

PUBLICATION

Spotlight on SALT: Is There a Bounty Hunter in Your Future?

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It is no secret that states are encountering challenging fiscal situations. While states may be loathe to raise tax rates as economic recovery may be gaining some traction, states are considering a variety of ways to increase tax collections. State audit functions have historically focused upon revenue raising rather than being used to implement broad changes in tax policy. Yet, state fiscal challenges have also affected their tax agency audit functions. As a result, some states are even more receptive to engaging "bounty hunters" -- that is, third party audit firms contracting with states to perform audit examinations of taxpayers for a contingent fee.

Background

For several years, states have used third party firms to conduct unclaimed property audits pursuant to state statutes, many of which permit the use of contingent fee compensation. These auditors are compensated based on a percentage of unclaimed property that they recover for the state. Often, the audits are conducted on behalf of multiple states. Recently, this practice has migrated to the corporate income tax arena. For example, New Jersey and Washington, D.C. have contracted with a third party firm to conduct transfer pricing "audits" for a contingent fee. In addition, Kentucky may have also entered into a similar contract with a third party firm to identify Section 482 audit candidates among multi-state corporate taxpayers in that State.

Last year the United States Patent and Trademark Office granted a patent to Chainbridge Software, Inc. for a "computer implemented method" to conduct contingent fee state income tax audits. Specifically, the patent application claims that by using state corporate income tax data a transfer pricing analysis can be performed on taxpayers and generate adjustments to income to correct for claimed avoidance of state corporate income tax. Chainbridge has apparently partnered this audit technique with at least one other third party organization in an effort to push these contingent fee arrangements to various jurisdictions.

While these analyses are nominally called "audits," they are nothing of the kind. Such analyses do not in any way involve a review of the taxpayer's books and records, but are simply a comparison of profit margins of supposedly comparable companies.

Legislation

Some states currently have legislation pending that would require the use of contingent fee auditors. For example, legislation has been proposed in both Indiana and Minnesota this session that would require their departments of revenue to engage the services of a bounty hunter transfer pricing audit firm. California has proposed legislation which certainly indicates its intent to utilize contingent fee auditors in the transfer pricing area.

Other states have taken a dim view of bounty hunter type audits. For example, Louisiana passed legislation in 2009 severely restricting the ability of its department of revenue to refer state tax cases to bounty hunters after July 10, 2009. However, bounty hunter type audits are still alive and well in Louisiana for unclaimed property audits as well as audits by local jurisdictions.

While states certainly differ on whether or when to allow bounty hunter type audits, the important message for multi-state business taxpayers is to recognize their exposure to these types of audits by understanding the statutory authorizations in their respective states in which they are doing business.*

Considerations Upon Audit

We continue to believe that any such comparative analysis approach is far too superficial to form a basis on which taxing jurisdictions could issue credible deficiency assessments. Such an approach certainly does not achieve the proposed goal of identifying taxpayers who are truly abusing the system.

In addition to these methodological and factual issues as to the operating characteristics of the taxpayer and the proper selection of comparables, taxpayers should also consider a number of other issues if confronted with a bounty hunter audit, including:

- Is the "bounty hunter" audit arrangement consistent with applicable state public policy?
- Do the economists who have prepared transfer pricing reports have the requisite objectivity to be competent to testify in court, or are they tainted by the contingent nature of the contract?
- Is the auditor required to adhere to established state tax audit policies and procedures?
- How will confidential taxpayer financial, tax return, and other information be protected from unauthorized disclosure?
- Are state officials involved in supervising the audit?
- Are due process requirements being followed?

These and many other considerations must be addressed by a taxpayer facing such a bounty hunter audit so that the appropriate array of defenses, both procedural and substantive, can be evaluated and, as appropriate, brought to bear on behalf of the taxpayer. Failing to fully address such considerations could leave the taxpayer exposed to a significant tax deficiency, the credibility of which would otherwise be subject to attack.

Summary

Taxpayers must be particularly concerned when facing a tax audit to be conducted through a bounty hunter methodology. If you have questions or are currently the subject of a bounty hunter audit and would like to discuss these matters, please contact one of the attorneys in our Tax Department.

*Other than the District of Columbia and Louisiana which are discussed above, those states in which Baker Donelson has offices generally address bounty hunter (i.e. contingent fee) type audits for tax purposes as follows: (i) Tennessee -- not authorized pursuant to 2005 and 2006 Attorney General Opinions with respect to non-delinquent taxes, although local jurisdictions are given authority on a non-contingency fee basis to engage third party firms with respect to certain property tax audit functions; (ii) Georgia -- local jurisdictions can contract with third party firms on a non-contingent basis for property tax audit services, but the Georgia Supreme Court has ruled that contingent fee arrangements violate public policy and are therefore prohibited; (iii) Alabama -- the state, counties and municipalities are prohibited from entering into contingent fee arrangements with third party auditors; and (iv) Mississippi -- no statute on point; however, local jurisdictions are allowed to hire third party contractors to collect ad valorem taxes.. The foregoing summary is general in nature, and does not address issues such as unclaimed property audits and others.