

TAXATION SECTION

Respectfully submits the following position on:

*

Third Party Contingent Fee Audits

*

The Taxation Section is not the State Bar of Michigan itself, but rather a Section which members of the State Bar choose voluntarily to join, based on common professional interest.

The position expressed is that of the Taxation Section only and is not the position of the State Bar of Michigan.

To date, the State Bar does not have a position on this matter.

The total membership of the Taxation Section is 1,366.

The position was adopted after discussion and vote at a scheduled meeting. The number of members in the decision-making body is 14. The number who voted in favor to this position was 13. The number who voted opposed to this position was 0.

Report on Public Policy Position

Name of section:

Taxation Section

Contact person:

Warren J. Widmayer

E-Mail:

warren@fw-pc.com

Regarding:

Third-Party Contingent Fee Audits

Date position was adopted:

April 19, 2012

Process used to take the ideological position:

Position adopted after discussion and vote at a scheduled meeting.

Number of members in the decision-making body:

14

Number who voted in favor and opposed to the position:

13 Voted for position

0 Voted against position

0 Abstained from vote

1 Did not vote

Explanation of the position, including any recommended amendments:

The position opposes the current practice of the Michigan Department of Treasury to compensate third-party independent contractor auditors who audit the unclaimed property records of Michigan businesses by paying them a percentage of the amount recovered. The Section opposes this practice because it promotes abusive practices and provides incentives for the auditor to inflate assessments in order to increase the contingent fee.

**CERTIFIED COPY OF RESOLUTION OF
COUNCIL OF THE TAXATION SECTION
OF THE
STATE BAR OF MICHIGAN**

I, Marjorie B. Gell, Secretary of the Council of the Taxation Section of the State Bar of Michigan, hereby certify that pursuant to Article VI, Section 4 of the Bylaws of the Taxation Section of the State Bar of Michigan, on April 19, 2012, a quorum was present, and the position referenced in the attached as "Taxation Section of the State Bar of Michigan, Public Policy Position Statement: Contingent Fee Audits" was approved by a vote of a majority of Council members present at the meeting and entitled to vote. Of the 13 voting members of the Council present, the vote was:

In favor: 13
Opposed: 0
Abstaining: 0
Not voting: 0

IN WITNESS WHEREOF, I have affixed my signature this 3rd day of May, 2012.



Marjorie B. Gell, Secretary

Taxation Section of the State Bar of Michigan

Public Policy Position

Contingent Fee Audits

SUMMARY

The Taxation Section of the State Bar of Michigan urges the Michigan Legislature to prohibit the practice of employing third-party auditors whose fees are determined as a percentage of the tax assessed or collected. This practice could violate the Michigan Constitution and raises significant public policy concerns.

BACKGROUND

The State of Michigan currently employs out-of-state third party contingent fee auditors to conduct unclaimed property and personal property tax audits. These auditors are compensated by means of a contingent fee based on the amount of tax assessed against the taxpayer. At issue is whether the use of such auditors is first, constitutional, and second, in line with sound tax policy.

This practice is not new. In Roman times, it was known as “tax farming” and was renowned for its tendency to promote abusive practices. Private citizens would bid for the right to collect particular taxes for the state in a particular region for a fixed period of time. This tended to lead to extortion, and almost always tended toward selection of the largest and most wealthy taxpayers as targets, focusing efforts where revenue was most easily available due to limited resources.

Below are some concerns raised by the modern use of contingent fee auditors:

- 1) Contingent fee audit arrangements encourage auditors to be overly aggressive and to ignore taxpayer errors that result in lower assessments. Combine that dynamic with the fact that taxpayers under audit for unclaimed property do not have any avenue of administrative review – any aggressive positions taken by the auditors must be fought in court.
- 2) Contingency fee arrangements are particularly troublesome if the auditor has discretion to select or strongly influences the selection of targets for audits, as they may select based on “deep pockets” rather than any real suspicion of non-compliance.
- 3) Use of contingent fee arrangements creates a perception of unfairness and mistrust that may undermine our system of voluntary compliance.

The US Supreme Court has long questioned arrangements where fines are imposed by individuals having a direct financial interest in the outcome.¹ State courts that have specifically considered the use of contingent-fee tax auditors reached different conclusions. The Georgia Supreme Court found that such arrangements offend public policy in *Sears, Roebuck & Co. v. Parsons*.² The North Carolina Supreme Court, however, found to the contrary in *Appeal of Phillip Morris USA*,³ on the grounds that the North Carolina legislature

¹ See, e.g., *Tumey v. Ohio*, 273 US 510 (1927).

² 401 SE2d 4 (1991).

³ 436 SE2d 828 (1993).

specifically prohibited contingent fee arrangements when it determined they were contrary to public policy. The Pennsylvania Supreme Court followed suit for the same reason in *Suburban Cable TV Co. v. City of Chester*.⁴

Michigan courts have yet to consider the issue of contingent fee arrangements, although the Court of Appeals addressed the issue of whether the state can contract with third parties to conduct audits in *General Motors Corp v. State Tax Commission*.⁵ In *General Motors Corp*, the Michigan Court of Appeals specifically noted that unlike the arrangements in *Sears* and *Phillip Morris*, the present case did not involve a contingent fee arrangement and the auditing firm could not choose the target of the audit. The State of Michigan has moved in that direction, however, not only by entering into contingent fee arrangements but allowing the auditor in at least one known instance to choose the target of the audit.

The use of contingent fee arrangements by practitioners has been restricted in some contexts. Section 10.27 of IRS Circular 230 prohibits tax practitioners from charging a contingent fee for services rendered in connection with any matter before the Internal Revenue Service except in a limited number of situations. As noted in the preamble to recent proposed regulations under Circular 230, “the primary rationale behind the prohibition on contingent fees is to preclude any fee arrangement that is related to or requires a favorable ruling by the IRS and that has the potential to exploit the audit selection process or compromise a practitioner’s duty of independent judgment.” *Internal Revenue Bulletin 2009-33*. The American Institute of CPAs also prohibits CPAs from charging a contingent fee for services rendered to clients for whom the CPA performs attest services and for the preparation of original tax returns.

Recent efforts to curb these arrangements have been directed more at the political arena. Political pressure recently caused the State of New Jersey to allow its contingent fee audit arrangement to expire. On September 30, 2011, the National Conference of State Legislators adopted a resolution opposing the use of contingent fee auditors. The Council of State Taxation and Tax Executives Institute have likewise urged state legislators to ban these arrangements.

THE TAXATION SECTION’S POSITION

Even though they may be good revenue raisers for financially-strapped governments, contingent fee arrangements in tax audits are almost universally criticized by constituencies on all sides of the tax policy debate for good reason. These arrangements encourage abusive practices by auditors. They severely undermine confidence in the fairness of tax administration. They are especially prone to abuse in cases where audit methodology involves extrapolation of tax liability from selective samples of taxpayer data, as often occurs in unclaimed property cases. Compensating third parties based on the amount of revenue they generate in the name of the State raises serious constitutional and public policy issues. For all of these reasons, the Michigan Legislature should enact legislation prohibiting the Department of Treasury from compensating third-party auditors through contingent fees.⁶

⁴ 685 A.2d 616 (1996).

⁵ 504 NW2d 10 (1993).

⁶ This is the position of the State Bar of Michigan Taxation Section only, which consists of 1,334 members of the State Bar of Michigan. The State Bar of Michigan has no position on this matter. This position was adopted by the Taxation Section Council after discussion and vote at a scheduled meeting held April 19, 2012. Of the 14 voting members of Council, all 13 members who were present at the meeting voted in favor of the position.