Government Utilization of Contingent Fee Arrangements in Tax Audits and Appeals

Policy Position

Position: *When States and localities enter into contingent-fee arrangements with third parties for tax audit and appeals services, they create incentives to distort the tax system for private gain. Such arrangements jeopardize the neutral and objective weighing of the public's interest and instead create a direct economic interest in the outcome of the services rendered. Consequently, such arrangements must be avoided.*

Explanation: In the case of tax audits, the amount of the liability, or even if there is a liability, is often unknown or disputed. The responsibility of an auditor is to determine the proper amount of tax. By contracting with third parties on a contingent-fee basis, governments provide an express incentive for the auditor to create a liability; a larger audit assessment means a larger payout to the auditor. Contingent-fee arrangements encourage auditors to be overly aggressive; to interpret State laws to their own advantage rather than in society's best interest; to "cherry pick" audit targets; and to ignore taxpayer errors that would result in lower assessments. The risk of abuse creates a perception of unfairness that colors taxpayers' relationships with administrators and creates an atmosphere of mistrust that hinders compliance.

Governments that hire counsel to assist with tax litigation on a contingent-fee basis create a pecuniary interest in a case. That interest may serve as a disincentive to a contingent-fee attorney to enter into a settlement discussion or act objectively in an effort to reach an appropriate compromise with the taxpayer.

Some States have expressed concern over their ability to hire skilled staff auditors or specialized counsel absent contingent-fee arrangements. The inability to hire skilled auditors or attorneys at salaries commensurate with other similar state positions is undoubtedly related to the fact that those States are currently willing to pay fees to outside contractors well in excess of anything a State employee could expect to earn. In other words, some States have created an artificial market and could eliminate that market as easily as it was created. Many States address such staffing concerns while avoiding the problems associated with contingent-fee arrangements by compensating third-party experts on an hourly basis for services rendered, thus reducing or eliminating the incentive for abuse. However, hiring a third-party, even on an hourly basis, still reduces the incentive to settle cases, as well as the objectivity of the third-party, since anything that reduces the time-period required to resolve the issue will reduce the amount of money earned by the third-party.

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