TAX EXECUTIVES INSTITUTE, INC.

State and Local Tax Policy Statement
Regarding Contingency Fee Audit Arrangements

Tax Executives Institute, Inc. urges States to renounce their use of contingency fee audits for all types of taxes, fees, and unclaimed property assessments. Governments have an obligation to determine whether a taxpayer has paid the correct amount of tax. Allowing governments to transfer their audit responsibilities to third parties, and making third party auditors' compensation contingent upon the outcome of an audit, undermines the fairness and impartiality essential to the sound functioning of the tax system.

States and localities have increasingly engaged third-party agents to audit taxpayers in exchange for a percentage of the increased taxes, fees, or other amounts collected. Although contingency fee audits have some superficial appeal because they limit governments' out-of-pocket costs, they undermine the fairness and impartiality essential to the sound functioning of the tax system and consign what has historically been a core government function to a for-profit, unregulated enterprise.[1] Because the policy objections to contingency fee audits are overwhelming, Tax Executives Institute (TEI) urges States to renounce their use for all types of taxes, fees, and unclaimed property audits.

Concerns about these arrangements are not new. In the early 1990s, one state supreme court eloquently catalogued the harmful effects contingency fee arrangements have on tax administration. In *Sears Roebuck & Co. v. Department of Revenue*,[2] the Georgia Supreme Court invalidated a contingency fee scheme on public policy grounds where an outside firm received 35 percent of additional amounts collected following its audit of property tax returns plus 100 percent of all first-year penalties:

> The people's entitlement to fair and impartial tax assessments lies at the heart of our system, and, indeed, was a basic principle upon which this country was founded. Fairness and impartiality are threatened when a private organization has a financial stake in the amount of tax collected as a result of the assessment it recommends.

[1] One argument made in support of contingency fee audits is that such exams allow the State to collect monies that otherwise would not be collected. Government and tax administration, however, are not just about the collection of revenue. They represent the core values of society and contingency fee auditors inevitably subvert those values.

[2] *Sears, Roebuck and Co. v. Parsons*, 260 Ga. 824 (1991).

Governments audit taxpayers with the goal of ensuring that the *correct* amount of tax is paid and collected – not to extract the highest settlements possible – and must do so in an equitable manner.[3] Making auditor compensation contingent upon generating additional revenues detracts from those objectives. For example, contingency fee auditors have a financial incentive *not* to inform taxpayers of audit adjustments that could benefit the taxpayer (*e.g.*, missed deductions, tax credits, refund claims, etc.). Likewise, where States and localities abdicate the responsibility of selecting taxpayers for audit to third-party auditors, the contingent nature of the auditor's compensation creates a corrosive incentive to focus only on the largest taxpayers in the jurisdiction rather than enforcing the jurisdiction's tax laws in an equitable manner that would encourage compliance across all taxpayer classifications.[4] Introducing the contingent fee dynamic into the relationship between taxpayers and tax administrators not only impairs generally accepted goals for auditing taxpayers, but also erodes the trust and communication that facilitates efficient and successful audits.

The potential for conflicts of interest increases when a contingency fee auditor is a subsidiary of a larger company with multiple affiliates that compete with the companies being audited. These business relationships could influence a contingency fee auditor's decision to audit and assess one company over another. Indeed, the risk exists that a contingency fee 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 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.

Allowing contingency fee auditors to handle confidential taxpayer information raises additional concerns. At all levels of government, laws and regulations prohibit disclosure of this sensitive information, subjecting government employees to disciplinary actions and providing for the payment of damages to taxpayers affected by unauthorized use of their confidential information; perhaps more important, safeguarding taxpayer confidentiality is a cultural value in most government agencies. In the case of a contingency fee auditor, that culture may not

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[3] *See e.g.,* Internal Revenue Manual § 1.2.13.1.10, Policy Statement 4-21 (approved June 1, 1974) ("[t]he primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance on the part of taxpayers. This requires the exercise of professional judgment in selecting sufficient returns of all classes of returns in order to assure all taxpayers of equitable consideration, in utilizing available experience and statistics indicating the probability of substantial error, and in making the most efficient use of examination staffing and other resources"); and Auditing Fundamentals, Texas Comptroller of Public Accounts, Chapter 1, Audit Elements (revised June 2008) ("[a]n auditor's primary function is to determine if a tax has been correctly reported and paid").

[4] General Audit Manual, New Mexico Department of Revenue Audit & Compliance Division, Primary Audit Objectives (revised February 2009) (stating that one of the basic objectives for audits performed by the Division is "[t]o administer and enforce the tax programs in an equitable manner.").

exist and the potential for monetary gain from unauthorized use of taxpayer data may outweigh any disincentive created by these rules given the uncertainty of applying privacy-related disciplinary rules to contingency fee auditors. This leaves taxpayers with little assurance that contingency fee auditors will employ the same high standards of data protection as those used by government employees.

TEI fully appreciates that States are revenue-constrained and that contingency fee audits have the allure of a no-cost way to enhance state revenues. The financial benefit flowing from the use of contingency fee auditors, however, comes at a tremendous cost: The integrity of the tax system would be at risk. Accordingly, TEI believes that governments at all levels should reject the use of contingency fee audit arrangements. In addition, governments should be circumspect about any use of outside auditors, taking steps to ensure not only the confidentiality of taxpayer information but also the uniformity and fairness (and, as important, the perception of fairness) of such arrangements.

Special Concerns Specific to Contingency Fee Transfer Pricing Audits

Adding a new wrinkle to contingency fee audits, many States have begun to employ contingency fee auditors in the transfer pricing area to evaluate whether transactions between related parties are reported at arm's-length rates on their tax returns. Jurisdictions that have used transfer pricing contract auditors include Alabama, the District of Columbia, Kentucky, Louisiana, and New Jersey; other states have considered their use (including California, Florida, Hawaii, Indiana, and Minnesota). The use of contingency fee arrangements for these audits creates additional concerns including increased litigation costs and potential violations of ethical rules.

When a taxpayer's income or deductions include transactions between related parties, tax rules require that they reflect market prices. Most States conform to applicable federal tax rules to provide some amount of uniformity and avoid the creation of separate state-level rules. Rather than applying state and federal legal principles, however, transfer pricing contingency fee auditors use proprietary software to perform an analysis based on public financial information and taxpayer data provided by state departments of revenue. The software generates a transfer pricing assessment comparing company profitability with that of other companies in the same industry based on the target company's NAICS code. To the extent the software program determines that the profitability ratio of the audited company is less than that of the industry average, it generates an assessment based on profitability ratios it determines to be appropriate for that industry.

The pernicious nature of transfer pricing contingency fee arrangements is illustrated by what has happened in the District of Columbia. The D.C. government's agreement with one contingency fee auditor required that the auditor generate 96 assessments over a four-year period, and accords the contingency fee auditor discretion to select which taxpayers to assess. For every dollar that the District recovers from an assessment, the auditor received a recovery

fee ranging from 14-16 percent. If a taxpayer challenges an assessment in court, or in administrative appeals, the contingency fee auditor was required to provide litigation support services to the District to defend the assessment (including expert witness testimony).

1. The Costs of Conducting an Audit in the Courtroom – Burden of Proof

State and local auditors generally base their assessments on calculations or theories developed after thoroughly examining the taxpayer's books and records and discussing the facts with the taxpayer. When a contingency fee auditor issues a computer-generated transfer pricing assessment without thoroughly reviewing the underlying facts and law, any ensuing litigation shifts much of that related factual development to the courtroom resulting in a *de facto* audit conducted in court. The inefficiency of this approach places unnecessary financial and resource burdens on taxpayers, tax administrators, and court systems.

2. Contingency Fee Expert Witnesses Violate Established Ethical Rules

Transfer pricing contingency fee auditors may be asked to provide expert witness services to substantiate the validity of their transfer pricing assessments in the event a taxpayer challenges the assessment administratively or in court. Where the auditor is compensated on a contingency fee basis, the unfairness of the arrangement puts it outside state ethics rules. For example, the comments to Rule 3.4(b) of the American Bar Association Model Rules of Professional Conduct provide that:

> The common law rule in most jurisdictions is that it is improper to pay an occurrence witness any fee for testifying and that ***it is improper to pay an expert witness a contingent fee***. (Emphasis added.)[5]

Given the general disapproval for these types of arrangements and the general inefficiency of the process, governments should abandon their use of contingency fee transfer pricing contract audit firms – especially those that require such auditors to provide expert witness services to support their assessments.

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[5] *See also* Cal. Rules of Professional Conduct R. 5-310(B); Il. Rules of Professional Conduct R. 3.4 cmt.; N.Y. Rules of Professional Conduct R. 3.4(b)(3); Pa. Rules of Professional Conduct R. 3.4; and Tex. Disc. Rules of Professional Conduct R. 3.04.