TEI Policy Statement on Contingency Fee Audit Arrangements

August 15, 2011

On August 15, 2011, Tax Executives Institute released the following policy statement setting forth the Institute's position on contingency fee audits. The statement urges jurisdictions to renounce the use of contingency fee auditors for all types of taxes, fees, and unclaimed property assessments. The policy statement was prepared under the aegis of TEI's State and Local Tax Committee, whose chair is Linda H. Dickens of Texas Instruments Incorporated. Contributing substantially to the development of TEI's comments was Greg Potts of Wal-Mart Stores, Inc. Daniel B. De Jong, TEI Tax Counsel, serves as legal staff liaison to the State and Local Tax Committee and coordinated the preparation of TEI's policy statement.

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 facial appeal by limiting governments' out-of-pocket costs, their use undermines the fairness and impartiality essential to the sound functioning of the tax system and consigns to a for-profit, unregulated enterprise what has historically been a core government function.[1] Because the policy objections to contingency fee audits are overwhelming, Tax Executives Institute urges states to renounce their use for all types of taxes, fees, and unclaimed property assessments.

Concerns about these arrangements are not new. A decade ago, 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 on public policy grounds a contingency fee scheme 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.

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 to 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 designed to encourage compliance across all taxpayer classifications.[4] Introducing this 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 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.

Allowing contract 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 unauthor-

ized 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 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 third-party contractors. This leaves taxpayers with little assurance that contract 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 of enhancing state revenues. The financial benefit flowing from the use of contract auditors, however, would come 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, and other states have recently 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.

Where 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 contract 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 contract auditor requires that the auditor generate 96 assessments over a four-year period, and accords the contract auditor discretion to select which taxpayers to assess. For every dollar that the District recovers from an assessment, the contractor receives a recovery fee ranging from 16 to 14-percent. If a taxpayer challenges an assessment in court, or in administrative appeals, the contract auditor will 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 contract 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 contract auditors may 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 contract 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 contract auditors to provide expert witness services in order to support their assessments.

1. One argument sometimes made in support of contingency fee audits is that they allow the state it collect monies that otherwise would escape the tax net. Government and tax administration, however, are not just about the money. They are about the core values of the society, and those values are inevitably subverted by the use of contingency fee audits.
2. *Sears, Roebuck and Co. v. Parsons*, 260 Ga. 824 (1991).
3. *See e.g.,* Internal Revenue Manual § 1.2.14.1.10, 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

Continued on Page 365

NFFEs consist primarily of royalties for the use of intangible property in the United States or for services provided in the United States, those payments should generally meet the contemplated active trade or business exception. It is unlikely, however, that a foreign vendor would be willing to sign a statement similar to one proposed above for holding companies and Financing Affiliates, since such vendors would generally not have knowledge of the cited provisions of the Internal Revenue Code and Treasury regulations.

Thus, instead of the quoted language above, TEI recommends that a withholding agent be permitted to have foreign vendors sign the following statement:

Statement required by FATCA

The undersigned, a person authorized to sign for [Foreign Vendor Company], hereby certifies that it is engaged in an active trade or business in an area other than the business of banking or the provision of other financial services.

4. Exception for Ordinary Course of Business Payments

Notice 2010-60 discusses a proposed exception to Chapter 4's documentation and information reporting requirements for "certain classes of payments, such as arm's-length payments made for goods or services in the ordinary course of the withholding agent's trade or business." During our meeting, TEI was asked about the kind of information that could be provided by withholding agents to document that a withholdable payment was made in the "ordinary course" of the agent's business. We responded that since most ordinary course payments are made pursuant to a written contract, the contracts could be used as the primary documentation demonstrating the payment's qualification for any "ordinary course of business" exception to Chapter 4.

Upon reflection, we further suggest that a purchase order generated in a company's "purchasing system" would provide additional documentation of the payment's nature. In addition, purchases made pursuant to approved purchasing thresholds that depend on the employee's title, position, function, and overall level of responsibility would be indicative of an ordinary course payment. Finally, evidence of an ordinary course payment includes purchases made pursuant to a worldwide or regional purchase agreement negotiated by a company's procurement department, at predetermined volume or value thresholds.

5. Conclusion

Tax Executives Institute appreciates the opportunity to offer its views on key issues related to the development of regulations implementing FATCA. We look forward to commenting on future regulatory releases on this very important subject. Please do not hesitate to contact Michael J. Bernard, Chair, TEI IRS Administrative Affairs Committee, mikebe@microsoft.com, Paul Heller, Vice-Chair, IRS Administrative Affairs Committee, paul.heller@rbc.com, or Benjamin R. Shreck, TEI Tax Counsel, at 202-638-5601 or bshreck@tei.org, should you have any additional questions regarding this letter, or our previous comments regarding FATCA.

1. See Notice 2010-60, 2010-37 I.R.B. 329, 331 (Sept. 10, 2010).
2. *Id.* at 332-33.
3. *See, e.g., id.* at 331 (requesting comments regarding what methods withholding agents could use to identify entities that qualify for certain exceptions to Chapter 4).
4. *Id.* at 344.
5. *Id.* at 331.
6. *Id.*
7. *Id.*
8. *See Comments of Tax Executives Institute, Inc., on Notice 2010-60 relating to the Foreign Account Tax Compliance Act* (FATCA) NOT-121556-10 Submitted to the Internal Revenue Service, *October 19, 2010*, at 6-7 (*hereinafter* "TEI October 2010 Comments"). [**Editor's Note:** TEI's October 2010 comments on FACTA appeared in the November-December 2010 issue of *The Tax Executive*.]
9. *See Comments of Tax Executives Institute, Inc., on Notice 2011-34 relating to The Foreign Account Tax Compliance Act* (FATCA), NOT-121556-10, *submitted to The Internal Revenue Service, June 7, 2011,* at 8-9 (hereinafter "TEI June 2011 Comments"). [**Editor's Note:** TEI's October 2010 comments on FACTA appeared in the July-August 2011 issue of *The Tax Executive*.]
10. *See* TEI October 2010 Comments at 6-7. Some of the activities suggested here may overlap with, or be similar to, those noted in our prior submission.
11. 2010-37 I.R.B. at 332-33.
12. TEI October 2010 Comments at 9.
13. *See, e.g.,* 2010-37 I.R.B. at 331 (requesting comments regarding what methods withholding agents could use to identify entities that qualify for certain exceptions to Chapter 4)
14. *See, e.g.*, TEI October 2010 Comments at 7 (relating to Financing Affiliates) and 9-10 (relating to retirement plans).

2010-37 I.R.B. at 344.

Comments on Contingency Fee Audits
...Continued from Page 359

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.").
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.