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A Dangerous Game: State and Local Taxing Authorities Using Outside Auditors on a Contingent-Fee Basis

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An alarming trend has surfaced among state and local taxing authorities as they become increasingly cash-strapped and eager to generate more revenue. Rather than engaging in the politically damaging activity of raising tax rates or imposing new taxes, more and more state and local taxing authorities are contracting with outside audit firms on a contingent-fee basis to scrutinize taxpayers' returns and impose additional assessments. Some states have gone so far in this direction as to draft legislation *mandating* that the state's taxing authority investigate the use of an outside firm to perform certain audit functions, primarily those relating to transfer-pricing issues. While the practice of hiring private firms to perform governmental audits has been employed (to varying degrees of success) by state and local governments for years, these new legislative mandates bring to the forefront an array of taxpayer concerns. From the government's standpoint, contingent-fee audits are attractive because they allow for more collected revenue, with fewer upfront (and budgeted) costs borne by taxpayers. But from the *taxpayer's* standpoint, the use of private auditors on a contingent-fee basis infringes on taxpayer privacy, encourages inflated deficiency assessments and, in many cases, forces taxpayers to mount expensive legal challenges to these assessments.

Legislation Mandating the Use of Auditors on a Contingent-Fee Basis

For years, states and municipalities have used private firms to conduct taxpayer audits. Taxpayers have challenged the use of these outside audit firms and, in particular, contingent-fee arrangements, in courts across the country, with some courts striking down such arrangements as a violation of public policy[1] and still others upholding the arrangements in the absence of an express legislative prohibition.[2] While a few states have laws prohibiting these contingent-fee arrangements,[3] several state legislatures have now introduced bills that would authorize or

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[1] *See, e.g.*, *Sears, Roebuck & Co. v. Parsons*, 401 S.E.2d 4 (Ga. 1991) (voiding as against public policy a contingent-fee arrangement, whereby auditor was to seek out and appraise unreturned personal properties).

[2] *See, e.g.*, *In re Appeal of Philip Morris U.S.A.*, 436 S.E.2d 828, 831 (N.C. 1993) (finding that contingent-fee arrangement did not violate public policy because the legislature "chose not to place any restrictions on" contingent-fee contracts for tax audits).

[3] *See, e.g.*, ARIZ. REV. STAT. 42-6002, as amended.

require state taxing authorities to investigate contracting with outside firms on a contingent-fee basis to conduct audits of corporate tax returns.

For example, the proposed budget bills of the California State Senate and Assembly, Senate Bill 69 and Assembly Bill 92, respectively, grant the Franchise Tax Board "advance authority to incur contingent obligations" of up to $600,000 "for vendor services associated with the development of a transfer pricing audit program."[4] These bills stand in stark contrast to Senate Bill 342, recently introduced by California state senator Lois Wolk. Senator Wolk's proposed bill would have prohibited taxpayers from entering into contingent-fee arrangements for legal or consulting services on any matter involving state tax law, including matters before the Franchise Tax Board and the State Board of Equalization.[5] Taxpayers and their counsel fought hard to defeat this bill, which if passed would have restricted their use of contingent-fee counsel.

At first glance, Minnesota seemed to go one step further, with both the House and Senate introducing bills, House File 904 and Senate File 740,[6] respectively, that would require the Minnesota Department of Revenue to issue requests for proposed contracts governing transfer-pricing audits on a contingent-fee basis. More recently, however, the Minnesota legislature added language to House File 1219 prohibiting state agencies from entering into contracts for tax audit-related activities that would compensate auditors on a contingent-fee basis; this bill appears to have more traction.[7]

In a similar vein, Oklahoma governor Mary Fallin recently approved Senate Bill 750, which allows municipalities to collect their own sales tax and requires taxpayers filing returns to remit taxes to these municipalities.[8] Though the bill does not require municipalities to use private firms to collect this tax, it specifically authorizes municipalities to "contract with private auditors or audit firms" and pay the auditors out of the tax assessment resulting from the audit. Cities that

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[4] Cal. Senate Bill 69, *available at* http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0051-0100/sb_69_bill_20110318_enrolled.pdf; Cal. Assembly Bill 92, as amended, *available at* http://www.leginfo.ca.gov/pub/11-12/bill/asm/ab_0051-0100/ab_92_bill_20110228_amended_asm_v98.pdf (all web sites herein last visited June 10, 2011). The Senate budget bill was adopted by both the Senate and Assembly and awaits the governor's approval. California governor Jerry Brown, however, continues to abide by his proposed budget, having released a revised budget on May 16, 2011.

[5] *See* Cal. Senate Bill 342, as amended, *available at* http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0301-0350/sb_342_bill_20110504_amended_sen_v97.pdf. The most recent version of the bill is not expressly limited to taxpayers, but Senator Wolk vowed to amend it to allow municipalities to enter into contingent-fee arrangements.

[6] Minn. House File 904, as introduced, https://www.revisor.mn.gov/bin/bldbill.php?bill=H0904.0.html&session=ls87; Minn. Senate File 740, as introduced, https://www.revisor.mn.gov/bin/bldbill.php?bill=S0740.0.html&session=ls87.

[7] *See* Minn. House File 1219, *available at* https://www.revisor.mn.gov/bin/bldbill.php?bill=H1219.3.html&session=ls87.

[8] Okla. Senate Bill 750, as enrolled, *available at* http://www.oklegislature.gov/BillInfo.aspx?Bill=SB750&Tab=3.

supported the bill have indicated their intention to use private collection agencies to collect sales tax.[9]

Despite having no legislation requiring the state taxing authority to request proposals for contingent-fee contracts, other states, including Kentucky, Alabama, and New Jersey, as well as the District of Columbia, have already entered into contingent-fee contracts for transfer-pricing audits.[10]

There has been some pushback, however, to the use of private audit firms on a contingent-fee basis. In April, Arizona governor Jan Brewer signed into law Senate Bill 1165, which prohibits localities from "employ[ing] auditors on a contingent fee basis or enter[ing] into contingent fee contracts for auditing any transaction privilege or affiliated tax levied by the city or town."[11]

Potential Taxpayer Concerns Arising From Contingent-Fee Arrangements

A. Problematic Methodology/Lack of Transparency

In the context of transfer-pricing contingent-fee audits, there is particular concern over the methodology used by the contingent-fee auditors. For example, under Kentucky's current contract with ACS State and Local Solutions, Inc., for "Corporate Net Income Compliance Tax Discovery Services," Kentucky's Department of Revenue selects multistate corporate taxpayers from a "Ranked Candidate List" compiled by ACS. ACS then performs a "Detailed Analysis" of the selected taxpayers and proposes income tax adjustments for companies that ACS determines fail to comply with Kentucky's add-back statute when engaging in related-party transactions.[12] ACS does not disclose, however, the methodology it uses to rank taxpayers or to perform its Detailed Analysis. For its services, ACS receives 15.2 percent of taxes collected from audit adjustments and 6 percent of taxes paid through a "Voluntary Compliance Program" developed by ACS for approximately 50 audited taxpayers facing tax adjustments.

Following the legislative proposals highlighted above, and in no small part because of its lucrative contingent-fee arrangements with other states, Chainbridge Software Inc. patented its

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[9] Barbara Hoberock, *Bill to let cities use private sales-tax collectors OK'd*, TULSA WORLD NEWS, Mar. 15, 2011, *available at* http://www.tulsaworld.com/news/article.aspx?subjectid=504&articleid=20110315_16_A8_OKLAHO968359&allcom=1.

[10] *See* Master Agreement Between Commonwealth of Kentucky and ACS State and Local Solutions, Inc., re: Collections and Tax Discovery Products and Services (Nov. 2, 2010), *available at* http://migration.kentucky.gov/opendoorsearch/StreamPDF.aspx?doccd=MA&docdpetcd=758&docid=1100000591&docversno=0; John Buhl, *Private-Sector Reps Warn NCSL Task Force About 'Bounty Hunter' Auditors*, STATE TAX TODAY, May 9, 2011.

[11] *See* ARIZ. REV. STAT. 42-6002, as amended.

[12] *See* Master Agreement Between Commonwealth of Kentucky and ACS State and Local Solutions, Inc., *supra* note 10.

"system and method for analyzing tax avoidance" on May 11, 2011.[13] This method operates by computing "one or more financial ratios based at least in part on the entity's return on assets, capital, sales and/or operating expenses." Using this opaque method, Chainbridge compares the taxpayer's reported operating profits and sales revenue to reported profits and sales of comparable firms (based on the firms' SIC and NAICS codes and sales levels, among other things). Chainbridge then adjusts the taxpayer's income so that the taxpayer's net profit-to-sales ratio falls within a specified range of comparable firms' net profit-to-sales ratios. All of this analysis is performed without any evaluation of the taxpayer's actual books and records.

While much of the current debate and newly proposed legislation focuses on the issue of transfer-pricing audits, taxpayer concerns should not be so limited. Many of the states employing Chainbridge or other private firms to conduct transfer-pricing audits have no laws that expressly limit their use of contingent-fee arrangements to the transfer-pricing context,[14] meaning that the mandated use of firms like Chainbridge could serve as the first step toward widespread legislative outsourcing of government audit functions.

Even outside the transfer-pricing context, lack of transparency poses serious problems for taxpayers. Because states' open-records acts cover only state and local agencies, taxpayers likely will be unable to file open-records-act requests to uncover the methodology used by private auditors to perform audits under these contracts.[15] Though the auditors' financial motive gives cause for concern that the methodology used will be flawed (in the state's favor), taxpayers with little or no understanding or awareness of the method may find it difficult to contest.

B. Confidentiality of Taxpayer Information

The widespread use of contingent-fee arrangements raises serious concerns over the confidentiality of taxpayer information. The U.S. Congress recognizes that taxpayers have a "justifiable expectation of privacy in the extensive information they furnish [to taxing authorities] under penalty of fine or imprisonment."[16] To respect this justifiable expectation, information contained in federal tax returns generally is kept confidential;[17] when inspecting federal tax

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[13] *See* Molly Moses, *Virginia Company Receives Patent for Transfer Pricing Study Method Used to Make Adjustments to Tax Base*, BNA WEEKLY STATE TAX REPORT, May 13, 2011.

[14] Some states that have used Chainbridge to perform transfer-pricing audits do expressly limit the use of contingent-fee arrangements when outside auditors engage in audit functions that require them to examine taxpayers' books and records. *See, e.g.*, Ala. Code § 40-2A-6 ("The state or any county or municipal governing authority may not enter into any contract or arrangement for the examination of a taxpayer's books and records if any part of the compensation or other benefits paid or payable for the services of the private examining or collecting firm conducting the examination is contingent upon or otherwise related to the amount of tax, interest, court cost, or penalty assessed or collected from the taxpayer.").

[15] *See, e.g.*, California Public Records Act of 2004, CAL. GOVT. CODE §§ 6250 *et seq.*

[16] Policy Position, Council On State Taxation, Confidentiality of Taxpayer Information (quoting United States Congress, Joint Committee on Taxation (2000)).

[17] 26 U.S.C. § 6103.

returns, state audit agencies likewise are required to keep confidential all taxpayer information.[18] The use of private audit firms may cause state and local taxing authorities to run afoul of Code Section 6103 if the taxing authority discloses information contained in federal tax returns to the auditors; however, the failure to disclose such information to private audit firms may lead to erroneous deficiency assessments. Federal legal concerns aside, absent strict confidentiality provisions in states' contracts with private firms, third-party firms simply may not afford information contained in state tax returns the protections offered by state revenue agencies. Private audit firms could use taxpayer information for the purpose of forcing settlements in other states or for some purpose wholly unrelated to audits.

C. Risk of Inflated Assessments

The risk of inflated assessments by third-party audit firms paid on a contingent-fee basis poses perhaps more of an immediate threat to taxpayers. Contingent-fee arrangements by definition give auditors a stake in the game, providing an incentive for them to levy high assessments on taxpayers. Yet because "governmental officers" are presumed to "act reasonably and according to law,"[19] taxpayers bear the burden of contesting any assessment.[20] Under California law, for example, if a taxpayer disputes a proposed deficiency assessment, the taxpayer must either protest by filing a written protest to the Franchise Tax Board or pay the assessment and file for a refund; throughout the entire process, the taxpayer bears the burden of establishing that the Franchise Tax Board's determination as to the amount owed is incorrect. Similarly, federal law places the initial burden of proof on the taxpayer for proving by a preponderance of the evidence that an assessment is incorrect, then shifts the burden to the IRS in any court proceeding over a factual issue if the taxpayer introduces credible evidence with respect to that issue.[21] California Assembly member Paul Cook recently introduced Assembly Bill 1006, which would amend the California Revenue and Taxation Code to place the burden of proof with respect to any factual issue relating to the taxpayer's liability on the Franchise Tax Board rather than the taxpayer,[22] but the bill is mired in the Assembly Committee on Revenue and Taxation.

Courts voiding contingent-fee arrangements have rested their decisions on the inherent unfairness that arises when private firms take over the audit function, concluding that "[t]he people's entitlement to fair and impartial tax assessments [which] lies at the heart of our system ... [is] threatened where a private organization has a financial stake in the amount of tax

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[18] *Id.* § 6103(d)(2).

[19] *United States v. Lease*, 346 F.2d 696, 703 n.13 (2d Cir. 1965).

[20] *See* CAL. REVENUE AND TAXATION CODE § 19032.

[21] *See* 26 U.S.C. § 7941; *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *United States v. Pomponio*, 635 F.2d 293, 297 n.4 (4th Cir. 1980).

[22] *See* CAL. ASSEMBLY BILL 1006 (as amended), available at http://www.leginfo.ca.gov/pub/11-12/bill/asm/ab_1001-1050/ab_1006_bill_20110425_amended_asm_v98.pdf.

collected as a result of the assessment it recommends."[23] It is perhaps for this very reason that Rule 302 of the American Institute of Certified Public Accountants ("AICPA") Code of Professional Conduct prohibits AICPA members in public practice from receiving contingent fees for any professional services, including audits or reviews of financial statements.[24]

In many situations, the high cost of litigating assessments may cause taxpayers to settle for reduced assessments via programs like Kentucky's Voluntary Compliance Program rather than contest the state's post-audit assessment. This is especially true in the transfer-pricing context, where firms likely would be required to engage experts to perform transfer-pricing analysis to contest an audit firm's calculated assessment to the extent the company does not already have a transfer-pricing study in place. Chainbridge's automated audit system serves as a striking example of the potential for third-party auditors to mask skewed audit assessments behind a seemingly legitimate—indeed, a *patented*—audit system, which taxpayers can challenge only after engaging in extensive discovery and expensive expert analysis.

Perversely, the more taxpayers choose to settle rather than openly contest assessments (and the methods used to calculate the amount allegedly owed), the greater the incentive for audit firms to skew assessments in the state's favor. Furthermore, because the same contract auditor may be employed in multiple states, settling in one state could make a taxpayer an attractive target in other states. For these reasons, taxpayer advocates have taken a firm stance against the use of contingent-fee arrangements with third parties in tax audits on the ground that these services "create incentives to distort the tax system for private gain," thereby "jeopardiz[ing] the neutral and objective weighing of the public's interest."[25]

Conclusion

Mounting budget shortfalls and hiring freezes have forced states to develop new ways to increase revenue with little upfront cost; contingent-fee auditors fit within this strategy. But the use of contingent-fee auditors threatens to chip away at existing protections against overly aggressive audits and misuse of taxpayer information. Though still nascent and narrow in scope, current proposed legislation may serve as a stepping stone to mandated contingent-fee contracts covering other audit functions traditionally performed by state and local authorities. Taxpayers should voice their concerns at this early stage to maintain transparency in this "uniquely governmental function."[26]

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[23] *See, e.g.*, *Sears, Roebuck & Co. v. Parsons*, 401 S.E.2d 4, 5 (Ga. 1991); *see also Yankee Gas Co. v. City of Meriden*, No. X07-CV-60072560-S, 2001 WL 477424, at *21 ("There exists a public policy in favor of fair and accurate taxation … . Contingent fee arrangements may very well lead to unfair results ... .").

[24] AIPCA Rule 302, *available at* http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_302.aspx#et_302_interpretations.

[25] Policy Position, Council On State Taxation, *Government Utilization of Contingent Fee Arrangements in Tax Audits and Appeals*.

[26] *Yankee Gas*, 2001 WL 477424, at *21.

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