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IRS allows taxpayers greater use of statistical sampling

The IRS recently issued Rev. Proc. 2011-42, which provides taxpayer-favorable guidance on the use and evaluation of statistical samples to support items on tax returns. The revenue procedure strengthens guidance that previously had been set forth only in the form of an IRS Large Business and International (LBI) Division field directive issued in November 2009.

The important aspects of Rev. Proc. 2011-42 are that it:

- provides a higher level of authority for use of statistical sampling than the field directive;
- is intended to be the primary IRS source for all statistical sampling guidance; and
- modifies other existing IRS sampling guidance, especially revenue procedures on sampling with respect to the section 274 meal and entertainment expense deduction (Rev. Proc, 2004-29) and the section 199 domestic production activities deduction (Rev. Proc. 2007-35), which have been made more taxpayer-friendly.

Rev. Proc. 2011-42 is effective for tax years ending on or after August 19, 2011, and may be applied to statistical sampling by taxpayers for tax years ending before that date.

The IRS also issued Rev. Proc. 2011-43, which addresses electric utility transmission and distribution repairs and in part discusses statistical sampling.

Background

The 2009 field directive issued by the LBI Division (then known as the Large and Midsize Business Division) superseded the original directive on statistical sampling issued in March 2002.

Statistical sampling is used both by taxpayers and the IRS as a tool for the estimation and the examination of various numbers that appear on a tax return or claim for a refund. There has been a substantial rise in taxpayer use of statistical sampling since the IRS issued the 2002 field directive.

Some of the areas in which sampling has been particularly helpful include:

- Producing estimates of qualified research expenditures for purposes of calculating the research credit.
- Estimating the amount of meal and entertainment expenses misclassified to accounts that are only 50-percent deductible.
- Generating figures for fixed-asset additions that can be depreciated over shorter useful lives.
- Reclassifying capitalized amounts as currently deductible repairs.
- Assisting in the determination of a taxpayer's domestic production deduction.

The IRS has been using sampling for decades to examine many areas of tax return supporting data that are too voluminous to approach with any other technique.

Over the years, as the IRS has become more familiar with sampling concepts and the evaluation and use of statistical samples, it also has become more sophisticated in its approach. In November 2002, the IRS demonstrated its commitment to sampling by creating sampling coordinator positions. Sampling coordinators are responsible for communicating sampling's benefits, writing guidance and training materials, achieving nationwide consistency in application, and expanding the IRS's sampling knowledge and capabilities.

2009 field directive

The 2009 field directive provided guidance to IRS personnel on how to evaluate "samples and sampling estimates by taxpayers." The directive stated that it was "not an official pronouncement of the law or the Service's position and cannot be used, cited, or relied upon as such." The IRS stated its intention to convert the field directive into a revenue procedure.

Consistent with prior guidance, the 2009 field directive did not place limitations on the types of issues that may be addressed through sampling. Rather, the taxpayer only must demonstrate that the use of sampling is appropriate, i.e., by showing that the burden of evaluating the necessary data without sampling would be high and that other books and records do not independently exist that would better address the particular issue. In practice, the IRS typically does not challenge the use of statistical sampling per se.

The 2009 field directive laid out the technical parameters for the design, execution, and documentation of a statistical sample, including the specific steps and formulae to be used.

The original 2002 field directive required taxpayers to reduce the estimate by the associated sampling error. The 2009 directive made three taxpayer-favorable changes:

- Forgiveness of the sampling error "haircut" when the relative precision of the estimate is 10 percent or less. For example, if the estimate produced by the sample is $1 million and the associated sampling error is $100,000 or less, the taxpayer may claim the full benefit of $1 million without any reduction for sampling error.
- Phase-in of the sampling error haircut when the relative precision is greater than 10 percent. That is, if the sampling error in the example in the first bullet above exceeds $100,000 but falls below $150,000, the taxpayer would be allowed to phase in the sampling error haircut over the range of 10 percent to 15 percent. Assume the sampling error is $120,000, or 12 percent of the $1 million estimate. The taxpayer would be required to recognize only two-fifths of the sampling error because 12 percent is two-fifths of the range between 10 percent and 15 percent. The recognized sampling error would be calculated as 2/5 of $120,000, or $48,000.
- Inclusion of any certainty strata in the calculation of relative precision.

Observations: These changes were indicative of the IRS's greater level of comfort with statistical sampling and a desire to promote its use. First, they reflect an appreciation that a sample that produces a relative precision of 10 percent or better is sufficiently well-designed to be relied on without an adjustment adverse to the taxpayer. Second, phasing in the haircut avoids a "cliff effect" when relative precision is slightly over 10 percent, while retaining an incentive for the taxpayer to achieve precision levels within the 10 percent no-haircut range. Third, allowing the inclusion of the certainty strata in the calculation of relative precision is consistent with widely accepted statistical sampling practices and produces a better precision result.

The 2009 field directive stated that it did not supersede the two revenue procedures addressing the use of sampling in connection with the section 199 deduction or the meal and entertainment expense deduction. However, IRS officials stated when the directive was issued that it would be unlikely that IRS would challenge the use of the sampling provisions in the new field directive in any situation in which sampling is appropriate.

IRS officials also said that a taxpayer's sampling methodology would not be challenged if it conforms to the provisions of the directive. This did not mean that other sampling techniques (such as model-based sampling) would not be acceptable to the IRS. The directive stated that a sampling coordinator should be consulted under such circumstances.

Rev. Proc. 2011-42

In line with the expressed IRS intention to convert the 2009 field directive to a revenue procedure, Section 4 of Rev. Proc. 2011-42 essentially repeats the field directive's criteria for determining whether to accept a statistical sampling estimate as adequate substantiation for a return position. ***Observation:*** Conversion of the field directive into a revenue procedure provides taxpayers with a higher level of authority for the use of statistical sampling

By modifying and amplifying the prior revenue procedures addressing sampling with respect to meal and entertainment expenses and the section 199 deduction, Rev. Proc. 2011-42 confirms that the taxpayer-favorable changes made in the 2009 field directive -- such as the change that eliminates the "cliff effect" for estimates with relative precision greater than 10 percent -- now apply to sampling in those important areas.

Like the field directive, Rev. Proc. 2011-42 recognizes that certain taxpayers and industries may use statistical sampling techniques not addressed by the guidance, and provides that estimates derived from such other techniques may be referred to a sampling coordinator.

Observations: Rev. Proc. 2011-42 should provide taxpayers with greater certainty with respect to use of the statistical sampling methods described in the revenue procedure. It also should reduce burdens and increase efficiency for both taxpayers and the IRS.

Rev. Proc. 2011-43

On the same day it issued Rev. Proc. 2011-42, the IRS issued Rev. Proc. 2011-43, which refers to Rev. Proc. 2011-42. Rev. Proc. 2011-43 provides guidance on electric utility transmission and distribution repairs. It allows statistical sampling and provides a special extrapolation procedure under which taxpayers may project the results of a testing period -- which may or may not have been analyzed using statistical sampling -- back to earlier years that were not reviewed. The minimum testing period is the most recent three years.

Taxpayers must apply a haircut to the tax benefit obtained under the new procedure, but the haircut may be outweighed by the significantly reduced burden on taxpayers seeking to obtain a tax benefit under the new guidance for all prior years. Further, the new procedure will be helpful to taxpayers that lack good records from those earlier years.

Observation: Taxpayers relying on the new extrapolation procedure should consider testing more than the minimum period of three years if the necessary information is reasonably available because the greater the number of contiguous years included within the testing period, the lesser will be the haircut that is applied to earlier years.

Rev. Proc. 2011-43 is effective for tax years ending on or after December 31, 2010.

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