

Statistical Sampling and the Transition Tax

by Jessica J. Ledingham



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In this article, Ledingham explains how multinational corporations can use the statistical sampling approach under Rev. Proc. 2011-42 to proactively alleviate some of the

substantiation burdens associated with an IRS transition tax examination.

Introduction

Many U.S.-based multinational corporations have a looming concern: IRS examination of their 2017 or 2018 federal income tax returns. The Tax Cuts and Jobs Act, enacted December 22, 2017, resulted in myriad tax law changes. Notable for multinational corporations (MNCs) is new section 965, commonly referred to as the one-time transition tax or toll charge, which has required MNCs to include on their 2017 or 2018 tax returns their pro rata share of subpart F income and allowable foreign tax credits attributable to post-1986 deferred foreign income.¹ An exhaustive IRS examination of these tax returns may create an onerous documentation burden for MNCs.

¹ See section 965(f) (requiring shareholders to determine their pro rata share amount under rules similar to the rules in section 951(a)(2)). Section 965(d)(2) defines accumulated post-1986 deferred foreign income, in general, as post-1986 earnings and profits.

That burden stems from IRS information document requests demanding substantiation of all components of the transition tax calculation, including amounts reported for post-1986 earnings and profits and post-1986 foreign taxes paid or accrued (foreign taxes claimed).² The fact that the transition tax is the largest corporate revenue-raising provision in the TCJA — estimated by the Joint Committee on Taxation to raise \$338.8 billion for the 2018-2027 budget period — suggests that section 965 will be an active area for audits.³

Thus, a section 965 examination may cover up to 31 tax years for each deferred foreign income corporation (DFIC), or even each specified foreign corporation (SFC).⁴ A DFIC is an SFC of a U.S. shareholder that has accumulated post-1986 E&P greater than zero.⁵ An SFC is a controlled foreign corporation or any foreign corporation with a U.S. shareholder.⁶ A CFC is a foreign corporation with more than 50 percent of the voting power or 50 percent of the total value of the stock owned (directly, indirectly, or constructively) by U.S. shareholders during the tax year of that corporation.⁷

Also, unless the SFC had a “significant event” under reg. section 1.964-1(c)(6), it may not have

² E&P is neither a book term nor a tax term, and it is not defined in the code; however, it has been understood as the measure of a corporation’s economic ability to pay dividends to its shareholders. *Welle v. Commissioner*, 140 T.C. 420, 423-424 (2013).

³ See JCT, “General Explanation of Public Law 115-97,” JCS-1-18, at 440 (Dec. 20, 2018).

⁴ The number of years may be abated if there was an IRS examination as a result of the MNC repatriating its foreign earnings in specific years, e.g., if there was a subpart F inclusion, a dividend, or an inclusion under the Homeland Investment Act of 2004 (the one-time tax holiday for the repatriation of foreign earnings).

⁵ Section 965(d)(1).

⁶ Section 965(e)(1). Section 951(b) defines a U.S. shareholder as a corporation that owns (directly, indirectly, or constructively) at least 10 percent of the voting power or 10 percent of the value of the stock.

⁷ Section 957(a).

adopted certain tax accounting standards.⁸ Hence, an IRS examination of the MNC's 2017 or 2018 tax returns may be a tedious and labor-intensive substantiation exercise, possibly resulting in material book and tax adjustments. Moreover, that substantiation exercise may cover all entities, regardless of the relative size of the U.S. federal tax attributes ascribed to them.

Accordingly, MNCs should consider a proactive strategy designed to alleviate burdens from a potential, or perhaps inevitable, IRS examination and to support its reported amounts in connection with section 965. Rev. Proc. 2011-42, 2011-37 IRB 318, may allow MNCs to prepare for an IRS transition tax examination by using statistical sampling to either (1) redetermine the original computations of E&P and foreign taxes claimed of each SFC for reporting on amended tax returns or (2) support those amounts stated on the originally filed returns.

This article focuses on using the statistical sampling approach under Rev. Proc. 2011-42 to substantiate the E&P and foreign taxes claimed by each SFC. The objective is to examine only a sample of randomly selected entity tax years⁹ and extrapolate the results over the entire population of E&P and foreign taxes claimed, rather than reexamine every tax year of each SFC. Statistical sampling under Rev. Proc. 2011-42 could reduce the time and cost associated with an IRS examination, reduce the volume of records required for examination, and help show that the reported amounts of E&P and foreign taxes claimed are statistically sound.

Section 965

Section 965 sets forth the rules for determining the treatment of deferred foreign income in computing the transition tax. Section 965(a) provides that in the last tax year of a DFIC before January 1, 2018, the foreign corporation's subpart

F income should be increased by the greater of (1) the accumulated post-1986 deferred foreign income as of November 2, 2017, or (2) the accumulated post-1986 deferred foreign income determined as of December 31, 2017.¹⁰

Section 965(g) allows a corporation an FTC for each applicable tax year, with section 965(g)(4) providing that subject to limitations, the section 78 gross-up applies for the section 965(a) inclusion amount.¹¹

Section 965 requires U.S. corporate shareholders to include their accumulated post-1986 E&P for each DFIC.¹² The section 965 inclusion is subject to tax at reduced rates of 15.5 percent or 8 percent. The 15.5 percent rate applies to an amount of the section 965 inclusion equal to the U.S. shareholder's aggregate foreign cash position, and the 8 percent rate applies to the remaining amount of this inclusion.¹³

An MNC was to have performed those calculations, elected whether to pay its section 965 tax liability in eight installments,¹⁴ and filed the transition tax statement with its 2017 or 2018 tax returns.¹⁵ The task of determining the section 965 transition tax liability was often muddled with confusion, especially since the proposed regulations were not published until August 9, 2018.¹⁶ MNCs would have had to comb through countless documents regarding prior tax years — possibly 31 tax years for each SFC — to provide E&P and foreign taxes claimed for every SFC.¹⁷

¹⁰ Section 965(a).

¹¹ Section 965(g)(4).

¹² Section 965(a). Section 965(b) provides for a reduction in amounts included in gross income of U.S. shareholders of SFCs with E&P deficits. A further discussion on this section is not relevant for this article because the entities under these calculations still will be included in the overall population from which the sample is randomly chosen.

¹³ Section 965(c).

¹⁴ Section 965(h) allows a shareholder of a DFIC to elect to pay the section 965 net tax liability in eight installments. See IRS Publication 5292, "How to Calculate Section 965 Amounts and Elections Available to Taxpayers."

¹⁵ IRS, Transition Tax Statement, "Questions and Answers About Reporting Related to Section 965 on 2017 Tax Returns" (Mar. 13, 2018).

¹⁶ REG-104226-18. Final regulations (T.D. 9846) were published February 5, 2019, considerably later than most MNCs calculated their transition tax liability.

¹⁷ The number of tax years for which an MNC will have to substantiate E&P and foreign taxes claimed will equal the number of tax years for each SFC the MNC has a current ownership interest in since the date of acquisition/incorporation or 1987 (whichever is later).

⁸ Reg. section 1.964-1(c)(1). Unless the foreign corporation elected to adopt a method of accounting for federal income tax purposes, it might never have computed its E&P. Reg. section 1.964-1 provides the rules foreign corporations must follow to compute the post-1986 E&P once they elect to adopt a method of accounting for federal income tax purposes.

⁹ An entity tax year is a single tax year for a particular entity. For example, a particular SFC may have 31 entity tax years, and an MNC with 1,000 SFCs could have 31,000 entity tax years.

regardless of the relative amount ascribed to the SFCs.

The transition tax liability may be significant, but the liability itself is not the only concern. There's also the volume of documentation an MNC will have to provide if the IRS examines its returns. Substantiation of E&P and foreign taxes claimed may be cumbersome and costly, especially because adequate records must be provided upon request.¹⁸

Improper substantiation could have significant consequences. The IRS examination could result in an adjustment of the section 965 inclusion and the issuance of a notice of deficiency. Public corporations estimated the impact of tax reform and noted estimated liabilities in their financial disclosure statements for shareholders. So if the results of an IRS examination materially differ from the estimated transition tax liability stated on the corporation's financial disclosure statements and thus require material tax adjustments, cash flow and current-year financial reporting might be affected.¹⁹ To avoid or minimize adjustments resulting from a potential IRS examination of their tax returns, MNCs need to plan ahead. They should consider supporting their E&P and foreign taxes claimed with statistical sampling.

Statistical Sampling

MNCs with numerous SFCs needed to collect a substantial amount of data to compute the transition tax, and because of time and budget constraints they may have used estimates or other approximations. However, any approach based on estimates might be challenged by the IRS upon examination. Apart from full documentation of every tax attribute, statistical sampling is the only other available method for reliably collecting information to support the computation of the transition tax.

The objective of statistical sampling is to reliably evaluate a population of data quickly and cost-effectively based on the examination of only a subset of units from the population.

Appropriate statistical techniques are used to analyze, evaluate, and document large volumes of data. An optimal number of units are randomly selected for examination, ensuring the sample design is objective and unbiased. The measure of precision of the sample is then determined mathematically.

The IRS has allowed taxpayers to use statistical sampling since at least 1964.²⁰ The agency used statistical sampling to reduce the burden of examinations in 1973,²¹ and it has since showed support for taxpayers using it.²²

Regulations, revenue procedures, revenue rulings, field directives, and other notices allow the use of statistical sampling in specified circumstances. Sampling is permissible in various instances, including in determining deductible business meal and entertainment expenses²³ and income attributable to domestic production activities.²⁴ Recently proposed regulations under section 250 provide that in lieu of the general documentation requirements for determining foreign use for sales of multiple items of general property, a seller may use statistical sampling to establish that some of the property is for foreign use.²⁵ Also, courts allow taxpayers to use appropriate estimation methods, including

²⁰ Rev. Proc. 64-4, 1964-1 C.B. 644.

²¹ Internal Revenue Manual section 42(18)(0), "Statistical Sampling Examination Program" (rev. Nov. 4, 1994).

²² LGM TL-97 (Sept. 9, 1992) ("We must be careful in attacking taxpayer use of sampling procedures in general; that is, as a policy, we should be supportive of sampling as a valid measurement of the impact of all similar tax records.")

²³ Rev. Proc. 2004-29, 2004-1 C.B. 918.

²⁴ Rev. Proc. 2007-35, 2007-23 C.B. 1349. Other examples of when the IRS permitted statistical sampling include reg. section 1.472-8, as amended by T.D. 7814 (dollar value last-in, first-out inventories); Rev. Proc. 72-36, 1972-2 C.B. 771 (determining the redemption rate of trading stamps); Rev. Proc. 80-19, 1980-1 C.B. 628 (tire weights for the section 4071 manufacturer's excise tax); Rev. Proc. 2002-55, 2002-2 C.B. 435 (external auditors of qualified intermediaries); and Rev. Proc. 2011-35, 2011-25 IRB 890 (safe harbor methods to determine basis in stock acquired in transfer basis).

²⁵ Prop. reg. section 1.250(b)-4(d)(3)(iii).

¹⁸ IRS, *supra* note 15, at Q&A 3. Documentation for the determination of E&P includes profit and loss statements, E&P adjustments, and IRS Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations." Receipts and foreign tax returns are some of the information required to substantiate foreign taxes claimed. See reg. section 1.905-2(a) and (b).

¹⁹ Andrew Velarde, "GE Tries to Allay Investor Fears About Potential Tax Liabilities," *Tax Notes Int'l*, Nov. 12, 2018, p. 760.

statistical sampling, to calculate research tax credits²⁶ and to use as an appropriate arm's-length pricing method.²⁷

In July 2011 the IRS continued its support of statistical sampling when it updated Internal Revenue Manual section 4.47.3, addressing the use of statistical sampling for examinations of large transactions. The IRM provides:

Statistical sampling should be considered whenever a group of accounting entries or transactions has sufficient adjustment potential to warrant examination, but the examination of the totality of all such transactions is prohibitive in terms of time and resources.²⁸

Hence, it is general practice for the IRS to use the results obtained from statistical sampling to propose adjustments to items reported on tax returns. Soon after it revised the IRM, the IRS issued Rev. Proc. 2011-42, 2011-37 IRB 318, its most recent authority on the use of statistical sampling by taxpayers.

Rev. Proc. 2011-42

Rev. Proc. 2011-42 is the first revenue procedure published by the IRS to endorse the general use of statistical sampling by taxpayers. It is classified in the area of "Examination of returns and claims for refund, credit or abatement; determination of the correct tax liability." The revenue procedure describes the criteria taxpayers must meet for a statistical sampling estimate to constitute adequate substantiation for a tax return position. It states that taxpayers may use statistical sampling to "either *support or be*

primary evidence of a tax amount"²⁹ (emphasis added).

The revenue procedure permits taxpayers to use statistical sampling when it is appropriate under prior published guidance or when all the requirements enumerated in the revenue procedure itself are met.³⁰ Specifically, sampling will be deemed statistically valid if all requirements of section 4 and the procedures in the appendices provided in are followed.³¹

Rev. Proc. 2011-42 provides for a facts and circumstances determination of whether it is appropriate for a taxpayer to use statistical sampling.³² Factors the IRS will consider include "the time required to analyze large volumes of data; the cost of analyzing data; and the other books and records that may independently exist or have greater probative value."³³ Statistical sampling will be deemed inappropriate if more reliable evidence is available from another source.³⁴ Taxpayers must maintain proper documentation to support their use of statistical sampling.³⁵

If a taxpayer meets the facts and circumstances test, it must satisfy the remaining criteria outlined in Rev. Proc. 2011-42. The taxpayer first must establish the population and initial sample size, then randomly select the sample units to test.³⁶ The initial sample size is relied on for evaluating the precision achieved, and those results are used to more accurately estimate the ultimate sample size needed. Then sample units are randomly selected. After the taxpayer examines the sample units, it projects the results in accordance with the procedures,³⁷ then calculates the relative precision of the estimate.

²⁹ Rev. Proc. 2011-42, section 4.02(1).

³⁰ *Id.* at sections 2 and 4.02(1)-(2).

³¹ *Id.* at section 4.01. The appendices address sampling plan standards (Appendix A), sampling documentation standards (Appendix B), and technical formulas (Appendix C).

³² *Id.* at section 4.02(1).

³³ *Id.*

³⁴ *Id.* This also requires taxpayers to follow financial accounting standards, *e.g.*, generally accepted accounting principles.

³⁵ *Id.* at section 4.02(2)(a).

³⁶ *Id.* at section 4.02(2)(b). This random selection is typically done with a computer program that is replicable, if desired, by the IRS.

³⁷ See *id.* at section 4.03 for an explanation of the methods taxpayers can use to estimate values from the sample data; and at section 4.04 for the attributes required for sampling plans to be acceptable.

²⁶ See, *e.g.*, *United States v. McFerrin*, 570 F.3d 672, 679 (5th Cir. 2009) (holding that the taxpayer would be allowed to estimate expenses if he established that the activities were "qualified research"; citing *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)); see also *Union Carbide v. Commissioner*, T.C. Memo. 2009-50 (deficiency for improper research tax credits resolved based on the parties' agreement to try the case on the five largest of 106 claimed projects); *Suder v. Commissioner*, T.C. Memo. 2014-201 (making a determination on the taxpayer's alleged excessive research tax credit claims based on the parties' stipulated selection of 12 of the 76 projects on which petitioners relied for computation of the claimed qualified research expenses reported on their tax returns).

²⁷ *Perkin-Elmer Corp. v. Commissioner*, T.C. Memo. 1993-414 (acknowledging that statistical sampling is an appropriate arm's-length pricing method).

²⁸ IRM section 4.47.3.3.

This is determined by dividing the sample error by the point estimate (the projected result from the sample).³⁸

A relative precision of 10 percent or less needs to be achieved to avoid an adverse statistical adjustment.³⁹ A relative precision between 10 and 15 percent requires an adjustment to the point estimate for the sampling error using a sliding scale.⁴⁰ Relative precision exceeding 15 percent requires a full adjustment to the projected amounts by the sample error.⁴¹ To encourage a well-designed statistical sample and an adequate sample size, any adjustment made will be the least favorable for the party responsible for the sampling (that is, the taxpayer or the IRS).

After the taxpayer follows all required procedures, it then possesses an estimate deemed statistically valid by Rev. Proc. 2011-42.

Rev. Proc. 2011-42 and the Transition Tax

The statistical sampling technique prescribed by Rev. Proc. 2011-42 could be used as an effective way to redetermine or substantiate amounts reflected on tax returns for E&P and deemed paid foreign taxes regarding the total amount required to be included in income under section 965(a).

As a result of the final regulations published February 5, MNCs wishing to modify their originally computed amounts could use statistical sampling to report newly derived amounts for amended tax returns.⁴² Under the approach of Rev. Proc. 2011-42, MNCs could redetermine these amounts and report them on the amended tax returns, and the IRS then would be able to effectively examine only those randomly selected sample units. This method could allow MNCs to provide substantiated amounts for E&P and foreign taxes claimed in a more effective and timely manner.

MNCs confident with the amounts they reported on their originally filed tax returns should be cognizant of the possibility of an IRS section 965 examination. Upon such an

examination, an MNC might be required to substantiate the E&P and foreign taxes claimed for each SFC in which it had a current ownership interest since the date of acquisition/incorporation or 1987 (whichever is later).⁴³ Providing the IRS adequate records of E&P computations and foreign taxes claimed for each SFC in the affiliated group would involve large volumes of data. To minimize the cost, simplify the substantiation process, and compute E&P in accordance with the methods provided by the code and applicable regulations, the MNC could use statistical sampling that conforms to the Rev. Proc. 2011-42 standards.⁴⁴

The population subject to testing typically would be every tax year for each SFC the MNC has a current ownership interest in since 1987.⁴⁵ Entity tax years from the population would be randomly selected for evaluation. Then both the E&P computation and foreign taxes claimed would be redetermined for each sample unit. An MNC could choose to use the same sample for both the redeterminations of E&P and foreign taxes claimed or to have two separate samples. The sampling error would be calculated. The relative precision could then be computed. If it is determined that the relative precision is 10 percent or less, a corresponding adjustment for sampling error need not be made.

Using a well-designed statistical sample may allow for a relatively small percentage of the units in the population of E&P and foreign taxes claimed to be substantiated. Thus the time, labor, and cost of substantiating the amounts claimed for every tax year for each SFC would be reduced.

Sound statistical design practices, including those used by the IRS, typically require analyzing the largest items with certainty — that is, a 100 percent review of all documentation of the largest items. This approach reduces statistical variability

³⁸ See *id.* at section 4.03(4).

³⁹ *Id.* at section 4.02(2)(c).

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² T.D. 9846, reg. section 1.965-1 through -9.

⁴³ The post-1986 E&P of each DFIC is eventually netted (at which level this occurs depends on whether the U.S. corporate shareholder is following the affiliated or consolidated group rules), and E&P deficits are allocated under section 965(b). Therefore, any adjustment to E&P of an SFC upon IRS examination affects the overall transition tax calculation of the affiliated group. See reg. section 1.965-8.

⁴⁴ See section 965(d)(3).

⁴⁵ The limits of the population cannot be narrowed in scope by country, entity, or any other attribute to make the population smaller (*i.e.*, stratum), except when the excluded items are reviewed through other means satisfactory to the IRS.

and improves precision. Designing a statistical sample for purposes of section 965 most likely will require the largest SFCs to be included with certainty and for smaller SFCs to be randomly chosen by entity year, sometimes with further dollar-based stratification. Incorporating the largest SFCs with certainty would be particularly helpful when strong supporting documentation already has been developed for those entities. A purely random selection approach likely would require the sample size to be significantly increased to achieve the desired precision.

The inclusion of the largest SFCs with certainty, the random selection of other SFCs, and the use of an appropriate sample size — coupled with statistical weighting and the fulfillment of all other requirements of Rev. Proc. 2011-42 — would provide assurance that the sample is representative of the population being tested. The sample design would follow the general design and execution process followed in other areas by the IRS and taxpayers, and it would be individually tailored to each MNC.

MNCs choosing the statistical sampling approach must recognize potential IRS challenges. Under Rev. Proc. 2011-42, all statistical sampling procedures must be followed or else the sampling results may be deemed invalid. When documenting the results for use by the IRS during examination of the tax returns, an MNC would have to demonstrate that the sample is being projected only to the population from which the sample was selected and that the sample is representative of that population.⁴⁶

A potential IRS challenge to any use of statistical sampling is the taxpayer's basis for statistical sampling. Specifically, section 4.02(1) of Rev. Proc. 2011-42 allows statistical sampling to be used when the taxpayer is faced with a large

volume of data.⁴⁷ Statistical sampling is authorized under Rev. Proc. 2011-42 because of the time and cost otherwise required to analyze large amounts of data, not because of insufficient recordkeeping.

Undertaking sampling would not avoid the need for an MNC to maintain the underlying documentation required for substantiation. Underlying data for each entity tax year must be preserved; however, only documentation collection and technical review of the documentation for each sample item will be conducted. Accordingly, the same level of support is required for a particular item regardless of whether statistical sampling is used. The purpose of documentation is to demonstrate the result of the sample's adequacy before it is extrapolated to the population.

Section 965 does not bar the application of statistical sampling, and it sets forth one antiabuse provision: that a transaction will be disregarded if its principal purpose was to reduce the aggregate foreign cash position.⁴⁸ Statistical sampling is not a transaction, and its principal purpose would not be to reduce the aggregate foreign cash position. The preamble to the final section 965 regulations provides that no alternative measurement methods are allowed by taxpayers to compute E&P amounts.⁴⁹ Statistical sampling is not an alternative measurement method; rather, it is a less burdensome approach for meeting these objectives by reviewing and statistically projecting the required calculations for a representative subset of the population of all SFCs and applicable tax years.

Many MNCs expect to need large amounts of supporting records to substantiate E&P and foreign taxes claimed. Collecting, analyzing, and providing that data will be costly.⁵⁰ Samples dealing with other tax matters conducted in

⁴⁶ See *Greenwald v. Commissioner*, T.C. Memo. 2011-239, n.5. The Tax Court held that statistical sampling was improper because the taxpayer did not provide a valid statistical sample. He did not include any items valued at less than \$2,000 in the sample, when some of the items he tried to substantiate were less than \$2,000. The court held that to provide estimations, the taxpayer must include everything the taxpayer seeks to substantiate. See also FAA 20154601F (concluding that the taxpayer's examples used in the statistical sampling study did not prove a structural component disposition loss).

⁴⁷ As noted, Rev. Proc. 2011-42 provides that large volumes of data, and significant time or cost to analyze that data, are important considerations in determining if statistical sampling is allowed. Rev. Proc. 2011-42, section 4.02(1).

⁴⁸ See section 965(c)(3)(F) ("If the Secretary determines that a principal purpose of any transaction was to reduce the aggregate foreign cash position taken into account under this subsection, such transaction shall be disregarded for purposes of this subsection.").

⁴⁹ Preamble to T.D. 9846.

⁵⁰ Rev. Proc. 2011-42, section 4.02(1).

accordance with published IRS guidance consistently have been deemed statistically valid by the IRS.

substantiate E&P and foreign taxes claimed, and it could be used in anticipation of an examination of their 2017 or 2018 tax returns. ■

Conclusion

An MNC with a DFIC was required to include its section 965 transition tax liability on its 2017 or 2018 tax return, stating post-1986 E&P and deemed paid foreign taxes of each SFC in the aggregate. It is reasonable to expect the IRS to ask for adequate records to substantiate both amounts.

Providing a statistical sampling estimate to substantiate a small selection of an MNC's records of its SFCs' E&P and foreign taxes claimed does not obviate the need for underlying records to exist; however, it may enable MNCs to meet the considerable substantiation requirement more efficiently.

Rev. Proc. 2011-42 permits taxpayers to use statistical sampling when considering the time and cost required to analyze large volumes of data, when other books and records do not independently exist or have greater probative value. Taxpayers with large volumes of data that follow the procedures of published IRS guidance consistently have had their samples deemed statistically valid by the IRS.

Statistical sampling conducted in conformity with Rev. Proc. 2011-42 could narrow the focus of an IRS examination of the MNC's E&P and foreign taxes claimed, thus allowing the MNC to save time, money, and effort. In turn, the IRS's corresponding burden of examining those tax returns would be reduced as the agency limited its focus to the support provided by the MNC for the sampled items.

The approach as authorized in Rev. Proc. 2011-42 could allow statistical sampling to redetermine E&P and foreign taxes claimed for each SFC in preparation of an amended tax return or to substantiate those amounts on the original filed tax return. Statistical sampling used for either purpose could reduce the production of large amounts of data required for the IRS, prevent the issuance of a deficiency notice, and prevent material adjustments. Statistical sampling would be an optimal technique for MNCs to