



**Multistate Tax Commission
Report of Hearing Officer
Model Audit Sampling Statute and Regulation**

July 20, 2007

Executive Summary

Upon direction by the MTC Executive Committee, the Uniformity Committee drafted a statute and regulation regarding the use of sampling methods when conducting taxpayer audits. The purpose of the proposed model statute and regulation is to give those states currently without explicit authority a model to use in enacting such legislation and implementing regulations.

A hearing on the proposed model statute and regulation was held on March 9, 2007. The Hearing Officer recommends that the substantial changes in the regulatory text and questions concerning the evidentiary value of the use of judgmental and probability sampling, it is suggested that the revised proposal should be referred back to the Uniformity for further consideration.

Introduction

Statistical sampling is a technique often employed by state revenue agencies to make more efficient use of time and resources in conducting audits. However, the use of sampling techniques is sometimes challenged by taxpayers in States where the statutes do not give the tax agency the explicit authority to use these particular audit techniques. The Statistical Sampling Project was initiated in the MTC Audit Committee and referred to the MTC Uniformity Committee at the request of the Executive Committee. The purpose of the project was to develop a model statute explicitly referencing the use of statistical sampling techniques when conducting taxpayer audits.

The Uniformity Committee referred the project to the Sales and Use Tax Subcommittee. In the course of its deliberations, the Subcommittee decided to broaden the project's scope to include not only the statistical sampling method, but other sampling methods as well (e.g., judgmental and probability sampling), so as not to constrain states without explicit statutory authorization to one type of sampling method. Staff initially developed two statutory approaches for the

committee to consider. The first approach provided states with blanket authority to employ statistical and other sampling techniques in conducting audits. The second approach was crafted in greater detail. Like the first approach, Section 1 of the second approach granted a state blanket authority to employ sampling techniques. Section 2 delineated the circumstances under which the use of sampling techniques is appropriate.¹ After considering these alternative approaches, the Subcommittee decided both should be utilized: the broad approach was designated as a model statute, and the detailed approach was designated as an accompanying regulation.

Hearing

A public hearing on the proposed model statute and regulation was held at the Hall of the States in Washington, D.C. on March 9, 2007. The Council on State Taxation (COST) submitted written comments (see Exhibit A). Because most of these comments echo those expressed orally by Dr. Will Yancy, PricewaterhouseCoopers, Deloitte & Touche, IBM and others at the public hearing, they will not be described here, but will be referred to in this report where appropriate.

Public Comments

In general, hearing participants stated that in its current form, the statutory and regulatory proposals are too vague and ambiguous to provide effective guidance to both taxpayers and states in using audit sampling techniques. A more specific observation was that the terms used to describe sampling techniques are not consistent throughout the document. The proposal describes sampling techniques as “techniques”, “method,” or “procedures”. These inconsistencies are bound to lead to confusion.

In general, the Hearing Officer agrees that the proposed statute and regulation would benefit from revisions that provide greater clarity and certainty regarding the proposal’s intent. Concerning the various terms used to describe sampling methods, the Hearing Officer recommends the consistent use of the term “technique” throughout the proposal.

The remainder of this report focuses on the regulatory proposal. Comments that are equally applicable to the proposed statute will be specifically noted.

Section 1. Authorization to Use Sampling Techniques

The current proposal does not include a definition of “sampling techniques.” A number of hearing participants suggested that it should. It was further recommended by COST in its written comments that the proposal incorporate the

¹ Such circumstances include voluminous or insufficient records, the cost/benefit ratio of conducting a detailed audit, and when the taxpayer has agreed to an audit employing sampling techniques.

definition of statistical sampling developed by the International Federation of Accountants²:

“Statistical sampling” means any approach to sampling that has the following characteristics:

- (a) random selection of a sample; and
- (b) use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (a) and (b) is considered nonstatistical sampling.

The Hearing Officer agrees that the proposal would benefit from a definition of sampling techniques and recommends that the above definition be incorporated in the proposal. Furthermore, because this proposal is intended to explicitly authorize all generally accepted sampling techniques, not just statistical sampling, the Hearing Officer recommends this section be revised to identify and define other sampling techniques as well:

“1. For purposes of administering this act, the [insert your State tax agency] is authorized to use judgmental, probability and statistical sampling techniques.

a. Judgmental sampling means any nonstatistical approach to sampling where the sample is selected based on convenience and judgment, showing characteristics where some elements of the population are subjectively favored over others, or where the chance of selection is unknown.

b. Probability sampling means any nonstatistical approach to sampling where the sample units are selected into the sample based on known probabilities, and includes any sample using a method in which every element of a finite population has a known but not necessarily equal chance of being selected.

c. Statistical sampling means any approach to sampling that has the following characteristics:

- i. Use of probability sampling techniques to select the sample; and

² ISA 530, 2002 Report of the FTA Electronic Data Interchange Task Force, p. 4.

ii. Use of probability theory to evaluate sample results, including measurement of sampling risk.

Section 2. When to Employ Sampling Techniques

A. The most oft-cited concern regarding the proposal is the undefined phrase “reasonable result” as it appears in both the statutory and regulatory header in Section 2. In the legal context, there exists a well-developed body of law that defines the standard of what are or are not “reasonable” expectations, i.e., the expectations of a “reasonable person” in the area of tort law. The Hearing Officer was informed that there is very little guidance from existing case law involving sampling disputes or from other sources regarding the concept of “reasonableness” as an audit standard. Without such guidance, determining what constitutes a “reasonable result” may be quite subjective. In its written comments, COST states that the lack of a definition will give rise to “intractable disputes” between taxpayers and tax administrators, and further objects to granting tax administrators unbridled discretion to determine which sampling technique will provide a “reasonable result.”

The Hearing Officer agrees, at least to the extent that the phrase “reasonable result” is too ambiguous to be useful as an audit standard and recommends that the term be deleted. The question of what is or is not reasonable refers to the technique itself, not the result of using a technique. With respect to the proposed statutory language, the Hearing Officer recommends that the final clause should be amended to read “use statistical sampling techniques or other sampling techniques *when such techniques are reasonable*” (emphasis added).

Regarding Section 2 of the proposed regulation, the same argument applies with respect to the term “reasonable result” as it appears in the header. The Hearing Officer recommends that the header should be amended to read:

“2. The use of sampling techniques is reasonable where:...”

B. The language in subsections 2(a) and (b) contain the same kind of ambiguities as pointed out in A. above. In describing the circumstances in which it is appropriate to employ sampling techniques, both subsections use the term “unreasonable.” The same arguments supporting the revisions to the proposed statute and Section 2 header are equally applicable here. The Hearing Officer recommends that, at a minimum, subsections 2(a) and (b) be revised as follows:

“a. The taxpayer’s records are substantially complete, but so detailed, complex or voluminous that an audit of all detailed records would be impractical; or

b. The cost of an audit of all detailed records to the taxpayer or to the State would be impractical; or...”

C. However, more significant changes may be in order with respect to the entire Section 2. During the hearing, participants noted that the language of subsections 2(a), (b), and (c), is too vague and ambiguous to provide much guidance to taxpayers or States on when sampling techniques should be used. Subsection 2(c), for example, provides that sampling techniques may be used where “[t]he taxpayer’s records are inadequate or insufficient[.]” The provision states no minimum threshold below which taxpayer’s records will be deemed inadequate or insufficient. The Hearing Officer’s recommended revisions notwithstanding, the same argument can be made regarding subsections 2(a) and (b) in that there is no minimum threshold to determine whether a taxpayer’s records are “so detailed, complex or voluminous,” or whether the cost of conducting a detailed audit is great enough to justify the use of sampling techniques.

The Hearing Officer agrees. Section 2 would benefit from language setting a more precise standard to justify the use of sampling techniques. The Hearing Officer recommends Sections 2(a)-(c) be deleted, and replaced with the following:

“2. The use of sampling techniques is reasonable under either of the following circumstances:

a. It can be objectively shown with [insert your state’s percentage] percent confidence that the difference between the results from a sample and audit using equal, complete coverage of all sampled records is within a [insert your state’s percentage] percent margin of error; or

b. Where the state, prior to selecting the sample, has provided to the taxpayer in writing that sampling will be used during the audit examination, and the taxpayer has not provided written and timely objection to the use of sampling methods before the sampling commences. The [insert you State’s tax agency] must provide [insert your state’s notice requirements] written notice prior to selecting the sample. Such notice should include the description of the records to be sampled, sample size, sample method and extrapolation methods in the event the sample uncovers tax adjustment errors.

Section 3. State/Taxpayer Agreement on Sampling Techniques and Possible Appeals Process.

While an agreement between a State and a taxpayer on sampling techniques is always preferable, hearing participants stressed that in cases where a taxpayer and the state cannot come to an agreement a means should be provided to allow the

taxpayer to appeal the sampling issues involved rather than simply having the state proceed over the taxpayer's objections. In its written commentary, COST recommended a procedure be developed that should contain at a minimum:

1) an opportunity for the taxpayer to demonstrate an alternative sampling technique to be applied to its "data or any other issues in the sampling plan, estimation or projection of results";

2) allow the appeal to be filed "during the sample planning stage before the sample is selected, or after the results are projected."

3) the appointment of an independent expert "familiar with tax audit sampling techniques" that is not a Department employee;

4) a 90-day window after an expert is appointed for the taxpayer and the Department to submit written or oral evidence, and an expert opinion on the issue; and

5) after the 90-day period has expired, the independent expert will submit a written report and recommendation to the Department's appeal process or to the tax court, whichever is applicable.

The Hearing Officer disagrees. The practical consequences of such a procedure would most likely be unacceptable to states. First, it is impossible to predict all the sampling issues that might arise. A sequential appeal of each issue would drag out the audit process unnecessarily. Second, a taxpayer that disagrees with the techniques a state used to conduct the audit (and presumably, the audit results) can always appeal through existing state processes once the audit has been completed. The Hearing Officer's recommendation is that the proposal should not include a special appeals process devoted to the issue of sampling techniques.

Recommendation

The Hearing Officer has further concerns regarding the proposed model statute and regulation, specifically with respect to the use of judgmental and probability sampling. The Hearing Officer certainly understands the desire of States to allow audit personnel the widest possible latitude in conducting taxpayer audits. However, the judgmental and probability sampling techniques present questionable legal evidence of a taxpayer's tax liability. Still, the Hearing Officer has been given to understand that such sampling techniques are not always unjustified. For example, in some instances the judgmental sampling technique may be the only viable approach to an audit where the taxpayer does not keep electronic records. Nevertheless, the Hearing Officer questions whether the Commission should endorse

a uniformity recommendation that includes audit techniques that have questionable legal evidentiary value due to the techniques' inherent flaws.

Therefore, in light of the extensive suggested revisions and the other concerns expressed above, the Hearing Officer recommends that the proposed Model Audit Sampling Statute and Regulation be referred back to the Uniformity Committee for further consideration.

Respectfully submitted,

Roxanne Bland
Hearing Officer