Contingent Fee Audit Arrangements

Issue

State and local jurisdictions have supplemented their audit activities by engaging independent third-party tax auditors.[1] In some cases, the third-party auditors are paid via contingent fee arrangements (i.e., a fee in exchange for a percentage of the increased taxes, fees, or other amounts collected).

Background

State and local jurisdictions are faced with the need for additional revenues, as well as the political and economic pressure to stabilize government expenses. In certain cases, state and local jurisdictions are contracting with independent third-party tax auditors to augment revenues, often via contingent fee arrangements.

The use of third-party tax auditors is commonly used in the area of unclaimed property or escheated property. State and local jurisdictions also utilize third-party tax auditors with respect to local property tax audits, sales and use tax audits, and transfer pricing audits.

A contingent fee audit arrangement raises a number of concerns for taxpayers. This type of arrangement creates an incentive for the contract auditor to assess the highest amount of tax and to interpret the statutes and regulations in an aggressive manner in favor of the jurisdiction. In addition, the contract auditor does not have an incentive to inform the taxpayer of potential overpayments, missed deductions, tax credits or refund claims. Furthermore, a contingent fee arrangement can result in the auditor receiving very large fees that are out of proportion to the amount of time and expense expended in the audit.

The contract auditor also has an incentive to close the audit to the detriment of the taxpayer. In general, many government auditors (versus contract auditors) allow the taxpayer time to review a draft assessment and the audit work papers before such items are submitted for final assessment. This process allows the taxpayer time to identify errors or to provide additional information to reduce the assessment before it becomes final. This type of review also allows the taxpayer to resolve issues with the auditor rather than incurring the time and cost for an audit appeal. Many contract auditors do not allow taxpayers time to review the draft assessment.

A significant concern is the security of confidential information that is requested and provided during tax audits performed by contract auditors in general, including those paid on a contingent fee basis. Data privacy and security are a top priority for businesses today due to the increase in identity theft and fraud. State and local jurisdictions have laws and regulations that prohibit state and local

[1] Some jurisdictions that are currently using third party auditors include: Alabama, District of Columbia, Louisiana, and Kentucky.

jurisdiction employees from the disclosure of confidential taxpayer information. In the case of a contract auditor, the taxpayer has little assurance that the contract auditor is bound by the same data privacy standards as those used by state and local government employees.

Another problem with the use of contract auditors involves the quality of the audit itself. Jurisdictions using contract auditors generally will have less control over the methods used to select taxpayers for audit and to conduct the audit than when audits are conducted by the jurisdiction's employees. Methodology used by the contract auditors may be improper and biased.

Recent State Activity

The issue of contingent fee audits is being addressed in several state legislatures, including prohibitions on contingent fee audits being passed in North Carolina in 2012 and Arizona in 2011, and introduced in Michigan in 2012. In addition, taxpayers have challenged the use of contract auditors in judicial proceedings. For example, in the District of Columbia, taxpayers have challenged the ability of contract auditors to use specific transfer pricing methods at audit.[2]

North Carolina Legislation

On July 17, 2012, North Carolina Governor Beverly Perdue signed into law House Bill 462, which prohibits the Department of Revenue, local governments and the State Treasurer from using third-party contractors paid on a contingent fee basis for audit and assessment purposes. The portion of the law relating to the Department of Revenue and State Treasurer became effective October 1, 2012, and the portion relating to local governments becomes effective July 1, 2013, and expires July 1, 2015.

The North Carolina legislation was supported by a number of local businesses and organizations including the North Carolina Chamber of Commerce and Council on State Taxation ("COST").[3] In a June 25, 2012 email to the North Carolina House of Representatives, COST provided its policy position on contingent fee audit arrangements.[4]

> *"When States and localities enter into contingent-fee arrangements with third parties for tax audit and appeals services, they create incentives to distort the tax system for private gain. Such arrangements jeopardize the neutral and objective weighing of the public's interest and instead create a direct economic interest in the outcome of the services rendered. Consequently, such arrangements must be avoided."*

In the same email, COST summarized a number of issues with contingent fee audit arrangements including: an express incentive for the auditor to create a liability and the potential risk for such auditors to be overly aggressive and to "cherry pick" audit targets.

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[2] See Microsoft Corp. v. Office of Tax and Revenue, District of Columbia Office of Administrative Hearings, No. 2010-OTR-00012, May 1, 2012, in which the assessment was struck down due to an invalid transfer pricing method used by the contract auditor; BP Products North America Inc. v. District of Columbia, D.C. Super Ct. No. 2011 cvt 10619, motion for summary judgment filed 9/24/12.

[3] North Carolina Chamber of Commerce http://www.ncchamber.net/docs/pdfs/SupportHB462.pdf

[4] Council on State Taxation http://www.cost.org/WorkArea/DownloadAsset.aspx?id=81606

Michigan Legislation

Three separate bills (HB 5524, HB 5525, and HB 5526) were introduced in Michigan in 2012 that would prohibit contingent fee audits for unclaimed property, property tax and tax services under the state's revenue act. All three bills were assigned to the Tax Policy Committee on March 29, 2012, but no further action on these bills was reported.

The Michigan Chamber of Commerce posted an analysis in support of the legislation on April 13, 2012.[5] The Chamber asserted that "contingent based auditing threatens a fair and impartial evaluation of tax." In support of its position, the Chamber noted that other national organizations, including the National Conference of State Legislatures (NCSL) Task Force (as detailed below), have taken positions against the use of contingent fee audits. On April 19, 2012, the Tax Section of the State Bar of Michigan took a public policy position against the use of employing third-party contingent fee auditors.[6]

Arizona Legislation

On April 12, 2011, Arizona Governor Jan Brewer signed into law Senate Bill 1165, which prohibits municipalities from contracting with or employing auditors on a contingent fee basis for the purpose of auditing any transaction privilege tax (TPT). In addition, the legislation prohibits a municipality from contracting with a third party other than a state or a political subdivision of the state for the collection, administration or processing of TPT or affiliated taxes except for contracts existing on January 1, 2011.

Vince Perez, Assistant Director of the Audit Division for the Arizona Department of Revenue, sent a letter[7] to Senator Yarbrough, the author of the bill. Mr. Perez states that "allowing cities to contract out their tax collection and audit responsibilities to private, for-profit companies has serious public policy implications." The letter states:

> *"First, there is an obvious conflict of interest if compensation for the performance of auditing and collecting services is based on the amount of dollars assessed or collected. Accordingly, the Arizona Revised Statutes provides in the Taxpayers' Bill of Rights that Department employees cannot be compensated on the basis of taxes assessed or collected. Even if the outside company compensates employees on a straight hourly basis, the company makes more money if more dollars are assessed and collected, so there is always the risk of compromising fairness and objectivity with respect to taxpayers.*
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> *Secondly, having two different taxing "authorities" applying the tax laws would undoubtedly lead to situations where taxpayers would be subject to different interpretations of the same law,*

[5] Michigan Chamber of Commerce http://www.michamber.com/files/michamber.com/bounty%20hunter%20auditors%20TPoints%20FULL%20VERSION%204.pdf

[6] State Bar of Michigan http://www.michbar.org/tax/pdfs/ThirdPartyContingentFee.pdf

[7] Arizona Tax Research Association http://www.arizonatax.org/sites/default/files/publications/position_papers/DOR_Response_Letter.pdf

particularly when one of the "authorities" is motivated by monetary gain. Consistency of application and predictability are two of the most sought after characteristics of any taxing structure, both of which would be jeopardized by having multiple taxing "authorities".

Finally, there is significant oversight of the Department to ensure that taxpayers are treated fairly and that the Department operates within its statutory framework. As part of the Executive branch of government, the Department is supervised by the Governor, subject to oversight by the Legislature and regularly audited by the Auditor General's Office. Those checks and balances would not be present if cities are allowed to contract out their audit and collection functions to private companies."

The position set forth by the Arizona Department of Revenue is significant given that these arguments are generally made by taxpayers and other business associations.

Other Activity

On September 30, 2011, the National Conference of State Legislatures (NCSL) Executive Committee Task Force on State and Local Taxation of Communications and Electronic Commerce passed a resolution opposing the use of contingent fee audit arrangements and encourages government to end such contingent-fee practices.[8] NCSL is a bipartisan organization that serves the legislators and staffs of the nation's 50 states, its commonwealths and territories.

The resolution states that "a properly conducted audit should serve three purposes: to determine the accuracy of a particular tax return, to create an incentive for all taxpayers to comply with the tax law, and to educate taxpayers about their future tax compliance obligations." In addition, the resolution states "government use of contingent fee arrangements in tax audits and appeals denies the transparency that taxpayers are owed and demand, creates a perception of unfairness that undermines taxpayers' relationships with tax administrators and fosters an atmosphere of mistrust that hinders voluntary compliance."

On August 15, 2011, the Tax Executives Institute (TEI) released a policy statement against the use of contingent fee auditors.[9] TEI is the preeminent international association of business executives responsible for the tax affairs for their employers. The TEI policy statement also notes the potential for a conflict of interest between the contract auditor and the taxpayer. Specifically, "the potential for conflicts of interest increase when the firms that governments engage to perform these audits are subsidiaries of larger companies with multiple affiliates that compete with the companies being audited. These business relationships could influence the contract auditor's decision to audit and assess one company over another. Indeed, the risk exists that a contract auditor may use its auditor status to confer a competitive advantage to an affiliate in a business competing with an audited company. Even if a contingency fee auditor could in practice navigate this conflict, it could not avoid the *appearance of impropriety* that simply does not exist when a government employee performs the audit function. The inevitability of these conflicts challenges the notion of a fair and impartial tax system."

[8] http://www.ncsl.org/documents/standcomm/sccomfc/ContingencyFeeAuditResolution.pdf
[9] http://www.tei.org/news/he Pages/TEI-Releases-Policy-Statement-Against-Use-of-Contingency-Fee-Auditors.aspx

Importance to CPAs

There are several reasons why contingent fee audit arrangements are a concern for taxpayers and CPAs. In addition, contingent fee arrangements impact the broader goal of good tax administration.

1) Contingent fee audits create an incentive to pursue unrealistically high tax assessments. The primary goal of an audit should be to ensure that the correct amount of tax is paid and collected.[10] Auditor compensation that is contingent-fee based detracts from this objective. Contingent fee auditors have an incentive to interpret statutes and regulations in a more aggressive manner and to not inform taxpayers of overpayments, missed deductions, tax credits or refund claims.

2) Permitting contract auditors access to confidential taxpayer information raises additional concerns. State and local jurisdictions have laws and regulations that prohibit disclosure of confidential taxpayer information. In the case of a contract auditor, the taxpayer has little assurance that the contract auditor is subject to the same data privacy standards as those used by state and local government employees.

3) Potential conflicts of interest and an appearance of impropriety are raised by having for-profit companies auditing potential competitors. These potential conflicts damage the notion of a fair and impartial tax system.

AICPA Position

While the AICPA does not lobby directly at the state level, it supports efforts by state CPA societies who may advocate for legislation that prohibits state and local jurisdictions from engaging independent third-party tax auditors on a contingent fee basis.

The AICPA and state CPA societies understand the attractiveness of contingent fee audit arrangements to augment revenues for state and local jurisdictions. However, the financial benefit from contingent fee audit arrangements is not worth the many negatives arising from such arrangements, including primarily that they likely will compromise the integrity of the tax system. Accordingly, the AICPA encourages state societies to suggest that governments at all levels reject the use of contingent fee audit arrangements. The AICPA is available to work with state societies to, at a minimum, require state and local governments that engage third-party auditors to take action to ensure the confidentiality of taxpayer information and the uniformity and fairness of the audits.

AICPA Staff Contacts

- **Mat Young**, Vice President, State Regulatory and Legislative Affairs, 202/434-9273, myoung@aicpa.org
- **Eileen Sherr**, Senior Technical Manager – Taxation, AICPA State and Local Taxation Technical Resource Panel, 202/434-9256, esherr@aicpa.org

[10] As IRS policy acknowledges, "the primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance." Policy Statement 4-21(2), IRM 1.2.13.1.10 (approved June 1, 1974); and California Manual of Audit Procedures, FTB 860 Manual, 001, §1.7, Audit Objectives, "the objective of an audit is to effectively and efficiently determine the correct amount of tax based on an analysis of relevant tax statutes, regulations, and case law as applied to the taxpayer's facts."