I'm not a fan of states turning tax auditing over to private companies. When I was a tax administrator, I opposed the idea whenever it came up. We fought the requirement in the Texas Legislature. That's not to say that our hands were entirely clean. We used contract auditors on some out-of-state unclaimed property audits and hired contractors to supplement our regular audit staff, although never on a contingent fee basis.

There are good reasons for not wanting private contractors auditing taxpayer records, a point on which tax agencies and taxpayers often agree. There are always worries about breaches of confidentiality, real or imagined. The agency has less-than-complete control over the contractor's business practices, and that can lead to unhappy taxpayers. And when contractors are paid according to how many dollars they assess, their aggressiveness can cause more headaches for the taxpayers and for the tax agency than whatever the actual returns are worth.

Still, it's amusing when legislators and others who are otherwise eager to sell off chunks of state government to the highest bidder squawk about privatizing even a sliver of tax auditing and collections. I thought the operative theory was that the private sector could always do a better job than government, but apparently not.

In some regards, this issue is a boat that's long since left the dock. State and local governments have been using contractors for years. One of the leading cases dealing with contingency fee auditors dates from 1991. This practice is emphatically not a recent development.

Tax agencies turn to private help for several reasons. Some do it because budget constraints mean they can’t afford the staff to keep up with the growing number of taxpayer accounts. Others do it because they’ve been told to do so by policymakers who hear the siren song of more tax revenue without new taxes, or because the policymakers have been persuaded by potential contractors, who generally can make a better case to lawmakers than they can to skeptical tax agencies, that they should require it.

The issue has been in the tax news lately because of a couple of stories. In October a class action lawsuit filed on behalf of a group of Alabama taxpayers against the state’s largest contract auditing firm and its city and county government clients survived a court challenge almost two years after the original suit was filed. On October 19 a Jefferson County Circuit judge denied in large part a motion to dismiss the case filed by the defendants in the case, Revenue Discovery Systems or RDS, formerly known as AlaTax.

RDS is a national firm that offers state and local governments tax-related services ranging from processing tax returns to conducting audits. A major reason that Alabama local governments contract with RDS is that the state gives them sales tax authority, and they hire the company because they don’t have the staff or expertise to handle the tax processing and auditing that’s required. The court case involves the company’s audit and collection activities, for which it’s paid on a contingency basis, its income tied to how much money it brings in.

The plaintiffs in the case have a long list of allegations about RDS. They allege multiple violations of the Alabama Taxpayers’ Bill of Rights and Uniform Revenue Procedures Act, including failure.
to notify taxpayers who had overpaid sales taxes of the procedures for filing a refund claim and failure to notify taxpayers of the right to an administrative appeal. Included in the complaints is a charge that the company has entered into contingency fee auditing contracts with local governments, and that it compensates its employees and independent contractors through incentive bonuses based on tax collections or assessments. The plaintiffs argue that state law doesn’t allow the firm’s employees to make assessments against taxpayers or to conduct administrative hearings for the local jurisdictions. They also allege that those agreements violate taxpayers’ due process rights and create a biased appeals process.

The case will drag on for a while, and it will be interesting to see how it comes out. Still, it sounds pretty much like business as usual where contract auditing is concerned, with all the usual taxpayer complaints plus a few that are new to me. What’s unusual — though certainly not unheard of — is that the case has landed in court.

The second news story is more interesting and also more unusual. Also in October, the National Conference of State Legislatures’ Executive Committee Task Force on State and Local Taxation of Communications and Electronic Commerce, having apparently grown bored with the online sales tax problem, passed a resolution opposing contingent fee audits. Fair enough. Maybe lawmakers have decided they don’t like hired gun auditors and will now provide tax agencies with the money and staff they need to do their jobs. The only problem is that the focus of the task force’s interest is not contract auditing but a service that wouldn’t be viewed as auditing by any tax administrator.

Maybe lawmakers have decided
they don’t like hired gun auditors and will now provide tax agencies with the money and staff they need to do their jobs.

The task force objected to a data analysis process that’s sold to states by two companies, Chainbridge Software and computer services giant ACS. The process uses specialized software to compare publicly available financial data on taxpayers to what they have reported on their tax returns to look for discrepancies — and specifically for evidence a tax agency can use as the basis of an adjustment to profits reported to the tax agency under state corporate income tax statutes. It is, in other words, a variation on the data mining that state tax agencies have been doing since the 1990s.

The focus of Chainbridge’s analysis is simple in concept but difficult to define. It’s related to one of the more ethereal concepts in tax administration, transfer pricing.

Transfer prices are the prices different companies in the same corporate group charge one another for various goods and services. Most large companies with multiple subsidiaries have any number of transactions that go on between their various components, often involving the payment of some sort of fee. Management fees, factoring fees, trademark fees, and loans are common, and companies also buy from and sell goods and other services to one another.

Transfer prices are important both for taxpayers and tax agencies because they help determine the income and expenses — and therefore taxable profits — realized by the different parts of the corporate group. States suspect, sometimes with reason and sometimes not, that companies use transfer pricing as a way of moving profits around for tax purposes. Taxpayers argue that the practice is either benign cost accounting or at most an entirely legal tax planning strategy.

The states are not alone in wondering if maybe something other than good bookkeeping is afoot. Some analysts, in fact, see the transfer pricing issues as considerably larger than the interests of a few states. Ray Baker, the director of Global Financial Integrity, a research and advocacy group in Washington, has written that transfer pricing is used by almost every multinational corporation to shift profits around the globe, and that it’s one of several strategies and loopholes used to move and hide financial flows.¹


A 2010 study of the use of transfer pricing in international tax avoidance described why nations — and not just the American states — are worried about the practice. “With the intensification of globalization, nation-states have become concerned about the malleability of ‘transfer prices’ and their role in avoiding taxes and knock on effect for public legitimacy and citizens’ life-chances,” the study said.³

The study cites various examples of the dubious use of transfer prices:

[Examining] US customs data and filings of import and export prices used by corporations . . . provide some instructive examples. Plastic
buckets from the Czech Republic have been priced at $972.98 each, a fence post from Canada at $1,853.50 each, a kilo of toilet paper from China at $4,121.81, a litre of apple juice from Israel for $2,052, a ballpoint pen from Trinidad for $8,500, and a pair of tweezers from Japan at $4,896 each. Examples of export prices include a toilet (with bowl and tank) to Hong Kong for $1,75, prefabricated buildings to Trinidad at $1,20 each, bulldozers to Venezuela at $387.83 each, and missile and rocket launchers to Israel for just $52.03 each. For the year 2001 alone, such practices may have deprived the US government of US $53.1 billion of tax revenues.

Remember, those are prices one part of a company charges another part, and the Pentagon isn’t involved.

Data like these have raised a few eyebrows in various national governments. More than 60 governments, including the United States, have transfer pricing rules that attempt to regulate the practice, and some, again including the United States, have given their revenue agencies considerable power to challenge corporate calculations.

The U.S. rules on transfer pricing are contained in section 482 of the Internal Revenue Code. The section authorizes the IRS to allocate income, deductions, credits, or other allowances between or among entities in a corporate group if that allocation is considered to be necessary to prevent evasion of taxes. For a transfer price to be valid, intercompany prices must be priced at arm’s length — in other words, it can’t be much lower or higher than the price the company might be charged by a vendor that isn’t part of the corporate group.

The first time I heard about this issue was in the 1980s. At that time, it mostly involved the movement of income between U.S. firms and their foreign components. The accounting firm where I worked did a brisk business helping companies defend against IRS transfer pricing adjustments.

It turned out, however, that the practice might not be limited to moving income around the globe but also among the states, and state tax agencies have taken an interest. Over the past several years, tax agencies in several states have been examining intercompany transactions to ensure that transactions are properly priced and that revenue and expenses are correctly allocated to their state.

Multistate companies aren’t thrilled with this development. In the April 4 issue of State Tax Notes, Cara Griffith quoted Todd Behrend, a principal with Ryan & Co. LLC, a large tax consulting firm, to the effect that given the condition of state finances, “we are likely to see states ratcheting up the audits and scrutiny on tax matters such as 482 and intercompany charges.”

Presumably a part of the ratcheting-up process could be based on the analysis provided by Chainbridge and ACS or their competitors. Once again, though, what the companies offer isn’t particularly new. Chainbridge has been offering the service for several years — since 2003, according to the company’s website. I remember meeting with CEO Eric Cook several years ago when I was in tax administration to discuss what Chainbridge offered, and he made presentations on the service at the Federation of Tax Administrators’ annual conferences in 2004 and 2005.

In his 2005 FTA presentation, Cook argued that transfer pricing had opened a sizable hole in state corporate taxes. He cited estimates from the Multi-state Tax Commission that the total loss of state corporate income tax revenue attributable to transfer pricing was $10.4 billion in 2001. Chainbridge’s research, he said, suggested that the problem was three to four times larger — so $30 billion $40 billion at a time when corporate income taxes nationwide amounted to about $32 billion. That was a decade ago. In 2010 corporate income taxes generated $38 billion nationwide — connect the dots any way you like.

Cook offered some other observations about how the issue had evolved to that point. He said that accounting and consulting firms at that time had more than 2,500 transfer pricing professionals and netted about half a billion dollars a year for their services, not the sort of money associated with just having someone around to remember that debits go on the left and credits on the right.

I’ve known Cook for many years, since he was an economist with PricewaterhouseCoopers in the late 1980s. He isn’t a tax auditor, and the services his company offers isn’t auditing. What it does is perform an analysis that calculates a particular company’s expected range of profits by comparing it with the estimated profits of comparable companies. If the income tax paid by the company is lower than the analysis indicates it should be, Chainbridge does what it calls a “transfer-pricing analysis” to see what’s needed to bring the company within the acceptable range. It turns that information over to

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26 U.S.C. section 482

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39, Doc 2011-5345, or 2011 STT 64-3.

the state tax agency and works with the state to
defend any assessments the state makes as a result,
including in court if necessary.

An example of how the agreement works was
included in a recent article in CFO Magazine. Under
a contract with the District of Columbia, ACS and
Chainbridge collect a contingency fee of 16 percent
of the tax revenue the district recovers as a result of
the companies’ analytical efforts, up to $30 million
in recoveries. They receive 14 percent of the revenue
recovered in excess of $30 million with an overall
cap of $9 million on the fees.7 Steve Cordi, the
district’s deputy CFO, said that as of last April, the
district hadn’t collected a nickel as a result of the
audits, but it had a $3 million case in litigation, with
other cases to follow. If the district ends up collecting
all the potential revenue identified by the audits to
that point, “you’re talking $50 million and up,” Cordi
said.

Chainbridge’s services originally came under fire
at the NCSL task force’s May 6 meeting, and the
source of the fire was Sutherland Asbill & Brennan LLP, a Washington law firm that specializes in
multistate tax issues. Representing Sutherland, at-
torney Stephen Kranz called Chainbridge “Magic-8
Ball bounty hunters,” which is a nice turn of phrase.
His complaint was that Chainbridge’s analysis uses
publicly available financial data instead of a compa-
y’s books and records to determine what tax is due,
which he considered inappropriate.

Consider the chain of reasoning. The financial
data are publicly available — meaning that you or I
are entitled to see them if we wish. Kranz objects
because a state might rely on an analysis based on
this hardly secret data rather than simply trusting a
taxpayer’s books alone. Why would that happen in
the pristine world of tax compliance? Well, here’s a
hypothetical: Suppose a tax agency believes there
might be some companies that cook their books to a
golden brown using culinary skills so staggeringly
complex that a regular schlub auditor might over-
look them, not understand them, or simply go cross-
eyed trying to figure them out. After all, who is a
$45,000-a-year state auditor to say how much it
costs to buy plastic buckets from the Czech Republic
when the auditor normally buys his plastic buckets
from the local Walmart?

That’s my interpretation of the complaint, al-
though I’m sure it’s actually more nuanced than I’m
making it sound. It won’t surprise you to learn that
Chainbridge denied Kranz’s characterization. Cook
made a presentation to the task force on August 8.
He insisted that Chainbridge’s patented software
uses objective economic analysis and methods based
on IRC section 482 to identify potential audit candi-
dates. “It’s literally incredible that Steve Kranz said
all these things,” Cook told Tax Analysts. “All of this
stuff is simply not true.” Unfortunately for Chain-
bridge, though, in politics, when you’re denying,
you’re losing.

In any case, Sutherland’s interest in Cook and his
merry band of alleged bounty hunters dates back at
least a few months before the May NCSL meeting,
when the topic originally came up. In an online
article last March, Sutherland told its state and
local tax readers that:

Washington, D.C., New Jersey, Kentucky, Louisi-
ana, and Alabama have entered into contracts with a bounty hunter firm resulting in
assessments that can reach $200 million.
These assessments are based on “transfer pricing” audits that ignore a taxpayer’s tax return
and instead focus on estimating a taxpayer’s
income attributable to a jurisdiction by examin-
ing financial statements and other publicly
available data. These assessments are being
challenged in Washington, D.C.

What a small world it is. It turns out that the law
firm representing the company involved in the dis-


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c_14565154.

8Sutherland, Asbill & Brennan LLP, “Bounty Hunters
Gone Wild! States Turn to Controversial Contingent-Fee
(Footnote continued on next page.)
the law firm also included New York’s new *qui tam* law, which allows private parties to sue taxpayers over allegedly unpaid taxes, as part of the scourg.

The brochure says that one of the coalition’s goals is to “work with state legislators to introduce proactive legislation prohibiting the use of contingent-fee contract audits and assessments.” I’m not sure how many companies have joined the coalition, but two months after it was announced, Sutherland was working to discredit Chainbridge’s services with the state legislators on the NCSL task force. And now here we are, a few short months later, and the task force has decided that “by contracting with third parties to conduct taxpayer audits on a contingent fee basis, governments incentivize the third-party auditor to arbitrarily inflate a taxpayer’s liability because a larger audit assessment results in a larger payment to the auditor.” The task force is also worried that “government use of contingent fee arrangements in tax audits and appeals denies the transparency that taxpayers are owed and demand, creates a perception of unfairness that undermines taxpayers’ relationships with tax administrators and fosters an atmosphere of mistrust that hinders voluntary compliance.”

The operative part of the resolution provides that “the National Conference of State Legislatures opposes the use of contingency fee arrangements for the conduct of taxpayer audits as well as arrangements with firms or organizations that rely on assumption rather than on an actual review of a taxpayer’s books and records, in tax audits and appeals.” The resolution is, of course, not binding on the states. So, it’s not mission accomplished, perhaps, but it’s a start.

As a matter of administrative practice, I am of two minds about this issue. As a practical matter, I do not, as I said, like having private contractors performing tax audits. On the other hand, I believe tax agencies have to do what they can to keep up with the rapidly evolving world around them. In this regard, I would categorize Chainbridge’s services as data analysis, not as a variation on the contingent-fee auditing — bounty hunting, if you will — that is at the heart of the Alabama court case. This controversy conflates two entirely different issues, sort of like having a chicken and a dog and calling them both roosters.

To me, there’s a clear distinction between the two services. It’s one thing to pay contract auditors directly based on how much tax they set up. That does, in fact, “incentivize the third-party auditor to arbitrarily inflate a taxpayer’s liability because a larger audit assessment results in a larger payment to the auditor,” to quote the task force. It’s another story, though, for a company like Chainbridge to provide an analysis of possible audit leads and to have its payment tied to how useful the information turns out to be. The first of those is true contingent-fee auditing, putting private-sector boots on the ground and giving them access to otherwise confidential tax records. The second is a practice called “performance-based contracting,” which states have used for years. People sometimes smirk at the idea, but it’s a way to prevent state agencies from spending millions of dollars on technology that doesn’t work — often called “vaporware” — with no choice but to pay just because it was installed on state computers. That used to happen — frequently. Performance-based contracting simply says if your product doesn’t work, then you don’t get paid, a very different sort of incentive to me. What in the name of capitalism is wrong with that?

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The difference is paying for people versus paying for information. What contingent-fee auditing businesses offer are aggressive auditors ready to find every dollar and then some, sometimes by imaginatively stretching of the tax laws. It’s understandable that taxpayers object to that practice. But Chainbridge isn’t conducting an audit. What it does is not too conceptually different from the sort of data mining that states have been doing for years, a more sophisticated version of the long-standing state practice of comparing publicly available business registration data with tax records to see if some businesses have failed to register to pay tax. In this sense, it’s an extension of a practice that states have found helpful in spotlighting potential noncompliance so they can make better use of their auditors’ time. The goal is to conduct business more efficiently — and it’s often described as doing business more like the private sector, although you can get a state-issued ballpoint pen for considerably less than $8,500 (but they usually leak).

What’s really going on here is that in the battleground that is modern tax compliance, the states may have stumbled onto a technology that tips the balance of power back slightly in their favor. The critics are absolutely right that at the moment state governments need all the revenue help they can get. However, it’s also apparent that there’s more at stake here than state tax dollars alone. Clearly, someone is more than a little anxious to see that the
balance of power isn’t shifted and that the issue of transfer pricing doesn’t draw any more scrutiny from the states than it already receives.

Clearly, someone is more than a little anxious to see that the issue of transfer pricing doesn’t draw any more scrutiny from the states than it already receives.

Where the controversy winds up is difficult to predict. It’s still early, but I would bet you the price of a plastic bucket from the Czech Republic that we haven’t heard the last of the phrase “Magic 8-Ball bounty hunters,” and we will be hearing a lot more about contingent-fee auditors in state legislatures over the next couple of years.

Editor’s Note: There is a letter from Eric Cook of Chainbridge on p. 546.

Billy Hamilton was the deputy comptroller for the Texas Office of the Comptroller of Public Accounts from 1990 until he retired in 2006. He is now a private consultant.