
Coates' Canons Blog: Prohibition on Certain Contingent Fee Audit Contracts

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UPDATE OCTOBER 2015: During the most recent legislative session, the General Assembly enacted S.L. 2015-109, which removed the sunset provision and thereby made the prohibition on the contingent fee audit contracts described below permanent.

In 1993, the North Carolina Supreme Court held that it did not violate public policy for a county to enter into a contingent fee contract with a private audit firm to assist the county tax assessor in discovering certain personal property subject to taxation. See *In the Matter of The Appeal of Philip Morris U.S.A.*, 335 N.C. 227, 436 S.E.2d 828 (1993). (Under the terms of the contract, the county paid the audit firm 35 percent of the taxes owed on property the audit firm discovered, including any penalties. The audit firm received no compensation if it did not discover any property subject to taxation). In so holding, the court found clear statutory authority in **G.S. 105-299** for a county to engage private entities to assist a tax assessor in performing the assessor's duties. And the court deferred to the legislature's decision, at the time, not to place any restrictions on allowable compensation methods for such services.

Fast forward almost twenty years and this time the legislature has addressed the issue, seemingly coming to a different conclusion. It enacted two bills this past session that, assuming they are not vetoed by the Governor, will effectively prohibit local governments from engaging a private person or entity on a contingent fee basis to assist in discovering real or personal property for purposes of taxation or to otherwise assist in the determination of a taxpayer's tax liability. The prohibition begins on July 1, 2013, and, at least for now, extends only until July 1, 2015.

What is a Contingent Fee Contract for Tax Audit Purposes?

Local governments have contracted with private audit firms for years to help identify and collect taxes and other revenues owed to the units. Often local governments hire the private audit firms on a contingent fee basis, whereby the cost of searching for unpaid taxes or fees is borne by the private firm until the revenue actually is collected. The local government only pays the private firm if the firm's efforts result in increased revenue collections to the government. The compensation paid to the audit firm often is directly measured by the total amount of assessment (including taxes or fees and any penalties) paid by the audited taxpayers or citizens.

The contingent fee arrangement allows a local government to potentially realize additional revenue without incurring up-front costs. Contingent fee contracts for tax audits are not without controversy, though. Some argue there is an inherent conflict of interest with this type of arrangement; commission-based fees potentially incentivize the private auditor to arbitrarily inflate a taxpayer's liability because a larger audit assessment results in a larger payment to the auditor. For this reason, a handful of courts in other jurisdictions have determined that such compensation methods violate public policy. 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 personal properties). And a few states have prohibited or restricted the use of contingent fee audit contracts for tax audits.

New Prohibitions on Contingent Fee Contracts for Tax Audit Purposes

The General Assembly recently added North Carolina to this list. **HB 462** (as modified by Section 61.5(b) of **SB 847**) enacts two broad prohibitions related to the use of contingent fee contracts by local governments.

First, as of July 1, 2013, a county may not compensate a person or firm hired to assist the property tax assessor in the performance of the assessor's duties "in whole or in part, on a contingent fee basis or any other similar method that may

impair the assessor's independence or the perception of the assessor's independence by the public." A county, for example, will not be able to pay a private entity on a contingent fee (or similar) basis to aid the tax assessor in discovering real or personal property subject to taxation or otherwise identifying other property taxes owed to the county (or owed to any unit of government, district, or authority for which the county collects taxes). The prohibition against contingent fee (or similar) payment methods also extends to any other work that a person or firm may do to assist the county assessor.

Second, again as of July 1, 2013, neither a county nor a municipality may employ an agent to aid in determining the liability of any taxpayer for a tax "who is compensated in whole or in part by the [local government] for services rendered on a contingent basis or any other basis related to the amount of tax, interest, or penalty assessed against or collected from the taxpayer." This prohibition applies not only to property taxes, but to any taxes imposed and/or collected by a county or municipality, including (but not necessarily limited to) privilege license taxes, local sales and use taxes, supplemental school taxes, special district taxes, animal taxes, rental car gross receipt taxes, short-term heavy equipment rentals taxes, occupancy taxes, local real estate transfer taxes, prepared food taxes, motor vehicle license taxes, county vehicle registration taxes, transportation sales and use taxes, disposal taxes, and franchise taxes. Thus, if a local government hires a tax audit firm to help it identify unpaid or underpaid taxes the unit must pay the audit firm on a flat fee basis that is not tied in any way to the amount of revenue identified or collected. Under a flat fee compensation scheme, a local unit will bear some or all of the risk that no or very little additional revenue will be collected as a result of the audit firm's efforts.

Note that the prohibition against using contingent fee contracts only applies if the audit firm is determining the liability of a taxpayer for a *tax*. A local unit is free to pay an audit firm on a contingent fee basis to identify and collect additional fee or special assessment revenue owed to the unit. A municipality also may pay an audit firm on a contingent fee basis to identify misallocations of tax revenue proceeds, as long as any allocation changes do not result in changes to individual taxpayer's liability for the tax. (A county may enter into a similar agreement as long as the audit firm is not assisting the county tax assessor in any way.) For example, a local government may pay an audit firm on a contingent fee basis to determine if the unit is receiving its appropriate share of local sales and use tax revenue or state franchise tax revenue. The audit firm could not be compensated on a contingent fee basis if it discovers additional taxpayer liability while analyzing the aggregate tax revenue allocations, though. A unit would have to compensate the audit firm on a flat fee basis for that portion of the work.

Timing of New Prohibitions and Effect on Existing Contracts

HB 462, which details the substance of the contingent fee prohibitions, had an effective date of July 1, 2012. Recognizing the potential negative revenue implications to local governments, the General Assembly subsequently enacted **SB 847**, which delays the effective date of the prohibitions until July 1, 2013, and repeals the prohibitions on July 1, 2015. As of July 1, 2013, no new contingent fee based contracts may be entered into to assist a county tax assessor or to aid a county or municipality in determining a taxpayer's liability for a tax. Nor may a county or municipality renew an existing contract that employs a prohibited compensation method. Finally, the Acts appear to prohibit a local government from honoring any multi-year contingent fee based contracts entered into before July 1, 2013, once the prohibitions are triggered. Specifically, the Act provides that

[f]rom July 1, 2013, until July 1, 2015, cities and counties shall not assign further audits on a contingency fee basis to an auditing firm under a contract that meets all the following conditions: (i) the contract would have been prohibited under this act had the contract been entered into after July 1, 2013, and (ii) the contract allows the assignment of audits on a discretionary basis.



It is not entirely clear if criteria (ii) is intended to limit the prohibition's applicability to only a subset of multi-year contingent fee contracts that are entered into before July 1, 2013. In other words, it is possible that a local government may continue to honor a multi-year contingent fee contract that it enters into before July 1, 2013, as long as the contract does not allow the assignment of audits on a discretionary basis. The Act does not indicate whether "discretionary basis" refers to the local government's discretion or to the audit firm's discretion (or to both). If it refers to the audit firm's discretion only, then perhaps a unit could identify specific taxpayers to be audited in the contract or set general criteria about when audits must be conducted to remove any discretion on the part of the audit firm. If "discretionary basis" refers to the local government's discretion then it is harder to see how a contract could be structured to avoid the prohibition. The safest approach for a local government is to assume that all contingent fee payments for assisting the county tax assessor or aiding a county or municipality in determining a taxpayer's liability for a tax must cease as of July 1, 2013.

Further Study

During the temporary prohibition on contingent fee contracts for tax audit purposes, the General Assembly apparently has agreed to further study the scope, purpose, and effect of contingent fee audits and to look at the possibility of imposing limitations, such as third-party review, to mitigate against conflicts of interest or other potential abuses.

Links

- www.ncleg.net/Sessions/2015/Bills/Senate/PDF/S682v3.pdf
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-299.html
- www.ncleg.net/Sessions/2011/Bills/House/PDF/H462v4.pdf
- www.ncleg.net/Sessions/2011/Bills/Senate/PDF/S847v5.pdf