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To: Executive Committee
From: Roxanne Bland, Counsel
Date: January 3, 2008
Subject: Proposed Model Audit Sampling Statute and Regulation

Background

At its August 2007 meeting, the Executive Committee reviewed the Hearing Officer's Report for the above-referenced proposed model audit sampling statute and accompanying regulation. Upon the Hearing Officer's recommendation, this Committee referred the proposal back to the Uniformity Committee for further consideration in light of the significant amendments suggested by the Hearing Officer. At its November 2007 meeting, the Uniformity Committee reviewed and discussed the Hearing Officer's Report and suggested amendments. The Committee amended the proposal beyond those suggested by the Hearing Officer, and voted to submit the proposal, as revised, to the Executive Committee for referral to public hearing. The Executive Committee, at its November 2007 meeting, decided to defer consideration of the proposal until January 2008 in order to provide it the opportunity to review the proposal before deciding whether to move it into public hearing process.

Model Audit Sampling Statute

In discussing the proposed statutory language, members of the Uniformity Committee expressed concern over use of the term "reasonable" as a standard for the tax department to follow in determining when the use of sampling techniques is appropriate in conducting an audit.¹ As it appears in the statute, the Committee decided the term is too vague and subjective to be of much guidance to either states or taxpayers, and furthermore gives taxpayers too much control over how an audit will be conducted. Moreover, it was pointed out that the Committee was asked to take on this project in the first instance because some states were increasingly finding themselves subject to taxpayer challenges regarding their ability to use audit sampling techniques in general, on

¹ Prior to amendment, the proposed model statute read as follows: "For purposes of administering this act, the Department may, when examining returns or records and making assessments or refunds, use statistical sampling techniques or other sampling techniques *when such other techniques are reasonable.*" (Emphasis added).

grounds that there existed no statutory basis for the authority to do so. Given that history, the Committee decided that placing any limitation on the proposed statutory grant of authority to use audit sampling techniques was contrary to the project's purpose. Thus, the Committee voted to delete the final clause "when such techniques are reasonable." As amended, the model statute language simply provides states explicit authority to use judgmental, probability and statistical sampling techniques when conducting taxpayer audits (see Attachment 2).

Model Audit Sampling Regulation

As previously drafted (incorporating the Hearing Officer's recommended changes), the model regulation contained three sections. Section 1 sets forth definitions of the judgmental, probability and statistical sampling techniques.² Section 2 describes the circumstances under which the use of sampling techniques to conduct an audit is appropriate. Section 3 requires the state tax agency to make a reasonable effort to reach agreement with the taxpayer providing for the means and techniques to be used in the sampling process, and further provided that the failure of the state tax agency to reach agreement would not prevent the state from using sampling techniques in its audit.

In considering the proposed regulatory language, the Committee expressed many of the same concerns it had with respect to the model statute, e.g., the vagueness of the term "reasonable" as it is used in the regulation and too much taxpayer control over how the state conducts an audit. Committee members further noted the inappropriateness of limiting a state's discretion to use sampling techniques and even questioned why a state would want to do so. Accordingly, the committee voted to delete Sections 2 and 3 of the model regulation, leaving only Section 1 defining the various sampling techniques.

²Definitions for judgmental and probability sampling techniques were taken from (Freund and Williams, *Dictionary/Outline of Basic Statistics*, Dover Publications, 1991), and the definition for statistical sampling was taken from the International Standards on Auditing 530 developed by the International Federation of Accountants. <http://www.taxadmin.org/fta/pub/sample.pdf>

**PROPOSED MODEL AUDIT SAMPLING AUTHORIZATION STATUTE
And
ACCOMPANYING REGULATION**

As approved by the Uniformity Committee on November 6, 2007

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Statute

Audit Procedures.—

For purposes of administering this act, the Department may, when examining returns or records and making assessments or refunds, use statistical sampling techniques or other sampling techniques, ~~when such other techniques are reasonable.~~

Regulation

Audit Procedures.—

~~1.~~ For purposes of administering this act, the Department is authorized to use judgmental, probability and statistical sampling techniques.

a. Judgmental sampling means any 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 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
- ii. Use of probability theory to evaluate the sample results, including measurement of sampling risk.

~~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 for all population units 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 your 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 technique and extrapolation methods in the event the sample uncovers tax adjustment errors.~~

~~3. Notwithstanding section 2(b), the ^[insert your state's tax agency] shall make a reasonable effort to reach agreement with the taxpayer providing for the means and techniques to be used in the sampling process; however, the failure of the ^[insert your state's tax agency] to reach an agreement with the taxpayer shall not preclude the ^[insert your state's tax agency] from using sampling techniques to audit a taxpayer's records.~~

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