E.2d 757 (2000). On the other hand, factual findings made by the Tax Department or any other administrative agency receive deference. See Syl. pt. 2, *CB&T Operations Co., Inc. v. Tax Commissioner of State*, 211 W. Va. 198, 564 S.E.2d 408 (2002).

VI. SUMMARY OF ARGUMENT

Every retail vendor is required by statute to maintain complete and accurate business records. See W. Va. Code § 11-15-23. The legislative rule specifically requires that vendors must keep cash register z-tapes or the digital equivalent if the vendor uses a computerized record keeping system, original source documents and all working papers used to prepare the consumers sales tax return. See W. Va. Code R. § 1101-5-14a.2. If a vendor fails to maintain adequate business records, then the Tax Department is authorized to estimate the sales tax liability based on the best information available. See W. Va. Code R. § 1101-5-14b.4.

The Tax Department routinely asks to review a vendor's business records when conducting an audit. Asian Grill's audit was no different. Auditor Hockensmith specifically requested to review cash register z-tapes or the daily sales summaries from Asian Grill's digital point-of-sale system on several occasions. However, Asian Grill could not provide the most basic of business records. Instead, Asian Grill provided adding machine tapes which purported to show daily sales, copies of credit card slips signed by customers, and handwritten sales journals.

Prior to conducting the audit, Auditors Hockensmith and Mills had eaten dinner at Asian Grill twice and observed that their sales were not entered into the cash register. Before requesting the business records, the Tax Department conducted surveillance on three different days and observed specific sales that were not entered not entered into the system. Once the records were provided, the auditors were not able to locate several of the observed transactions in Asian Grill's records. There is no doubt that Asian Grill failed to report all sales during the audit period.

Since Asian Grill did not maintain complete and accurate business records, the Tax Department was required to estimate the sales tax liability based on the best information available. Based upon the surveillance from January 28, 2011, the Tax Department concluded that Asian Grill was only reporting 34% of sales; therefore, total sales were underreported by 66%. Asian Grill was given full credit for the consumers sales tax that it remitted with the tax returns in calculating the estimated assessment.

The Office of Tax Appeals ruled that Asian Grill's records did not accurately reflect its business operations and the Circuit Court agreed. *See* AR 0284 and 0005-0006. However, the Circuit Court specifically ruled that the estimated assessment should be calculated based solely

on grossing up the cash sales actually reported by Asian Grill. *See* AR 0011-0012. The Court criticized the Tax Department, in particular, for grossing up total sales despite Auditor Hockensmith's testimony that all credit card sales were reported by the Taxpayer.

The question becomes why did the Tax Department gross up total sales instead of the cash sales actually reported by Asian Grill? The purpose of any consumers sales tax audit is to verify that the Taxpayer reported all taxable sales on the return. Asian Grill could not provide the fundamental documentation for any retail business—cash register z-tapes. Therefore, the Tax Department was required to estimate the total sales based on the best information available. Credit card sales are generally processed through a bank and leave a digital trail for the auditor to follow and Auditor Hockensmith did so.

However, without the cash register z-tapes which would show every sale sequentially and time verified, the auditor was required to estimate total sales. On January 28, 2011, the Auditors counted 87 customers while Asian Grill only reported 30 customers for that day. The Auditor concluded that sales were underreported by 66%. Since Asian Grill's records did not identify **all** sales that were made on January 28, the Tax Department could not simply gross up cash sales actually reported by Asian Grill. Without cash register z-tapes which would show all sales, the Auditors could not determine whether Asian Grill reported 17% of cash sales or 52% of cash sales for January 28. If Asian Grill had provided the z-tapes, then the Tax Department would know the amount of unreported cash sales; but, Asian Grill never provided the critical piece of missing information. Without cash register z-tapes showing all sales, the Auditors could not determine the actual ratio of credit card sales versus cash sales for January 28. Without cash register z-tapes it was impossible to determine whether credit card sales represented 72% or 29% of Asian Grill total sales on January 28.

Therefore, Auditor Hockensmith was forced to estimate the consumers sales tax liability based on the known information for January 28. Auditor Hockensmith knew the observed customer count of 87, the number of transactions reported by Asian Grill of 30, credit card sales reported and tax remitted by Asian Grill, plus the cash sales reported and tax remitted by Asian Grill. Auditor Hockensmith grossed up total sales reported by Asian Grill by multiplying the reported sales by 1.66. The Auditor calculated consumers sales tax liability based on the grossed-up sales and gave Asian Grill full credit for the sales tax that was remitted with the tax returns. The net result was the sales tax due on the unreported sales which represent unreported cash sales.

Subsequently, Auditor Hockensmith calculated the estimated assessment a second time independent of reported sales. Auditor Hockensmith based the second estimate on the observed customer count, multiplied by the average size of households in Kanawha County (2.28) and multiplied by the average cost of a meal from Asian Grill's menu. The second estimate is independent of reported sales. The total difference between the two estimated assessments calculated with different methodologies was approximately \$1,000 covering a 42 month audit period.

The vendor has the responsibility of proving that he has reported all sales and remitted all of the tax collected. *See* W. Va. Code §§ 11-15-6, 11-15-5 and W. Va. Code § 11-10A-10(e). Asian Grill's failure to maintain basic business records required by statute created the problems in this case. The Supreme Court should not reward Asian Grill for its failure to keep basic records by limiting the tax assessment to grossing up the cash sales actually reported on the tax return. No retail vendor should be able to limit a tax assessment due to its failure to create

complete and accurate business records required by law. In doing so, the Circuit Court has erroneously shifted the burden of proof from the retail vendor to the Tax Department.

VII. ARGUMENT

A. THE TAX DEPARTMENT BASED THE ESTIMATED ASSESSMENT ON THE BEST AVAILABLE INFORMATION CONTRARY TO THE CIRCUIT COURT'S DECISION.

1. Asian Grill failed to maintain adequate business records as required by law.

West Virginia imposes a general consumers sales tax on all sales of tangible personal property and services. *See* W. Va. Code §§ 11-15-1, *et seq.* Accordingly, all sales of tangible personal property and services are subject to consumers sales tax. *See* W. Va. Code § 11-15-3. Argued below at AR 0106-0107. If a vendor fails to collect and remit the consumers sales tax, the vendor is personally liable for the tax. *See* W. Va. Code § 11-15-4a. In order to prevent evasion, all sales are presumed to be taxable until proven otherwise. *See* W. Va. Code § 11-15-6(b). All sales of food and beverages by restaurants and bars are subject to the consumers sales tax. *See* W. Va. Code R. § 110-15-91.1. Consumers sales tax is a trust tax. The retail vendor collects the tax from his customers at the time of sale and holds the tax in trust for the State of West Virginia. *See* W. Va. Code §§ 11-10-5j, 11-15-3, and 11-15-5. In short, the consumers sales tax collected by the vendor is never the vendor's money; it is money held in trust by the vendor for the State of West Virginia. Since Asian Grill could not provide the most basic of records—the cash register z-tapes—Asian Grill cannot prove that it remitted all of the consumers sales tax it collected.

The Tax Commissioner is charged with ensuring that the tax laws of this State are faithfully enforced. *See* W. Va. Code § 11-1-2. In order to ensure that taxpayers comply with the laws, the Tax Department is specifically authorized by statute to examine the books, papers,

records, or memoranda for any business, related to tax returns filed by that business. *See* W. Va. Code §§ 11-10-5a and 11-10-3(a). If the Tax Commissioner believes that any tax return is deficient, he may proceed to investigate and determine or estimate the tax liability and issue a tax assessment. W. Va. Code § 11 10-7(a). Argued below at Circuit Court Brief, AR 0106-0107.

Every person is free to operate his business as he sees fits; however, the consumers sales tax statute specifically requires that every business owner must keep complete and accurate business records.

Each taxpayer shall keep complete and accurate records of taxable sales and of charges, together with a record of the tax collected thereon, and shall keep all invoices, bills of lading and such other pertinent documents in such form as the tax commissioner may by regulation require. Such records and other documents shall be preserved for a period of time not less than three years, unless the tax commissioner shall consent in writing to their destruction within that period or by order require that they be kept longer.

W. Va. Code § 11-15-23. Business owners are charged with the responsibility to maintain business records since they have sole custody of their records and are in the best position to create, organize, and preserve their records. Argued below at AR 0107.

The legislative rule also explains the types of records that every business is required to keep. Vendors are required to keep “[r]eceipts of sales and leases of tangible personal property....” W. Va. Code R. § 110-15-14a1.1. In addition, the legislative rule requires:

Each record shall consist of the normal books of account ordinarily maintained by the average prudent person engaged in the activity in question, **including bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account**, and all schedules or working papers used in connection with the preparation of tax returns.

W. Va. Code R. § 110-15-14a.2. (emphasis added). Argued below at Circuit Court Brief, AR 0106-0107.

Asian Grill failed to meet the clear statutory requirement to keep complete and accurate business records as well as the requirement in the legislative rule to keep original source documents such as cash register z-tapes. As Auditor Hockensmith testified, Asian Grill failed to keep the most fundamental business records such as cash register z-tapes; nevertheless, Asian Grill argued that the estimated assessment was arbitrary and capricious as well as erroneous. It is well settled that the taxpayer has the burden of proof to demonstrate that the assessment issued by the State Tax Department is wrong or contrary to law. *See* W. Va. Code § 11-10A-10(e). If a business fails to keep the most basic and fundamental of business records—cash register z-tapes, then the business has no basis on which to object to the estimated assessment. Asian Grill’s failure to keep fundamental business records does not shift the burden of proof to the Tax Department.

Under West Virginia law, legislative rules have the full force and effect as law. In the recent decision applying the legislative rule for ad valorem property tax, the Supreme Court ruled:

“A regulation that is proposed by an agency and approved by the Legislature is a ‘legislative rule’ as defined by the State Administrative Procedures Act, *W. Va. Code*, 29A-1-2(d) [1982], and such a legislative rule has the force and effect of law.” Syl. Pt. 5, *Smith v. W. Va. Human Rights Comm’n*, 216 W. Va. 2, 4, 602 S.E.2d 445, 447 (2004).

Syl. Pt. 4, *Dale W. Steager, WV State Tax Commissioner, et al., v. CONSOL Energy, Inc., dba, CNX Gas Company, LLC, et al.*, 242 W.Va. 209, 832 S.E. 2d 135 (2019); *see also*, Syl. Pt. 2, *Chico Dairy Company, Store No. 22, v. W.Va. Human Rights Commission*, 181 W.Va. 238, 382 S.E.2d 75 (1989)(legislative rules have the full force and effect of law); *Appalachian Power Company, et al., v. State Tax Department*, 195 W.Va. 573, 583, 466 S.E. 2d 424, 434 (1995)(legislative rules have the full force and effect of law); and W. Va. Code § 29A-1-2(e).

Consequently, the mandatory requirements set forth in the legislative rule carry the same weight as if they were set forth in a statute.

The Tax Department had two reasons to question the adequacy and reliability of Asian Grill's tax records. First, the known failure to record all observed transactions raises a red flag regarding the accuracy of the information reported by any business to the Tax Department. Second, Asian Grill's failure to produce cash register tapes - the critical original source document for every retail vendor. If a business maintains complete and accurate business records, then a tax audit can be a fairly simple process of verifying what the business reported to the State. However, the absence of supporting documents raises questions concerning the accuracy of combined sales and use tax returns and remittances. In short, without the cash register z-tapes and daily sales summaries, the Tax Department has no confidence that the vendor is reporting all sales. As argued above, the statute places the obligation on the business owner to keep complete and accurate business records. Asian Grill failed to meet its statutory obligation to keep accurate books and records.

Auditor Hockensmith explained at the administrative hearing why Asian Grill was selected for surveillance and audit by the Tax Department.

ATTORNEY RODAK: Is it unusual to have to resort to surveillance when the records are inadequate?

MS. HOCKENSMITH: **I think the only time we've resorted to surveillance is when we have been - - - as auditors - - - or it's been reported to us by just regular customers that they have viewed sales not being rung in the cash registers, where you place an order, they already know how much it is because it's the lunch special and with tax it's \$8, so it's just \$8. And it never actually makes it into the cash register, other than made change for your \$10 and said have a nice day. That's not the proper way of conducting business. That is why you have a cash register, because all of your sales, cash, credit card, check, should be recorded on that tape in that cash register for every single day you are in business.**

ATTORNEY RODAK: Did you observe that type of activity with this taxpayer prior to the audit?

MS. HOCKENSMITH: I did not. Auditor Mills and I were in there - - - I believe it would have been September of '10, and then again in December of '10. On one occasion, she paid with a credit card and it went through the credit card machine, **but it was never entered into the cash register.** But mine was a cash sale and he wrote it down on a piece of paper and then told me how much it was. **And it was never entered into the cash register.** And again, as an auditor - - - even as a customer somewhere, that's a red flag that sales are being grossly underreported, which is why after a conversation with management, this taxpayer was selected for surveillance, and subsequently an audit letter sent out.

OTA Tr. 2, 133-134, AR 0797-0798 (emphasis added). *See also* OTA Tr. 2, p. 121 at line 6; p. 122 at line 5; p. 164 at line 14 and p. 165 at line 6, AR 0785-0786 and 0828-0829. The failure to record all transactions in the cash register, or in this case in the point-of-sale computer system, undermines Asian Grill's argument that it kept complete, accurate, and reliable business records. Without accurate business records, Asian Grill's reported sales cannot be verified and Asian Grill cannot meet its statutory burden of proof.

2. The estimated assessment was based on the best information available.

When a vendor fails to maintain complete and accurate business records, the legislative rules to the consumer sales tax authorize the Tax Department to base the audit on the best available information.

14b.4 If records are inadequate to accurately reflect the business operations of the taxpayer, the auditor will determine the best information available and will base the audit report on that information.

W. Va. Code R. § 110-15-14b.4. The initial inquiry is whether the taxpayer maintains adequate business records which create an audit trail so that sales to customers can be tracked accurately and verify the information reported to the Tax Department on the consumers sales tax returns.

During the audit and also at the administrative hearing, Asian Grill provided "tapes" that they proffered as cash register tapes. The Auditing Division requested the cash register tapes or

the z-tapes in order to review the original source documents for the consumers sales tax returns. See Tax Department's Exhibit 6, AR 1680-1681 (email dated April 13, 2012, from S. Hockensmith to P. Corbett). The records provided by Asian Grill and included in Petitioner's Exhibit 1 are not the z-tapes requested by the auditors.

Nevertheless, Asian Grill argued at the Office of Tax Appeals that Petitioner's Exhibit 1 includes "cash register tapes" for January 2011. See OTA Tr., Day 1 31-32, AR 0436-0437. Auditor Hockensmith contradicted David Zheng's testimony, the owners' son, that Petitioner's Exhibit 1 included "cash register tapes." Auditor Hockensmith testified:

ATTORNEY RODAK: Thank you. Can you tell us what those are?

MS. HOCKENSMITH: These are the taxpayers' reported records for January 2011. There is a bundle with the credit card printouts for their daily sales, and there is a bundle of calculator tapes. And they are calculator tapes, not cash register tapes. A calculator tape has the ability to be - - - a cash register tape has the ability to be Z'ed out at the end of every day. These have been done on a calculator. There's no total at the end of them, nor are they numbered, as where you would have - - - even with the cash register, you would have some basic numbering on them.

The only numbers that were written on them when I reviewed them are the numbers up in the top - - - let's see, if you're looking at it, it's going to be the top left corner - - - that says 28, and then it looks like maybe it's the at sign on this one, \$95.54. Because that's the total of this little tiny calculator tape. The date wasn't clearly written on here and the amounts weren't written on here. I think each one of these bundles, when I reviewed them, had another piece of calculator tape that said, like, January. And I took this to be the 28th of January, the 27th of January, not necessarily 28 sales. But this was the 28th, and they had \$95.54 of cash sales that day.

Upon reviewing January 28th, January 20th and January 27th, I found that sales that were overheard by other auditors, in the detail that they had provided to me and that there is a cash register receipt for, are not in these records, and that - - -. If this were an actual register tape, it would look like the receipt that was provided on January 20th, 2011, to Auditor Mills. That is State's Exhibit - - -

JUDGE POLLACK: Ten?

MS. HOCKENSMITH: - - - Ten. The receipt there on the left is the receipt that she received on January 20th. . . .

OTA Tr. 2, 119-120, AR 0783-0784. Asian Grill's failure to provide cash register z-tapes documenting all sales demonstrates why their records are fundamentally inadequate.

In addition, ALJ Pollack questioned Ms. Hockensmith regarding the significance of z-tapes in record keeping. ALJ Pollack wanted to know why the "tapes" provided by the Taxpayer in Petitioner's Exhibit 1 were not cash register tapes.

JUDGE POLLACK: How do you know that? How do you know that there isn't a cash register that has a tape like this?

MS. HOCKENSMITH: Because a cash register in any form generates a number for each transaction. If it has six zeros across the top and then 337, the next one's going to have six zeroes and 338. It's going to have a numbering system. That was the whole purpose of a cash register, was to have a record of your sales. So even if you stopped today on 337, tomorrow you could start on 338, but it shouldn't. You should total it out for the end of the day, which is what cash registers are made to do, so that you don't have to go through 3,000 transactions and total them up by hand. A cash register has that feature. A calculator tape does not have that feature.

OTA Tr. 2, 201, AR 0864. According to Auditor Hockensmith, the Taxpayer could only provide adding machine tapes as the source of cash sales not cash register tapes. Furthermore, Asian Grill kept handwritten records which only showed daily credit card sales in total amount and cash sales in total amount for each day of the month. *See* Petitioners' Exhibit 4, AR 1115, *et seq.*, (69 pages). Asian Grill's handwritten summaries do not indicate how many transactions occurred per day; the summaries only indicate the total dollar amount which was reported on the tax return. Asian Grill paid the correct amount of consumers sales tax on all **reported** sales; the problem is that Asian Grill was unable to prove that it reported all sales to customers. Transactions were missing based on the auditors' personal observations prior to the surveillance,

the observations made during the surveillance days, and a review of the records provided by the Taxpayer for audit.

At the administrative hearing, Auditor Hockensmith testified that Asian Grill used a digital point-of-sale system for record keeping during the days of surveillance and the audit period. Auditor Hockensmith testified there was no reason for Asian Grill to provide adding machine tapes and handwritten sales ledgers since the digital point-of-sale system should be able to produce a report similar to the cash register z-tapes. *See* Tr. 2, 121, AR 0785. Argued below at AR 0309. The Tax Department included pictures of the point-of-sale terminal in the administrative record. *See* Tax Department's Exhibit 1, AR 1651-1654. In fact, the Office of Tax Appeals expressly ruled, "We find it highly unlikely that the purported cash register tapes in Petitioner's Exhibit 1 [adding machine tapes] came from the [digital] system shown in the photograph in State's Exhibit 1." *See also* OTA Decision at Footnote 4, AR 0284. Argued below at AR 0309 and AR 0118.

Furthermore, Asian Grill did not provide an integrated listing showing the credit card sales, debit card sales, and cash sales, running in a complete series for every day. Asian Grill could only show photocopies of several credit card receipts each day to be physically added to the adding machine tapes for cash sales. The computerized point-of-sale system shown in Tax Department's Exhibit 1 should be able to print out a complete report daily showing all sales as they occurred; the z-tape from a cash register would show the exact same information for each days' sales.

Asian Grill cannot trace its business records from the original entry document to the total sales reported on the consumers sales tax returns as required by the legislative rule. Proffered records support what was reported; but, the proffered records do not include the original source

records such as cash register z-tapes and daily summaries from the point-of-sale system. Therefore, Asian Grill has not been able to show that it included all sales in the bookkeeping systems. Auditor Hockensmith testified that she observed specific transactions which were not entered into the bookkeeping system. Without the ability to show that all sales have been recorded and reported, Asian Grill cannot meet its statutory burden of proof.

Consequently, Auditor Hockensmith concluded that the records provided by Asian Grill were inadequate. The Tax Department proceeded to estimate the combined sales and use tax liability from the best information available – the customer count from the surveillance period and the sales reported by the Taxpayer. Argued below at AR 0107-0112. ALJ Pollack agreed that the records provided by Asian Grill for the audit were not adequate to support the sales reported on the tax returns for the reasons identified by the Auditors. *See* OTA Decision at AR 0283-0284. In fact, the Circuit Court agreed that Asian Grill's books and records were not adequate as required by law. *See* AR 0005-0006.

Therefore, the Tax Department based the estimated assessment on the best information available. Auditor Hockensmith explained the methodology used for the estimated assessment above. Auditor Hockensmith reviewed all of the records provided by Asian Grill during the course of the audit. Since Asian Grill only reported 34% of observed sales from January 28, 2011, Auditor Hockensmith "grossed up" reported sales by 66%. As argued above, Auditor Hockensmith calculated the estimated assessment a second time independent of the reported credit card sales. The two estimates covered an audit period of forty-two months and were within \$1,000 of each other even though they were calculated by different methodologies. The Office of Tax Appeals has previously ruled that in the absence of complete and accurate business records, the Tax Department may base the estimated assessment on two days of surveillance.

See OTA Decision 11-237 C and 11-238 U, 2011 WL 11320973; Argued below at AR 0314. Chief ALJ Pollack agreed that the estimated assessment was based on the best available information.

It is well settled that the taxpayer has the burden of proof to demonstrate that the assessment issued by the State Tax Department is wrong or contrary to law. See W. Va. Code § 11-10A-10(e). The Circuit Court erroneously concluded that Asian Grill has met the burden of proof to show that the estimated assessment was erroneous, arbitrary and capricious, and contrary to law.

B. THE CIRCUIT COURT'S DIRECTIONS TO RECALCULATE THE ESTIMATED ASSESSMENT ARE CONTRADICTORY AND CONTRARY TO THE EVIDENCE IN THE ADMINISTRATIVE RECORD.

The Circuit Court decision contradicts itself. As noted above, the Court ruled that Asian Grill did not maintain adequate business records as required by law. However, the Court also ruled that the estimated assessment was not based on the best information available.

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.

Circuit Court Decision, AR 0005-0006 (emphasis added). In essence, the Court ruled that Asian Grill's records showing cash sales actually reported constitute the best information available.

Specifically, the Court ruled that the Tax Department erroneously grossed up total sales based on the single day of surveillance. In particular the Court ruled that the proper ratio of credit card sales to cash sales should be approximately 80:20 based on testimony of Asian Grill's expert witness, D. Patrick Donahoe, C.P.A. See Circuit Court Decision, AR 0011-0012. Significantly, the Court clearly directed the Tax Department to re-calculate the estimated assessment based on cash sales actually reported by Asian Grill.

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 assessment is 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.

Circuit Court Decision, AR0012 (emphasis added).

The Circuit Court's direction to recalculate the assessment based solely on cash sales actually reported by Asian Grill's fails for four reasons. First, the Court criticized the Tax Department's estimated assessment based on Mr. Patrick Donahoe's testimony. The Court accepted the critical point of Mr. Donahoe's testimony "... that credit card sales on average are equivalent to approximately 80% of the revenue generated by a typical business of the type in question here." See Circuit Court Decision, AR0012.

A simple review of Asian Grill's records does not reflect Mr. Donahoe's rule of thumb that credit card sales should be approximately of 80% of sales. On cross-examination, Mr. Donahoe testified that, generally speaking, in the restaurant industry, credit card and debit sales constituted, at a minimum, 80% of sales and cash sales constituted 20% of total sales. See OTA Tr., Day 1, 123-124, AR 0528-0529. In her testimony at the administrative hearing, Auditor Hockensmith pointed out that Asian Grill's percentage of credit card sales to cash sales does not

reflect the norm set forth in Mr. Donahoe's testimony. *See* Tr. 2, 139, AR 0803. Argued below at Circuit Court Brief, AR 0112-0115.

ASIAN GRILL			
ANNUAL CASH SALES v. CREDIT CARD SALES			
<u>Year</u>	<u>Credit Card</u>	<u>Cash</u>	<u>Check</u>
2008	\$48,734	\$39,209	
2009	\$66,359	\$35,990	
2010	\$75,627	\$47,241	
2011	\$93,081	\$46,642	
2012	\$103,386	\$42,977	\$855

See Petitioner's Exhibit 9, AR 1470-1474 and Petitioner's Exhibit 10, AR 1527 & 1543. Argued below AR 0112.

The ratio of credit card sales to cash sales reported by Asian Grill does not reflect the 80:20 ratio that Mr. Donahoe testified should be expected. For the 2011 calendar year, Asian Grill's own records show a ratio of 93:47 or almost 2:1. For the five years listed above, Asian Grill's credit card sales do not constitute a minimum of 80% of total sales. A ratio of 80:20 (4:1) is not reflected in any of the five calendar years set forth in Asian Grill's books and records. Argued below at Circuit Court Brief, AR 0115.

At the administrative hearing, Asian Grill introduced tax documents into the evidentiary record. Asian Grill's tax documents further undermine the credibility of Mr. Donahoe's 80:20 ratio and any reliance on the bank statements.

	<u>Credit Card Sales</u>	<u>Cash & Check Sales</u>
January 2011	\$ 7,005	\$ 3,520
February 2011	\$ 7,452	\$ 3,512
March 2011	\$ 8,190	\$ 3,848

See Asian Grill Tax Documents, Petitioner's Exhibit 10, AR 1527. Obviously, the ratio of Asian Grill's reported credit card sales to cash sales is approximately 2:1 as opposed to the 4:1 ratio which Mr. Donahoe used as a rule of thumb.

In addition, the Circuit Court erroneously relied on Mr. Donahoe's assertion that the Tax Department was searching for "phantom credit card sales" which were not reported by Asian Grill. See Circuit Court Decision, AR 0012. However, the Court correctly observed that Auditor Hockensmith agreed that all credit card sales were reported by Asian Grill. See Tr., 2, 196-198, AR 0859-0861. Asian Grill did not provide basic records to show all sales on a daily basis, such as cash register z-tapes. Since it was impossible to determine the **total sales** for January 28, based on Asian Grill's inadequate business records, the Tax Department could not calculate **unreported cash sales** from the Taxpayer's records. As argued above, it was impossible to determine the percentage of credit card sales versus cash sales on January 28 based on Asian Grill's records. Asian Grill's records did not show all cash sales made on January 28, so the Tax Department could not determine the amount of unreported cash transactions. Therefore the Tax Department grossed up total sales and Asian Grill was given full credit for the sales tax remitted on both credit card sales and cash sales. Since Auditor Hockensmith agreed that all credit card sales were processed through the bank account, the estimated assessment represents unreported cash sales and not "phantom credit card sales."

The Circuit Court's direction to rely on Mr. Donahoe's rule of thumb overlooked the fact that Asian Grill's books and records do not reflect the 80:20 ratio advocated by Mr. Donahoe. Thus, the records kept by Asian Grill do not meet the general percentage of 80% of total sales which the Taxpayer's own expert witness said were normal for the restaurant industry. Either Mr. Donahoe's rule of thumb is wrong or Asian Grill's books and records are wrong. In either event, the Circuit Court has directed the Tax Department to rely on a metric that has no statutory basis under West Virginia law and is contradicted by Asian Grill's own records which the Court found to be inadequate.

Second, the Court ruled that Asian Grill's bank statements were more reliable regarding credit card sales than the Tax Department's single day of surveillance and directed the Tax Department to recalculate the tax assessment. However, a review of the bank records in the administrative record illustrates the underlying problem with Asian Grill's books and records. While the Court stated that credit card sales were direct deposited into Asian Grill's bank account, the BB&T bank statements show that Asian Grill deposited very little cash into the checking account.

	<u>Credit Card Deposits</u>	<u>Counter/ Cash Deposits⁴</u>
January 2011	\$ 7,408	\$ 354
February 2011	\$ 7,678	\$ 431
March 2011	\$ 8,462	\$ 400

See Asian Grill's Bank Statements, Petitioner's Exhibit 6, AR 1403-1408.

⁴ Calculated as Total Deposits minus Counter Deposit equals Credit Card Deposits. The Tax Department has assumed that a counter deposit is a cash deposit.

Clearly, Asian Grill failed to deposit all of its cash sales into its bank account at BB&T Bank. In January of 2011, Asian Grill deposited \$354 into the BB&T bank account. However, Asian Grill's tax documents introduced into the administrative records show that Asian Grill had \$3,520 in cash sales for January 2011. The same holds true for February and March of 2011. Common sense tells you that a significant portion of the cash sales was not deposited into the bank account. The question becomes obvious—where did all the cash sales go? If Asian Grill had produced cash register z-tapes for the audit period, then we would know the correct amount of cash sales. Without cash register z-tapes, Asian Grill cannot prove that it only made \$3,520 in cash sales for January of 2011. Without cash register z-tapes, Asian Grill cannot prove that it only made \$46,642 in cash sales for the 2011 calendar year. According to W. Va. Code § 11-15-23, every retail vendor is required to keep complete and accurate business records which Asian grill has failed to do. Nevertheless, the Court directed the Tax Department to base the estimated assessment on the cash sales actually reported by Asian Grill.

Third, the Tax Department did not ignore Asian Grill's other financial records to complete the audit as the Circuit Court stated. *See* Circuit Court Decision, quoted *supra*, AR0005-0006. Auditor Hockensmith testified that she reviewed all of the business records that were provided by Asian Grill. Auditor Hockensmith reviewed the tax documents provided by Mr. Corbett on behalf of Asian Grill; tax returns from Mr. Corbett; handwritten ledgers for sales; monthly sales for 2008, 2009 and 2010; federal form 1065 for 2008, 2009 and 2010; and credit card and cash receipts for 2008 through 2010. *See* Tr. 2, 116-118, AR 0780-0782. As argued above, Auditor Hockensmith repeatedly requested actual point-of-sale receipts, daily z-summaries, daily reports from the digital system, and monthly reports from the digital system; these critical documents were not provided. *See* Tr. 2, 122, AR 0786. In addition, Auditor

Hockensmith included Asian Grill's reported credit card sales and cash sales in calculating the consumers sales tax assessment. *See* Tax Department's Exhibit 8, AR 1708-1712, 1735-1736, and 1745-1746. The Tax Department examined every document that Asian Grill provided for the audit. The problem is that Asian Grill could not provide cash register z-tapes and daily sales reports from the digital record keeping system. The Court's statement that the Tax Department disregarded other financial records in calculating the estimated assessment is simply wrong.

Fourth, the Circuit Court's ruling is based on an erroneous premise. Contrary to the Circuit Court's ruling, the Tax Department relied on more than simply grossing up the reported total sales. After Auditor Hockensmith calculated the estimated assessment based on the surveillance data and reported sales, she calculated the percentage of unreported sales a second time employing a different methodology. The alternate calculation was based on the number of customers observed on January 28, 2011, the average size per household in Kanawha County (2.28 people), and the average menu price from Asian Grill. The second calculation yielded a calculated sales figure of \$1219.66 (audited figure) for January 28, 2001, versus reported sales of \$463.78 based upon Asian Grill's records.

Based on the second calculation, Auditor Hockensmith concluded that Asian Grill was reporting 38% of daily sales and not reporting 62% of daily sales. *See* OTA Tr. 2, 148-149, AR 0812-0813 and Tax Department's Exhibit 14, AR 1843. As argued above, in the first calculation, based on the surveillance observations from January 28, 2011, and reported total sales, Auditor Hockensmith concluded that Asian Grill was reporting approximately 34% of daily sales and failing to report 66% of sales. *See* Tax Department's Exhibit 11, AR 1817-1818.

Chief ALJ Pollack noted in the administrative decision that the auditor calculated the percentage of unreported sales using two different methodologies and arrived at remarkably

similar percentages; the two estimated liabilities were within approximately \$1,000 of each other. *See* OTA Decision, AR 0291-0292. Argued below at AR 0117-0118. Even though the underreported sales were calculated in two very different methodologies, they provided similar percentages—underreporting of 34% and 38%. The second calculation is based on the average menu price and was calculated independent of the credit card and debit card sales which were reported by Asian Grill. Therefore, the Circuit Court’s conclusion that the estimated assessment was based solely on grossing up credit card sales which were reported by Asian Grill is erroneous.

Asian Grill faces one consistent underlying problem of its own making. Asian Grill failed to create the most fundamental bookkeeping document for a retail business —cash register z-tapes. At no time did Asian Grill produce the z-tapes for the auditors to review despite repeated requests for the cash register tapes. During the audit, Asian Grill could only produce handwritten summaries showing total credit card sales and total cash sales recorded on adding machine tapes. Without the most basic of business records, Asian Grill cannot prove that it reported all meals sold at its restaurant. Asian Grill should not be rewarded for its failure to keep basic business records; especially, since Asian Grill’s records contradict the testimony of its own expert witness. In addition, Asian Grill should not be allowed to refuse to create business records that are specifically required under the legislative rule such as cash register z-tapes or the digital equivalent. Simply put, Asian Grill did not keep complete and accurate records as required by W. Va. Code § 11-15-23 and cannot meet its statutory burden to prove that the estimated assessment is erroneous.

The Tax Department reviewed every document provided by Asian Grill during the audit. However, Asian Grill failed to provide the basic business records for a retail business—cash

register z-tapes and daily sales summaries from the digital Point-of-Sale system. Asian Grill should not be rewarded for its failure to create and maintain basic business records. The estimated consumers sales tax assessment was based on the best information available to the Tax Department contrary to the Circuit Court's conclusion.

C. THE CIRCUIT COURT ERRONEOUSLY REVERSED THE BURDEN OF PROOF REGARDING ESTIMATED ASSESSMENTS.

The Circuit Court's direction to the State Tax Department to re-calculate the estimated assessment based on cash sales actually reported by Asian Grill has reversed the burden of proof for consumers sales tax assessments contrary to statute. The Circuit Court ruled:

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 assessment is 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.

See Circuit Court Decision, AR 0012 (emphasis added).

First, the Circuit Court's direction to the Tax Department is a *non sequitur*. The problem is that Asian Grill did **not** report all of its sales on the consumers sales tax returns. Asian Grill did not provide cash register z-tapes and daily sales summaries from the digital point-of-sale system. Therefore, the Court has inadvertently rewarded a business for its failure to maintain complete and accurate business records. The Circuit Court has chosen Asian Grill's **reported cash sales** as the basis for an estimated assessment and directed the Tax Department to gross-up **only** what the business chose to report.

As noted above, W. Va. Code § 11-15-23 clearly states that the retail vendor must keep complete and accurate books and records. The Circuit Court has reversed the statutory burden of proof and placed it on the Tax Department. Any retail business can now choose how much

consumers sales tax to remit to the State by simply under-reporting cash sales. The Circuit Court has directed the Tax Department to base an estimated assessment on cash sales as reported by Asian Grill despite the Court's own conclusion "...that Asian Grill's business records were inadequate as to the cash register tapes and hand written ledgers, as this evidence is credible and undisputed[.]" Circuit Court Decision, AR 0005-0006.

More importantly, the Circuit Court's direction is contrary to statute as well as the legislative rule cited *supra*. As argued above, every business owner is required to keep complete and accurate books and records. See W. Va. Code § 11-15-23. The legislative rules specifically requires every business to maintain original source documents supporting the entries in the books and records such as cash register z-tapes and daily summaries from automated record keeping systems such as a digital point-of-sale system used by Asian Grill. See W. Va. Code R. § 110-15-14a.2. By overlooking Asian Grill's failure to create basic records for a retail business, the Court has effectively repealed the statute and the legislative rule.

The Internal Revenue Code specifically addresses situations where the burden of proof can be shifted from the taxpayer to the Internal Revenue Service.

(a) Burden shifts where taxpayer produces credible evidence.--

(1) General rule.--If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, **the Secretary shall have the burden of proof with respect to such issue.**

(2) Limitations.--Paragraph (1) shall apply with respect to an issue **only if**--

(A) the taxpayer has complied with the requirements under this title to substantiate any item;

(B) the taxpayer has maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews; and...

26 USC § 7491 (emphasis added). The Internal Revenue Code allows for a taxpayer who cooperates in good faith with the Internal Revenue Service to shift the burden of proof to the IRS on a factual issue relevant to ascertaining the tax liability at issue.

However, there are two critical limitations that would be applicable to the case before the Supreme Court. Asian Grill has violated both limitations set forth in 26 USC § 7491. First, Asian Grill has failed to substantiate its claim that it reported all sales to customers and remitted all the consumers sales tax collected. Without the basic records for a retail business, Asian Grill cannot substantiate its claim. Second, Asian Grill did not create and keep basic documents such as cash register z-tapes and other original source documents supporting the entries in their books of account. Such basic records are specifically required by the legislative rule and set forth in W. Va. Code R. § 110-15-14a.2. Instead, the Court has reversed the burden of proof and directed the Tax Department to base the estimated assessment on cash sales **actually reported** by Asian Grill despite the Court's own conclusion that Asian Grill's records are inadequate.

In *Nkonoki v. Commissioner of Internal Revenue*, T.C. Memo. 2016-93, 2016 WL 2763863, a federal income tax case, the US Tax Court ruled that a taxpayer who did not maintain adequate records to substantiate alleged business expense deductions and did not produce those records for the Internal Revenue Service to review, could not shift the burden of proof to the Internal Revenue Service. Similarly, in the case of *Allnutt v. Commissioner of Internal Revenue*, T.C. Memo. 2004-239, 2014 WL 23398136, (cited with approval in *Nkonoki*) the U.S. Tax Court ruled that the failure to maintain adequate records and to provide those records for review, prohibited the taxpayer from shifting the burden of proof to the Internal Revenue Service. In both cases the Tax Court refused to shift the burden of proof as authorized by IRC § 7491.

Obviously, this is a West Virginia consumers sales tax case and not a federal tax case

operating under the Internal Revenue Code. However, the policy reasons behind the Internal Revenue Code section are applicable to the case before the Court. The Internal Revenue Code prohibits shifting the burden of proof from the taxpayer to the Internal Revenue Service when a taxpayer has not complied with the requirements of the Internal Revenue Code and has failed to keep all records required by law. No taxpayer should be rewarded for his own failure to comply with the clear statutory requirements of state tax law regarding record keeping. No taxpayer should be rewarded for failing to keep fundamental business records for a retail business.

The legal and practical ramifications of a business failing to keep adequate records is not limited to tax law. For example, under the Fair Labor Standards Act a business that fails to keep adequate business records may suffer the consequences of that failure. The United States Supreme Court ruled in *Anderson v. Mt. Clemens Pottery Co.*, 328 U.S. 680 at ___, 66 S. Ct. 1187 at 1192-1193, (1946), “The employer cannot be heard to complain that the damages lack the exactness and precision of measurement that would be possible had he kept records in accordance with the requirements of Section 11 of the Act.” Although, *Anderson v. Mt. Clemens Pottery* has been superseded by statute, the record keeping requirements placed on employers remains a fundamental principal of labor law. *See, e.g., United States Department of Labor v. Fire & Safety Investigation Consulting Services, LLC*, 915 F. 3d 277 at 286-287 (4th Circ. 2019). The same rule should prevail in this case before the Court.

The burden belongs on the business owner because the business owner is the person in the best position to create adequate and complete business records. The business owner has control of all business records and is free to determine the record-keeping procedures for his business. If the business owner fails to live up to his clear statutory obligations, then he should not be rewarded for his failure to keep basic records. The Supreme Court should not grant the

business owner the ability to reduce a consumers sales tax assessment to the cash sales that he actually chose to report.

Furthermore, the Circuit Court's direction is especially egregious because the Tax Department issued an estimated assessment for WV Consumers Sales and Service Tax which is a trust tax. The unreported sales and unremitted sales tax was never Asian Grill's money. The unremitted sales tax was collected from customers and held in trust for the State of West Virginia. *See* W. Va. Code §§ 11-10-5j, 11-15-3, and 11-15-5.

Finally, the Court's ruling that the customer count from the days of surveillance should be disregarded because the Tax Department did not train its auditors in conducting surveillance is erroneous. *See* Circuit Court decision, AR 0009-0011. Asian Grill has the burden to create and maintain "complete and accurate" business records under W. Va. Code § 11-15-23. The specific records that must be kept are set forth in W. Va. Code R. § 110-15-14a.2. Asian Grill's failure to create complete and accurate business records is fundamental; without accurate records which are required by law, Asian Grill has failed to meet its burden of proof in this case. The argument that a lack of formal training in counting the number of customers who enter and exit a business during business hours is a further attempt to reverse the burden of proof which is placed squarely on the business owner under the statute and the legislative rule..

By directing the Tax Department to restrict the estimated assessment to the cash sales that were **actually reported** by Asian Grill, the Circuit Court has reversed the burden of proof contrary to statute and the legislative rule.

**D. THE BUSINESS FRANCHISE TAX ASSESSMENT AND
PERSONAL INCOME TAX ASSESSMENT ARE CORRECT
CONTRARY TO THE CIRCUIT COURT'S RULING.**

The business franchise tax assessment and the personal income tax assessments were based on the unreported income generated by the sales which Asian Grill did not report. Since the Circuit court ruled that the consumers sales tax assessment was overstated, the Court also ruled that the other two assessments were incorrect. *See* Circuit Court Decision, AR 0012-0013.

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

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

W. Va. Code § 11-23-3(b)(2)(C).

According to Petitioner's Exhibit 12, AR 1549-1649, Kang M. and Mei D. Zheng operated Asian Grill as a partnership for federal income tax purposes for the years 2007 through 2011. The auditor testified that Asian Grill did not file a West Virginia business franchise tax return for the years 2005 through 2009. *See* OTA Tr., Day 2, 145-146, AR 0809-0810. Auditor Hockensmith created a business franchise return for the Zhengs for the years 2005 through 2011 based upon the information on the Zheng's federal income tax returns. Since the federal returns did not indicate a distribution to the partners, the increased sales were classified as partners' equity. *Id.*, *see also* OTA Tr., Day 2, 220, AR 0880.

Similarly, the unreported sales by Asian Grill affected the personal income tax returns filed by the Zhengs for the years 2009, 2010 and 2011. Auditor Hockensmith added the unreported sales to the federal adjusted gross income of the Zhengs. *See* Tax Department's Exhibit 15, AR 1849-1887 and Exhibit 16, AR 1889. Federal adjusted gross income is the starting point in calculating West Virginia taxable income. W. Va. Code § 11-21-12(a). The

unreported sales by Asian Grill had the net effect of increasing federal adjusted gross income which, in turn, increased the West Virginia taxable income for the Zhengs. *See* W. Va. Code § 11-21-12g(d). Argued below at AR 0121-0122; 0315-0316.

As argued above, Asian Grill has failed to meet its burden of proof to demonstrate that the consumers sales tax assessment is erroneous. The Supreme Court should reverse the Circuit Court's decision and affirm the business franchise tax assessment and the personal income tax assessment based on the sales which Asian Grill failed to report.

VIII. CONCLUSION

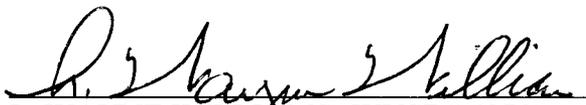
For the reasons set forth above, the Circuit Court decision should be reversed, the decision from the Office of Tax Appeals should be affirmed, and the estimated assessments should be affirmed by this Court.

Respectfully submitted,

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

By counsel,

PATRICK MORRISEY
ATTORNEY GENERAL



L. WAYNE WILLIAMS (WVSB# 4370)
ASSISTANT ATTORNEY GENERAL
1900 Kanawha Boulevard, East
Building 1, Room W-435
Charleston, West Virginia 25305
304-558-2522
l.wayne.williams@wvago.gov

IN THE SUPREME COURT OF APPEALS OF WEST VIRGINIA
No. 20-0226

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

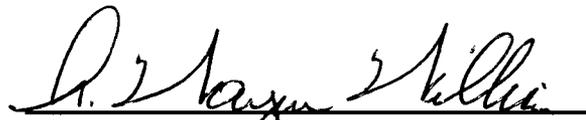
v.

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

CERTIFICATE OF SERVICE

I, L. Wayne Williams, counsel for Dale W. Steager, State Tax Commissioner of West Virginia, do hereby certify that the following *West Virginia State Tax Department's Supreme Court Brief* and the Appendix Record have been served upon counsel of record by depositing a true copy thereof, in the United States mail, first class, postage prepaid, on this 15th, day of June, 2020 addressed as follows:

C. Page Hamrick III
1550 Kanawha Blvd, East
PO Box 2521
Charleston, WV 25329


L. Wayne Williams