REDACTED DECISION - DK#s 12-388 P, 12-389 CU, 12-390 PT - By – A. M. "FENWAY" POLLACK – CHIEF ADMINISTRATIVE LAW JUDGE – SUBMITTED for DECISION on SEPTEMBER 6, 2013 – DECISION ISSUED on DECEMBER 4, 2013

SYNOPSIS

TAXATION
SUPERVISION
GENERAL DUTIES AND POWERS OF COMMISSIONER

It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. § 11-1-2 (West 2010).

TAXATION
PROCEDURE AND ADMINISTRATION
COLLECTION OF TAX

"The Tax Commissioner shall collect the taxes, additions to tax, penalties and interest imposed by this article or any of the other articles of this chapter to which this article is applicable." W. Va. Code Ann. § 11-10-11(a) (West 2010).

TAXATION
CONSUMERS SALES AND SERVICE TAX
DUTY OF VENDOR

Article Fifteen of the West Virginia Tax Code imposes a general consumers sales and service tax, for the privilege of selling tangible personal property or custom software and for the privilege of furnishing certain selected services, and it is the duty of the vendor to collect the same. *See* W. Va. Code Ann. § 11-15-1 and § 11-15-3 (West 2010).

TAXATION
CONSUMERS SALES AND SERVICE TAX
PURCHASER TO PAY

"The purchaser shall pay to the vendor the amount of tax levied by this article which is added to and constitutes a part of the sales price, and is collectible by the vendor who shall account to the State for all tax paid by the purchaser." W. Va. Code Ann. § 11-15-4 (a) (West 2010).

TAXATION
CONSUMERS SALES AND SERVICE TAX
ACCOUNTING BY VENDOR

"The vendor shall keep records necessary to account for: (1) The vendor's gross proceeds from sales of personal property and services; (2) The vendor's gross proceeds from taxable sales; (3) The vendor's gross proceeds from exempt sales; (4) The amount of taxes collected under this article, which taxes shall be held in trust for the state of West Virginia until paid over to the tax commissioner . . . ." W. Va. Code Ann. § 11-15-4 (b) (West 2010).

TAXATION
CONSUMERS SALES AND SERVICE TAX
PRESUMPTION

"To prevent evasion, it is presumed that all sales and services are subject to the tax until the contrary is clearly established." W. Va. Code Ann. § 11-15-6(b) (West 2010).

TAXATION
RECORD KEEPING OF TRANSACTIONS
COMPLETE AND ACCURATE RECORDS

"Every person doing business in the State of West Virginia . . .shall keep complete and accurate records as are necessary for the Tax Commissioner to determine the liability of each vendor or vendee for consumers sales and use tax purposes." W. Va. Code R. § 110-15-14a.1 (1993).

TAXATION
AUDITING TAXPAYER RECORDS
RECORD KEEPING

Each record kept by persons doing business in West Virginia "shall consist of the normal books of account ordinarily maintained by the average prudent person engaged in the activity in question . . . ." W. Va. Code R. §110-15-14b.2 (1993).

TAXATION
AUDITING TAXPAYER RECORDS
BEST INFORMATION AVAILABLE

If, when auditing taxpayer records, said 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 (1993).

OFFICE OF TAX APPEALS
CONCLUSION OF LAW

Petitioner B failed to account for and remit to the Tax Commissioner all of the consumers sales and service taxes collected from its customers.

OFFICE OF TAX APPEALS
CONCLUSION OF LAW

The records, which were provided to the Tax Commissioner, were not complete and accurate enough to determine Petitioner B's liability for consumers sales and use tax purposes. Nor were they adequate to accurately reflect Petitioner B's business operations.

OFFICE OF TAX APPEALS
CONCLUSION OF LAW

The Tax Commissioner did not abuse his discretion in the manner in which he conducted the survey of Petitioner B's operations from its parking lot.

OFFICE OF TAX APPEALS
CONCLUSION OF LAW

The Tax Commissioner did not abuse his discretion in ascertaining the extent of Petitioner B's under-reported sales.

TAXATION
TAX PROCEDURE AND ADMINISTRATION ACT
ASSESSMENT

"If the Tax Commissioner believes that any tax administered under this article has been insufficiently returned by a taxpayer, either because the taxpayer has failed to properly remit the tax, or has failed to make a return, or has made a return which is incomplete, deficient or otherwise erroneous, he may proceed to investigate and determine or estimate the tax liability and make an assessment therefor." W. Va. Code Ann. § 11-10-7(a) (West 2010).

OFFICE OF TAX APPEALS
CONCLUSION OF LAW

The Tax Commissioner's investigation in this matter also showed that Petitioner B had not paid West Virginia business franchise taxes for 2005 through 2009 and had only paid the minimum fifty dollars for tax years 2010 and 2011.

TAXATION
BUSINESS FRANCHISE TAX
LEGISLATIVE FINDING

West Virginia's business franchise tax is a tax for the privilege of doing business in the state. *See* W. Va. Code Ann. § 11-23-1 (West 2013).

TAXATION
BUSINESS FRANCHISE TAX
DEFINITION

For the purposes of West Virginia's business franchise tax, a Taxpayer's tax base shall be its capital, as defined in West Virginia Code Section 11-23-3. *See* W. Va. Code Ann. § 11-23-3 (West 2013).

OFFICE OF TAX APPEALS
CONCLUSION OF LAW

The business franchise tax assessment issued by the Tax Commissioner against Petitioner B was not clearly wrong, arbitrary and capricious, or contrary to West Virginia law.

TAXATION
PERSONAL INCOME TAX
RESIDENT INDIVIDUAL

The West Virginia adjusted income of a resident individual is the "federal adjusted gross income as defined in the laws of the United States" with modifications allowed by West Virginia law. *See* W. Va. Code Ann. § 11-21-12(a) (West 2010).

TAXATION
PERSONAL INCOME TAX
DISALLOWANCE OF DEDUCTION

"When auditing for compliance with this article, the Tax Commissioner may change a taxpayer's computation of federal taxable income or pro forma taxable income to comply with the laws of the United States as in effect for the taxable year and incorporated by reference into this article." W. Va. Code Ann. § 11-21-12g(d) (West 2010).

OFFICE OF TAX APPEALS
CONCLUSION OF LAW

For tax years 2009, 2010 and 2011 Petitioners A made personal income tax returns that were erroneous in that they under-reported their West Virginia adjusted income.

OFFICE OF TAX APPALS
CONCLUSION OF LAW

The Tax Commissioner's changes to Petitioner A's federal taxable income (and subsequent changes to their Federal adjusted gross income and their West Virginia adjusted gross income) complied with the laws of the United States as well as with West Virginia law.

TAXATION
WEST VIRGINIA OFFICE OF TAX APPEALS
HEARING PROCEDURES

In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is upon Petitioners to show that any assessment of tax against it is erroneous, unlawful, void, or otherwise invalid. *See* W. Va. Code Ann. § 11-10A-10(e) (West 2010); W. Va. Code. R. §§ 121-1-63.1 and 69.2 (2003).

OFFICE OF TAX APPEALS
CONCLUSION OF LAW

Petitioner B has not met its burden of showing that the consumers sales, service and use tax assessment or the business franchise tax assessment issued against it was clearly wrong, arbitrary and capricious, or contrary to West Virginia law.

OFFICE OF TAX APPEALS
CONCLUSION OF LAW

Petitioners A have not met their burden of showing that the personal income tax assessment issued against them was clearly wrong, arbitrary and capricious, or contrary to West Virginia law.

FINAL DECISION

On August 28, 2012, the Auditing Division of the West Virginia State Tax Commissioner's Office (the Tax Department or the Respondent) issued two Audit Notice of

Assessments, against Petitioner B (hereinafter Petitioner B) and one Audit Notice of Assessment against Petitioners A (hereinafter Petitioners A)[1]. These assessments were issued pursuant to the authority of the State Tax Commissioner, granted to him by the provisions of Chapter 11, Article 10 *et seq*, of the West Virginia Code. The first assessment was for combined sales and use tax for the period of January 1, 2009, through June 30, 2012, for tax in the amount of $____, interest in the amount of $____, and additions to tax in the amount of $____, for a total assessed tax liability of $____. The second assessment was for pass through entity/business franchise tax for the period October 26, 2005 to December 31, 2011, for tax in the amount of $____, interest in the amount of $____ and additions to tax in the amount of $____, for a total assessed liability of $____. The third assessment was for personal income tax for the period January 1, 2009 to December 31, 2011, for tax in the amount of $____, interest in the amount of $____ and additions to tax in the amount of $____, for a total assessed liability of $____. Written notice of these assessments was served on the Petitioners as required by law. Thereafter, on October 19, 2012, the Petitioners timely filed with this Tribunal, the West Virginia Office of Tax Appeals, three petitions for reassessment. *See* W. Va. Code Ann. §§ 11-10A-8(1); 11-10A-9 (West 2010). Subsequently, notice of a hearing on the petitions was sent to the Petitioners, and an evidentiary hearing was held over two days, April 30, 2013 and May 1, 2013, at the conclusion of which the parties filed legal briefs. The matter became ripe for a decision at the conclusion of the briefing schedule.

[1] To be clear, the Petitioner in Docket Nos. 12-389 CU and 12-390 PT is Petitioner B, a partnership between Petitioners A, which operates a restaurant. Petitioners in Docket No 12-388 P are the Petitioners A's individually. Hereafter, references to the Petitioner will be referring to Petitioner B and Petitioners A will be referred to as Petitioner A.

FINDINGS OF FACT

1. Petitioner B is a partnership operated by Petitioners A, in a West Virginia City, located in a West Virginia County.

2. On numerous occasions, employees of the West Virginia State Tax Department visited Petitioner A's restaurant and observed transactions that were not rung into the cash register. These observations led to an audit of Petitioner A's business.

3. The audit began with Tax Department employees conducting surveillance of Petitioner A'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 audit selection letter to the Petitioner B'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 between assigning an audit and an auditor actually being able to begin work.

5. Once the delays were over and the auditor knew whom to deal with, certain financial documents were requested and reviewed, including state and federal tax returns, and some credit card and cash receipts for the period 2008-2010. However, the auditor also requested cash register tapes for the period January through March 2011. 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 reflect the food ordered by the Tax Department employee, nor some of the other overheard phone orders.

6. As a result of these omissions, the auditor determined that the Petitioner B's records were insufficient to accurately reflect its business operations.

7. Due to the fact that the auditor did not have financial documents that accurately reflected Petitioner A's business operations, she was forced to use other information to complete the audit.

8. The auditor completed the audit by a ratio analysis. She took the number of customers that the Petitioner B's records showed having been served on January 28, 2011, (30) and divided that number by the number of customers actually observed being served, (87) [2]. That division showed that the Petitioner B was underreporting its sales by 66 percent (30 divided by 87 = 34.5; 100-34=66%).

9. The auditor next took Petitioner B's reported sales and increased them by 66 percent to arrive at a calculated amount of daily, monthly and yearly sales. The auditors then took these extrapolated sales amounts, calculated Petitioner B's unremitted sales taxes, and issued the assessments in the amounts listed above.

10. The audit also revealed that Petitioner B, as a partnership, had not filed West Virginia business franchise tax returns for tax years 2005-2009. Additionally, for tax years 2010

[2] The restaurant is primarily a take-out establishment. 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.

and 2011, the Petitioner B filed business franchise returns, but only paid the minimum $____ franchise tax. For all of the years in question, Petitioner B 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. The auditor did this upon her discovery that the partnership's Schedule C's from their Federal 1065 returns, did not show distribution of that taxable capital.

11. Lastly, the auditor applied the amount of under-reported sales from the restaurant to Petitioner A's personal income. Specifically, for tax years 2009-2011 she added the attributed sales from the restaurant to the income Petitioners A reported on their Federal tax returns. She then recalculated Petitioner A'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 Petitioner A's West Virginia personal income tax return. The increased income obviously led to additional income tax due and that additional tax due led to the issuance of the personal income tax assessment.

DISCUSSION

The West Virginia Code provides that "[f]or the privilege of selling tangible personal property . . . and for the privilege of furnishing certain selected services . . . the vendor shall collect from the purchaser the tax as provided under this article . . . and shall pay the amount of tax to the Commissioner in accordance with the provisions of this article . . ." W. Va. Code Ann. § 11-15-3(a) (West 2010). "'Vendor' means any person engaged in this state in furnishing services taxed by this article or making sales of tangible personal property . . . ." W. Va. Code Ann. § 11-15-2(26) (West 2010).

Likewise, the Code provides that "The purchaser shall pay to the vendor the amount of tax levied by this article which is added to and constitutes a part of the sales price, and is collectible by the vendor who shall account to the State for all tax paid by the purchaser." W. Va. Code Ann. § 11-15-4 (West 2010). Section 4 also lays out the record keeping requirements for vendors tasked with collecting sales tax.

> (b) The vendor shall keep records necessary to account for: (1) The vendor's gross proceeds from sales of personal property and services; (2) The vendor's gross proceeds from taxable sales; (3) The vendor's gross proceeds from exempt sales; (4) The amount of taxes collected under this article, which taxes shall be held in trust for the state of West Virginia until paid over to the tax commissioner . . . .

Id.

Section 14a of Title 110, Series 15 of the West Virginia Code of State Rules also lays out the record keeping requirements of business people in the state, "Every person doing business in the State of West Virginia . . . shall keep complete and accurate records as are necessary for the Tax Commissioner to determine the liability of each vendor or vendee for consumers sales and use tax purposes." W. Va. Code R. § 110-15-14a.1 (1993). Each record kept by persons doing business in West Virginia "shall consist of the normal books of account ordinarily maintained by the average prudent person engaged in the activity in question . . . ." *Id* at 14a.2. Further, "[I]f 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." *Id* at 14b.4.

Finally,

> If the Tax Commissioner believes that any tax administered under this article has been insufficiently returned by a taxpayer, either because the taxpayer has failed to properly remit the tax, or has failed to make a return, or has made a return which is incomplete,

> deficient or otherwise erroneous, he may proceed to investigate and determine or estimate the tax liability and make an assessment therefor.

W. Va. Code Ann. § 11-10-7(a) (West 2010)

Before we begin the discussion of the arguments presented by the parties in this case, some background is necessary. As will be discussed in greater detail below, this background is important because of things the Tax Commissioner did differently in this matter and because of the different legal arguments being made by Petitioner B.

Over the last few years, this Tribunal has had over thirty cases similar to this one. Some of those cases have had prehearing conferences and three have proceeded to evidentiary hearings and the issuance of written decisions. As a result, this Tribunal is well versed in both the facts of this matter and the legal issues presented. In each of the other cases that went to hearing the facts were virtually identical to the facts here. Those facts being the suspicions of the Tax Department that the Taxpayer was underreporting sales, surveillance of the business, and a lack of complete and accurate records as are necessary for the Tax Commissioner to determine the business operations of the taxpayer. In plain English, what the Tax Commissioner did in this case and the other three was to observe the restaurant and then go to the Taxpayer and say "show me cash register tapes or guest checks for _____" (whatever day the observation took place). In every case, including this one, the Taxpayer was unable to provide adequate records. The inadequacy had three components. First, the records themselves were suspect, in that they were never true cash register tapes or sequential guest checks. Second, the records from the actual observation day never showed the same amount of customers served as the Tax Department employees counted. Finally, and perhaps most damning, the Tax Department

employees would always purchase a meal during their observations, and keep the receipt. In none of the cases, would the employee's purchase show up correctly in the records.

This Petitioner B, like all the others discussed above, makes a half-hearted attempt at claiming that its records were in fact adequate to accurately reflect its business operations. We say half-hearted because Petitioner B is in a tough spot. It did not even attempt to show some animus against it by the Tax Commissioner. Nor did it effectively challenge the Tax Department's count of eighty-seven customers served. Yet its purported records for January 28, 2011, show thirty customers served.[3] These facts make it difficult for Petitioner B to argue that it kept adequate records, hence the half-hearted attempt. As a result, this Tribunal finds, as a matter of law, that the Petitioner B's records were inadequate to accurately reflect its business operations.[4]

Having ruled that Petitioner B's records were inadequate, we now turn to the second part of Section 14b.4 *supra* regarding the Tax Commissioner's mandate to use the best information available in preparing the audit report. It is here that Petitioner B makes its most strident argument. Petitioner B contends that the Tax Commissioner has conducted a sample and projection audit in this matter, and as such, the customer counts from the restaurant's parking lot must achieve statistical validity with a 95 percent confidence level. In layman's terms that means, according to the testimony of Petitioner B's expert witness, that the Tax Department observers would have needed to sit and observe the restaurant on thirty-six different days, ideally

[3] Petitioner B did introduce its records for January 28. Its credit card records show 21 customers served and its cash register tape purports to show that over a period of eleven hours Petitioner B had nine customers who paid cash.

[4] To keep this decision shorter and simple, we will point out in this footnote additional evidence regarding the inadequacy of Petitioner B's records. The purported cash register tapes look like they came from an adding machine. However, Petitioner B uses a computerized point of sale type system that generates a computerized receipt. *See* State's Exhibits 1 & 10. We find it highly unlikely that the purported cash register tapes in Petitioner B's Exhibit 1 came from the system shown in the photograph in State's Ex. 1.

over the course of three years. Petitioner B claims that absent this amount of counting, the audit is not statistically valid and therefore not a proper sample and projection audit.

In making this argument, Petitioner B relies on Sections 14b.2 and 14b.3 of Series 15, Title 110 of the West Virginia Code of State Rules, which state:

> 14b.2. The Tax Commissioner may use a detailed auditing procedure or a sample and projection auditing method to determine tax liability.
>
> 14b.3. A sample and projection auditing method is appropriate if:
>
> 14b.3.1. the taxpayer's records are so detailed, complex, or voluminous that an audit of all detailed records would be impractical or unreasonable;
>
> 14b.3.2. the taxpayer's records are inadequate or insufficient, so that a competent audit for the period in question is not otherwise possible; or
>
> 14b.3.3. the cost of an audit of all detailed records to the taxpayer or the State will be unreasonable in relation to the benefits derived, and sampling procedures will produce a reasonable result.

W. Va. Code R. §110-15-14b (1993). Petitioner B's reliance on these sections is curious, because at both the prehearing conference and the evidentiary hearing, the undersigned informed counsel for Petitioner B that this Tribunal was of the opinion that Section 14b.4 *supra* controlled this matter as it did in the other similar cases discussed above. However, rather than arguing how 14b.4 does not apply in this matter, Petitioner B's brief makes no mention of that section at all. Throughout this matter, Petitioner B has continued to insist that what the Tax Commissioner has done in this matter is a sample and projection audit as outlined in Section 14b.3.

For a variety of reasons, we are not persuaded by the Petitioner B's arguments. First, it should be noted that Petitioner B is not asking us to construe Section 14b a certain way, or to find two sections of the regulations *in pari materia.* Instead, Petitioner B apparently hopes that it

can, by sheer force of will, make Section 14b.4 go away. Unfortunately, for Petitioner B, Section 14b.4 is part of the law of West Virginia, and more importantly, is the law relied on by this Tribunal to decide other similar matters. We could end this portion of the discussion there, without any analysis of why we believe that Section 14b.4 controls in this matter. However, some further discussion is warranted, in part, because other Petitioners have made arguments similar to Petitioner B's, just not as stridently.

Section 14b of Series 15, Title 110 of the West Virginia Code of State Rules is a properly promulgated legislative rule, and therefore, absent certain circumstances not present here, it has the force and effect of law. *See e.g.* Appalachian Power Company v. State Tax Department of West Virginia, 195 W.Va. 573, 466 S.E.2d 424 (1995). Section 14b concerns auditing taxpayer records and discusses three types of audits. Section 14b.2 clearly states that the Tax Commissioner **may** use either a detailed auditing procedure or a sample and projection audit method. Section 14b.3 then goes on to discuss three times when a sample and projection audit is appropriate, when the records are too detailed or complex, when the records are inadequate to do a detailed audit, or when the cost of a detailed audit will be higher than the benefits derived. That brings us to Section 14b.4, and the third type of audit, which for lack of a better term we will call a "best information available" audit. "[I]f 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 (1993). And that one sentence is the heart of the matter in this case and all the other restaurant cases recently decided by this Tribunal. There is a difference between a Taxpayer who keeps good records, but has some missing, (thereby allowing a sample and projection audit, but not a detailed) and a Taxpayer like Petitioner B here, whose records are not good enough to give the Tax

Commissioner any idea about its business. In the latter case, the Legislature had given the Tax Commissioner the discretion to figure out what information is available in an effort to figure out how much the Taxpayer owes. Reading and giving effect to all of Section 14b (which we obviously are required to do) clearly shows this distinction. If the Tax Commissioner is required to use sample and projection for Taxpayers who keep inadequate records then why does Section 14b.4 exist? Or put another way, why doesn't the Section 14b.3 list of situations where a sample and projection audit is appropriate include those times where the Taxpayer's records are inadequate to accurately reflect its business operations? This Tribunal believes that Sections 14b.3 and 14b.4 are clear and unambiguous on this point, that being under what circumstances the Tax Commissioner can perform what type of audit.

The reason this argument is important is due to Petitioner B's insistence that when the Tax Commissioner performs a sample and projection audit it must be done with statistical validity. This Tribunal has ruled in the past, and rules here that the plain and unambiguous language in Section 14b.4 controls all situations where the Tax Commissioner determines that a Taxpayer's records are inadequate to accurately reflect its business operations.

Of course, Petitioner B would undoubtedly argue that even if this was a "best information available" audit, by not observing the restaurant over the course of thirty-six days the Tax Commissioner still did not use the best information. In fact, during the evidentiary hearing, Petitioner B's expert witness was very explicit on this point

> **JUDGE POLLACK**: *You've got this number, ---*
>
> **Witness A**: *There's no ---.*
>
> **JUDGE POLLACK**: *--- this number of thirty-six. The closer you get to it, the better you are. So your testimony today is that*

I should overturn this assessment because the Tax Department didn't reach this number of thirty-six; correct?

Witness A: *I'm saying, not only that. That's only* ---

JUDGE POLLACK: *Well,* ---.

Witness A: --- *the first part of the problem.*

JUDGE POLLACK: *Let's just talk* ---. *I don't want to go* ---.

Witness A: *Okay.*

JUDGE POLLACK: *We'll get to the rest later.*

Witness A: *Do you* ---?

JUDGE POLLACK: *But as far as statistical validity, I should overturn the assessment because they didn't get to 36?*

Witness A: *Absolutely.*

See Transcript April 30, 2013, p. 151. We find Petitioner B's argument in this regard to be totally without merit. It strains credibility to suggest that anyone in power, the Governor, the Legislature or the West Virginia Supreme Court of Appeals would approve of a situation whereby the Tax Commissioner suspects a Taxpayer of taking, for its own use, monies held in trust for the State, yet his or her investigation takes three years in order to satisfy a "statistical validity" standard that does not even exist under West Virginia law. Instead, we believe that the powers that be would direct the Tax Commissioner to do the opposite, namely to put a stop to suspected tax cheating as quickly as possible. Even if we give Petitioner B the benefit of the doubt, and apply this statistical validity/high confidence standard to thirty-six days, **not** spread out over three years, Petitioner B's argument still falls woefully short for at least three reasons. First, the Tax Commissioner does not have the manpower to spend thirty-six days observing the operations of Taxpayers he or she suspects are cheating. Moreover, Petitioner B is trying to

impermissibly shift the burden to the Tax Commissioner. Petitioner B, like the Petitioners in the other restaurant cases, is essentially saying, "well, even if I kept terrible records, if you can't figure out how many customers I served on any given day, to a degree of accuracy that I dictate, then you can't assess me." Again, Petitioner B's argument is totally without merit. As cited above, the consumers sales, service and use tax regulations require business people to keep complete and accurate records. West Virginia Code of State Rules, Section 14a.1 *supra.* When Taxpayers don't keep such records, all the Tax Commissioner has to do is his or her best, pursuant to Section 14b.4. Section 14b.4 does not give Taxpayers the right to determine what is the best information available. Finally, Petitioner B has not provided this Tribunal with any authority for either of its propositions.[5] During the evidentiary hearing, Petitioner B's expert witness could not point this Tribunal to any West Virginia law to support its argument. In its post hearing briefs, Petitioner B provides citation to five cases, four federal employment discrimination cases and a toxic tort case from Texas. We do not find these cases to be persuasive regarding Petitioner B's theory that the Tax Commissioner must reach statistical validity when conducting a best information audit, or for that matter, when conducting a sample and projection audit.[6]

Despite our ruling, Section 14b.4 does not give the Tax Commissioner unfettered discretion to pick a tax due number out of thin air. We believe that the Tax Commissioner has been given discretion to determine what constitutes the best information available in an audit such as was conducted here. Our task is to determine whether the Tax Commissioner has abused

[5] The two propositions being that the Tax Commissioner must achieve statistical validity with both sample and projection audits and best information audits. While it is not entirely clear from the record, we believe that Petitioner B believes both propositions.

[6] The cases are unpersuasive because they have nothing to do with the issue before us. The federal cases involve the importance of statistical evidence in establishing disparate impact employment discrimination cases. The Texas case discussed what constitutes an epidemiological study that is scientifically reliable.

that discretion. It is here that the references above, regarding the other restaurant cases, requires further discussion. In all the other cases discussed above, the first step was the same as in this matter, the auditors observed the restaurant to ascertain how many customers were served. The second step, figuring out how much each customer spent was done differently. In the other cases, the auditors would try to arrive at some average check amount. In every such situation, this Tribunal found that the Tax Commissioner had not used the best information available. These findings were based upon various factors, such as in one case the auditors attributing a beverage sale to every single customer over the course of three years. This Tribunal also took issue with the way the auditors weighted busier days counted, (Fridays) with days earlier in the week. Here, the Tax Commissioner has taken a different track. By using a ratio method, the Tax Commissioner has ended debate about how much each person spends or which days of the week are busier for the restaurant. Instead, the Tax Commissioner has assumed that Petitioner B's level of underreporting was consistent throughout the audit period.

This Tribunal is aware of the visceral reaction many people might have (including Petitioner B) to taking one day's business and extrapolating that out over three years. Nonetheless, we are still of the opinion that by using the ratio method discussed above the Tax Commissioner has obviated those concerns. We believe as such for one simple reason, who is to say that if the observers had sat outside the restaurant for another day or two, that would have been helpful to Petitioner B?[7] Petitioner B has assumed throughout the course of this litigation that more counting would be better. However, what if a second day of observation had yielded a

[7] Some clarification on one point may be necessary. The observers in this case did sit outside the restaurant for two half days and one full day. Once the auditor decided to use the ratio method, the half-day counts needed to be discarded due to the fact that they are useless in a comparison of how many customers Petitioner B reports having served versus how many customers are actually observed.

higher percentage of underreporting? The auditor testified that during the audit period, Petitioner B's reported sales were fairly consistent. Therefore, it is reasonable to assume that Petitioner B's ratio of underreported would also be consistent. It is for this reason that we rule that the Tax Commissioner has used the best information available in conducting the audit in this matter and that he has not abused his discretion or been arbitrary and capricious.

Petitioner B also argues that the ratio method used by the auditor, incorrectly grossed up both cash and credit card sales. According to Petitioner B, it is undisputed that Petitioner B correctly reported its credit card sales. At hearing, the auditor tacitly acknowledged that Petitioner B had probably reported all of its credit card sales, or at least had done so on January 28, 2011. Therefore, Petitioner B argues that the auditor was incorrect when, in calculating the underreported sales, she applied the sixty-six percent calculation to the entire day's sales on the 28th, as opposed to just the cash sales reported for that day.

We would be inclined to agree with Petitioner B on this point, were it not for the fact that the auditor, out of an abundance of caution, calculated Petitioner B's underreported sales two ways. In the second calculation, the auditor used a method similar to the other restaurant cases discussed above. Simply put, she arrived at an average menu price and a calculation for the amount of take-out orders based upon the average household size in Petitioner B's West Virginia County. She did this to follow the rulings from this Tribunal rendered in another restaurant case. This second method created a tax due amount that was within approximately one thousand dollars of the amount due based upon the ratio method. At the hearing and in its post-hearing briefs, Petitioner B made no argument regarding this second calculation. Due to the fact that the two different methods of calculating Petitioner B's underreported sales ended up with virtually

identical amounts, we rule that the Tax Commissioner has not abused his discretion in this regard.

Petitioner B's final argument is that the Tax Commissioner was incorrect in issuing both a business franchise tax and a personal income tax assessment in these matters. Petitioner B and/or Petitioners A argue that these two assessments create a situation of double taxation on the same income.[8] This argument is the most problematic for this Tribunal because of the way it has been presented. First, counsel for Petitioner B made no mention of this argument at the prehearing conference held in this matter. More importantly, Petitioner B's expert witness never addressed this argument. In fact, the expert stated that Petitioner B did not owe business franchise tax because it is not really a partnership. When questioned further on this point, as to what evidence there was to show that Petitioner B was not a partnership, he could provide none.

> **JUDGE POLLACK**: *Here's my question. When the Tax Commissioner did the audit in this case, what evidence did he have in front of him that they were a sole proprietorship and not a partnership?*
>
> **Witness A**: *We're not necessarily --- now, that's the one part of the audit ---.We're not really saying that they messed up. We're just saying that the facts and circumstances are not what the New York firm did, and therefore we are going to amend that tax return. It would be easier if you threw it out rather than amending. The reason, there being statute of limitation problems. Okay? It would be easier if you threw it out. But one way or the other, we're going to attack that issue and we think we have a valid reasoning for doing th*at.

See Transcript April 30, 2013, p. 172. This argument was raised again when counsel for Petitioner B cross examined the auditor, only then it had morphed into a complaint that by issuing a business franchise tax assessment against the restaurant and a personal income tax

[8] Petitioners A seem to tacitly admit that if this Tribunal upholds the assessment against the restaurant then they will owe additional personal income tax.

assessment against Petitioners A, the Tax Commissioner had double taxed the Petitioners A. This cross examination, (and numerous questions from the undersigned) fleshed out this double taxation argument. Petitioners A was now arguing that the partnership income was fully distributed, and that Petitioner A's personal income tax returns showed this distribution. The Tax Commissioner argued that absent a distribution being shown on Line 19 of Petitioner B's Federal K-1's, there is no evidence as to the extent of the distribution. Petitioners A then argued that if there was not a full distribution, the remaining income would have to have shown up somewhere on Petitioner B's books as a retained asset. The Tax Commissioner then argued that absent a million dollars or more in assets, the federal government does not require taxpayers to fill out a balance sheet.

This Tribunal understands this argument, but we are troubled by the way it was raised. Petitioners A never mentioned it at the prehearing conference. More troubling is the fact that Petitioner's expert witness, a certified public accountant, never even testified regarding double taxation, let alone showing this Tribunal, through financial documents, how it occurred. Nor did the expert's report mention this supposed error by the Tax Commissioner. Rather, the argument came up at the end of a two-day hearing, during cross examination. The result of this complicated 11th hour argument was to render this Tribunal unprepared to properly hear it. The undersigned advised the parties as to his confusion on this issue and explained that the post-hearing briefs would need to clarify this argument. Unfortunately, the Petitioners' brief fails to provide the needed clarification, instead it merely mirrors the cross examination, insisting that Petitioner A's tax returns show no retained assets. The problem is that Petitioner A never points this Tribunal to any specific exhibit (let alone a specific line on a financial document) that shows this supposedly uncontroverted fact. Petitioner A in this case, as in all cases before the Office of

Tax Appeals, has the burden of proving errors committed by the Tax Commissioner. We cannot rule that Petitioner B and/or Petitioners A have met their burden of proof on this issue.

CONCLUSIONS OF LAW

1. It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. § 11-1-2 (West 2010).

2. "The Tax Commissioner shall collect the taxes, additions to tax, penalties and interest imposed by this article or any of the other articles of this chapter to which this article is applicable." W. Va. Code Ann. § 11-10-11(a) (West 2010).

3. Article Fifteen of the West Virginia Tax Code imposes a general consumers sales and service tax, for the privilege of selling tangible personal property or custom software and for the privilege of furnishing certain selected services, and it is the duty of the vendor to collect the same. *See* W. Va. Code Ann. § 11-15-1 and § 11-15-3 (West 2010).

4. "The purchaser shall pay to the vendor the amount of tax levied by this article which is added to and constitutes a part of the sales price, and is collectible by the vendor who shall account to the State for all tax paid by the purchaser." W. Va. Code Ann. § 11-15-4 (a) (West 2010).

5. "The vendor shall keep records necessary to account for: (1) The vendor's gross proceeds from sales of personal property and services; (2) The vendor's gross proceeds from taxable sales; (3) The vendor's gross proceeds from exempt sales; (4) The amount of taxes collected under this article, which taxes shall be held in trust for the state of West Virginia until paid over to the tax commissioner . . . ." W. Va. Code Ann. § 11-15-4 (b) (West 2010).

6. "To prevent evasion, it is presumed that all sales and services are subject to the tax until the contrary is clearly established." W. Va. Code Ann. § 11-15-6(b) (West 2010).

7. "Every person doing business in the State of West Virginia . . .shall keep complete and accurate records as are necessary for the Tax Commissioner to determine the liability of each vendor or vendee for consumers sales and use tax purposes." W. Va. Code R. § 110-15-14a.1 (1993).

8. Each record kept by persons doing business in West Virginia "shall consist of the normal books of account ordinarily maintained by the average prudent person engaged in the activity in question . . . ." W. Va. Code R. §110-15-14b.2 (1993).

9. If, when auditing taxpayer records, said 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 (1993).

10. Petitioner B failed to account for and remit to the Tax Commissioner all of the consumers sales and service taxes collected from its customers.

11. The records, which were provided to the Tax Commissioner, were not complete and accurate enough to determine Petitioner B's liability for consumers sales and use tax purposes. Nor were they adequate to accurately reflect Petitioner B's business operations.

12. The Tax Commissioner did not abuse his discretion in the manner in which he conducted the survey of Petitioner B's operations from its parking lot.

13. Tax Commissioner did not abuse his discretion in ascertaining the extent of Petitioner B's under-reported sales.

14. "If the Tax Commissioner believes that any tax administered under this article has been insufficiently returned by a taxpayer, either because the taxpayer has failed to properly remit the tax, or has failed to make a return, or has made a return which is incomplete, deficient or otherwise erroneous, he may proceed to investigate and determine, or estimate the tax liability and make an assessment therefor." W. Va. Code Ann. § 11-10-7(a) (West 2010).

15. The Tax Commissioner's investigation in this matter also showed that Petitioner B had not paid West Virginia business franchise taxes for 2005 through 2009 and had only paid the minimum ____ dollars for tax years 2010 and 2011.

16. West Virginia's business franchise tax is a tax for the privilege of doing business in the state. *See* W. Va. Code Ann. § 11-23-1 (West 2013).

17. For the purposes of West Virginia's business franchise tax, a Taxpayer's tax base shall be its capital, as defined in West Virginia Code Section 11-23-3. *See* W. Va. Code Ann. § 11-23-3 (West 2013).

18. The business franchise tax assessment issued by the Tax Commissioner against Petitioner B was not clearly wrong, arbitrary and capricious, or contrary to West Virginia law.

19. The West Virginia adjusted income of a resident individual is the "federal adjusted gross income as defined in the laws of the United States" with modifications allowed by West Virginia law. *See* W. Va. Code Ann. § 11-21-12(a) (West 2010).

20. "When auditing for compliance with this article, the Tax Commissioner may change a taxpayer's computation of federal taxable income or pro forma taxable income to comply with the laws of the United States as in effect for the taxable year and incorporated by reference into this article." W. Va. Code Ann. § 11-21-12g(d) (West 2010).

21. For tax years 2009, 2010 and 2011 Petitioners A made personal income tax returns that were erroneous in that they under-reported their West Virginia adjusted income.

22. The Tax Commissioner's changes to Petitioner A's federal taxable income (and subsequent changes to their Federal adjusted gross income and their West Virginia adjusted gross income) complied with the laws of the United States as well as with West Virginia law.

23. In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is upon the Petitioner to show that any assessment of tax against it is erroneous, unlawful, void or otherwise invalid. *See* W. Va. Code Ann. § 11-10A-10(e) (West 2010); W. Va. Code. R. §§ 121-1-63.1 and 69.2 (2003).

24. Petitioner B has not met its burden of showing that the consumers sales, service and use tax assessment or the business franchise tax assessment issued against it was clearly wrong, arbitrary and capricious, or contrary to West Virginia law.

25. Petitioners A have not met their burden of showing that the personal income tax assessment issued against them was clearly wrong, arbitrary and capricious, or contrary to West Virginia law.

DISPOSITION

WHEREFORE, it is the final decision of the West Virginia Office of Tax Appeals that: the combined sales and use tax assessment issued against Petitioner B on August 28, 2012, for a total liability of $____is hereby **AFFIRMED.**

The pass through entity/business franchise tax assessment issued against Petitioner B on August 28, 2012, for a total liability of $____ is hereby **AFFIRMED**.

The personal income tax assessment issued against Petitioners A on August 28, 2012, for a total liability of $____is hereby **AFFIRMED**.

Pursuant to West Virginia Law, interest accrues on the assessments until the liabilities are fully paid. *See* W. Va. Code Ann. §11-10-17(a) (West 2010).

WEST VIRGINIA OFFICE OF TAX APPEALS

By: _____
A. M. "Fenway" Pollack
Chief Administrative Law Judge

_____
Date Entered