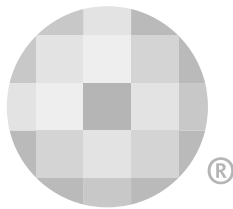


Tax Trends

Too Much Information

By Rocky B. Cummings



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How many of us have made the mistake of providing state auditors with too much information? Of course, that never happens. But, what if I was more specific and asked the same question but only as applied to sales and use tax audits? Would you be as confident in your response? Yes, I do have a point here. I am seeing far too many sales tax audits that either take too long or result in too much tax being assessed. Not surprisingly, I don't see many of these audits uncovering any refunds. Why? Oftentimes the problem is a result of statistical sampling of electronic information. Or what may be a more technically correct description—nonstatistical sampling of too much electronic information.

Statistical sampling is good, and it's fair to both parties—states and taxpayers alike. Statistical (a.k.a. Stat) sampling has many advantages. For example, statistical sampling should produce results that are, by definition, objective and defensible. Stat sampling also provides a reasonable estimate of how much a sample projection may deviate from an actual full examination. This deviation can be controlled to both the taxpayers' and the auditors' satisfaction based on the sample size. Further, Stat sampling saves time and money for both parties. Ok, but you knew that already. So why is it I am so concerned about the recent trends some states have used in statistical sampling for sales and use tax audit purposes?

The problem is that auditors realize that taxing agencies are a major source of balancing any state's budget and view their role as being a major revenue producing department as opposed to one of assuring compliance with the laws. Of course, this is not true of every auditor or every state taxing agency. Nonetheless, taxpayers need to be vigilant in assuring that sales tax audits focus on compliance and are not designed to maximize revenue. Taxpayers need to put more effort in at the front end of the audit, espe-

cially in planning the sample and determining what information is relevant and appropriate to provide an auditor to arrive at a fair statistical sample. As a general rule of thumb a “blind” sample should produce more accurate and fair results than a complete download of data from a taxpayer’s ERP system.

Blind sampling promotes fair sampling. The goal of blind sampling is to assure that all items in the population have an equal chance for selection as a sampling item. Sure, we may need to stratify the sample population to focus on material items, but each item within each stratum should have an equal chance of selection. It would seem difficult

to argue that blind sampling is not fair. Despite being completely unbiased, several states are currently eliminating the concept of blind sampling in their sampling plans. They are instead requesting a complete electronic download of all the taxpayer’s transactional details supporting their general ledger or financial statements *before* a sample is ever selected. And many taxpayers are complying with this request.

What purpose does having the additional transactional data serve in selecting a sample? None, if your goal is to select a fair sample. The only data a state should need to select a sample is invoice number (or something equivalent) to identify the detail record selected, dollar amount of the transaction and the date of the transaction.

So what do the states gain by having excessive data such as vendor type, vendor location, expense classification, etc.? Well, the states are likely taking the detail of a taxpayer’s individual transactions and analyzing them before a sample is ever formulated, designed or selected with a goal of over sampling items that would contain potential under-reported tax. In essence, no longer performing a statistical sample but rather using statistics to design a sample weighed heavily in the state’s favor. Therefore, the sample is skewed during the sample selection process to select a transaction that has a higher probability of resulting in an underpayment error.

But that cannot be the case, you say. Consider this. The amount of time needed to select a statistically valid sample is very limited. There are tables designed for this task. All a taxpayer and state need to agree upon is the confidence level and the appropriate strata. From that point, a sample size can be selected and a

sample determined. Done fairly, this process should take a few hours. I often invite and encourage the state’s sampling expert to be present during this process with the auditor, but this is rarely the case. So if it only takes a few hours for this process, why does it take three to six months for most samples to be determined where the extra data is provided? Good question.

My firm recently represented a taxpayer where the auditor responsible for the sample selection process openly admitted that their sampling plans are designed to select “items of interest.” Listen to those words people! Sampling plan designed to select “items of interest.” Yikes!

The same auditor later defined “items of interest” as transactions that would only be subject to sales or use tax. Well, that takes care of any fairness. Further, the sample in this situation is clearly not being designed to test a taxpayer’s compliance under the law. Funny, I thought that was supposed to be the goal.

To make matters worse, some states are requiring a minimum number of errors to be found in a sample before any error projections may be made into the population. The minimum error requirement has been established because an acceptable standard deviation is usually not achieved without finding a minimum number of errors in a sample. For example, one large state has established that a minimum of three errors must be found before a projection of a sample can be extrapolated into the population.

Some auditors argue that this minimum number of error requirement is why it takes so long to develop statistical samples. Their goal is to determine samples that will quickly obtain the desired minimum errors results. But, in a blind sample, an error would be defined as underpaid tax or overpaid tax. If the sample size selected failed to yield the requisite error frequency, the correction should be to the sample size. However, when the state’s emphasis during the design of the sampling plan is strictly on isolating general ledger accounts that would most likely discover any underreporting of tax, then the sample selected is probably not a fair, representative sample of the population as a whole. Therefore, the sample is not reliable and should not be projected.

Taxpayers have a right to a fair audit. The goal should be for the state to determine if the taxpayer is complying with the law. Taxpayers should have a

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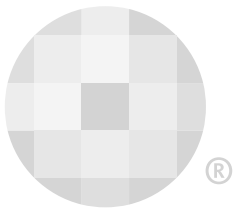
sample that provides an equally likely chance that overpaid items are selected for review and that such items, when identified, are properly projected into the population as a whole. I have seen scenarios develop where the state's sample is so skewed that a large assessment was projected. When refund items were subsequently identified, they were, as you would expect by now, not part of the sample. As such, they could not be projected. Rather, the taxpayer would have to specifically prove up each refund item. Such situations occur all too frequently.

States want reasonably small sample sizes in order to save audit hours and related field auditing costs, and are in turn designing audit samples

that are designed to quickly find errors that may not be representative of the population and should not be projected. Conversely, taxpayers are also finding that the sampling plans are not designed to uncover any overpayments that may have been made. So what should you do? Taxpayers must take an active role in designing a fair sampling plan at the beginning of every audit engagement in order to avoid inaccurate or unfavorable results. While this may, in many instances, accelerate the adversarial nature of the audit it must be done. Focus on fairness in developing the sample plan. Then make sure your IT department provides only the requisite information.

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