A Mutiny Against the Bounty Hunters Is Long Overdue

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In some contexts, contingent fee compensation arrangements may be beneficial by allowing access to otherwise unaffordable professional counsel. However, if state or local governments enter into the arrangements to render routine governmental functions, particularly revenue collection, those arrangements taint the process, raise confidentiality issues, and may result in decreased accountability and increased costs to the government.

At least partly because of fiscal and political constraints in hiring and appropriately compensating experienced personnel, however, third-party audit and collection arrangements — with all manner of compensation arrangements — have proliferated. The arrangements have been primarily in the unclaimed property and transfer pricing areas, but also have involved sales and use taxes, corporate income and franchise taxes, local business gross receipts and license taxes, personal property taxes, and utility taxes.

There has been considerable focus on the issue in the last several years. In 2011 the National Conference of State Legislatures approved a resolution opposing the use of contingent fee auditors and third-party auditors that do not rely on a taxpayer’s books and records, after concerns were raised over the “negative perception” that such audits can create. Also, a 2011 Tax Executives Institute policy statement urged states to renounce participation in such arrangements. In 2012 North Carolina passed legislation imposing a temporary ban on the use of contingent fee tax audit arrangements. The Council On State Taxation urged passage of the North Carolina legislation based on its policy 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.

Despite the support of the State Bar of Michigan’s Taxation Section and the Michigan Chamber of Commerce, similar legislation introduced to prohibit contingent fee audits failed to pass in the state in 2012.

Historical Background

Private tax collectors have been viewed with suspicion if not outright hatred throughout history. Often the animus stems from their affiliation with the conquering ruling body, but they were also

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2TEI, “Policy Statement on Contingent Fee Audit Arrangements.”
3HB 462, as modified by SB 847.
4Letter from Ferdinand S. Hogroian to Members of the North Carolina House of Representatives, “Re: COST’s Support of H.B. 462 (An Act to Limit Use of Contingent-Based Contracts for Audit or Assessment Purposes).” COST expressed its view that such audits are “distortive and wasteful,” resulting in payments for services vastly in excess of their “true value.”
derided because of odious tax collection methods. For example, Roman tax collectors were known to have “carried off by force [the tax debtors'] wives and children and the rest of their families . . . [and t]he tax collector did not release them until he had tortured their bodies with racks and wheels and had killed them with newly-invented devices of death.”

In the United States, Congress first authorized the use of private individuals to collect taxes in 1872. The provision, which authorized the secretary of the Treasury to employ up to three people to assist in discovering and collecting money due to the government, was slipped into an appropriations provision in the last hours of the legislative session. The secretary of the Treasury entered into the first contract on June 8, 1872, with former U.S. Rep. W.H. Kelsey, who had been instrumental in securing the law's passage.

Although Kelsey was not successful in collecting any taxes, another contractor, John D. Sanborn — who had a personal relationship with the then-secretary of Treasury and his successor — applied for one of the contracts to cover many taxpayers, including substantially all the railroad companies then existing, and then used the “whole power of the Internal Revenue Bureau, as well as the entire machinery of the Government for the collection of taxes.” Sanborn’s cut was 50 percent of the amounts collected, even though the government would have collected those amounts as a matter of course. The House Ways and Means Committee urged Congress to repeal the 1872 law and revoke contracts made pursuant to it, and concluded that “any system of farming the collection of any portion of the revenues of the Government is fundamentally wrong.”

In Rules by Which a Great Empire May Be Reduced to a Small One, Benjamin Franklin suggested the impropriety of contingency fee tax collectors when he sarcastically commented that tax collectors should be “composed of the most indiscreet, ill-bred and insolent as you can find” and that they be paid “large Salaries out of the extorted Revenue.” The U.S. Supreme Court has long recognized that contingent fee arrangements — particularly if the “regular administration of justice” and traditional governmental functions are involved — are highly suspect: “Agreements for compensation contingent upon success, suggest the use of sinister and corrupt means for the accomplishment of the end desired. The law meets the suggestion of evil, and strikes down the contract from its inception.” There is no question that tax collection is an essential governmental function or that eschew a right that resides in government.

The Court has also long recognized that an unfair system can lead to the denial of fundamental due process rights: “every procedure which would offer a possible temptation to the average man as a judge . . . not to hold the balance nice, clear and true between the State and the accused, denies the latter due process of law.” The Court has further recognized that the neutrality requirement of procedural due process must preserve both the appearance and reality of fairness, “generating the feeling, so important to a popular government, that justice has been done.” A decision-maker having a pecuniary interest in the outcome violates the Constitution. Further, de novo review does not cure the lack of due process, as the litigant is “entitled to a neutral and detached judge in the first instance.”

State Decisions Addressing Contingent Fee Auditors

In MacDougall v. Board of Land Commissioners of the State of Wyoming, 49 F.2d 663 (Wyo. 1935), the Wyoming Supreme Court held that a contract providing for an auditor to be paid on a contingent fee basis was not authorized by the Wyoming Constitution or statute and that the contract, “involving as it does the authority to demand and inspect books and records, and thus harass citizens or residents of this

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8Thorndike, supra note 7.
9Id.
10Id.
11Id.
12Tool Co. v. Norris, 69 U.S. 45, 56 (1865). “Generally, that all agreements for pecuniary considerations to control the business operations of the Government, or the regular administration of justice, or the appointments to public offices, or the ordinary course of legislation, are void as against public policy, without reference to the question, whether improper means are contemplated or used in their execution. The law looks to the general tendency of such agreements; and it closes the door to temptation, by refusing them recognition in any of the courts of the country.”
13Pickett v. United States, 100 F.2d 909, 911 (8th Cir. 1938), cert. denied, 306 U.S. 647 (1939). “It is not disputed that taxation and the collection of taxes are essential governmental functions.”
14Cunnion v. Reading School Dist., 198 U.S. 458, 469 (1905). “The right to regulate concerning the estate or property of absentee is an attribute, which, in its very essence, must belong to all governments.”
15Tumey v. Ohio, 273 U.S. 510, 532 (1927). See also In re Murchison, 349 U.S. 133, 136 (1955). “A fair trial in a fair tribunal is a basic requirement of due process . . . . But our system of law has always endeavored to prevent even the probability of unfairness.”
18Id. at 61-62.
state," was invalid. The court said that delegating a vested duty to another amounted to the usurpation by the executive department of a legislative function. Another fundamental reason offered by the court for striking the contract was that it “discourages diligence and honesty in public officials,” allowing them to “act merely perfunctorily” regarding their duties, and that the state “might [be] deprive[d] . . . of large amounts of money” and “might easily open wide the door to fraud.”

The Georgia Supreme Court has held a contingency fee audit contract void as against public policy in the absence of express legislation authorizing the contract. The court held that “fairness and impartiality are threatened where a private organization has a financial stake in the amount of tax collected as a result of the assessment it recommends.” However, when the state General Assembly had specifically authorized contingent fee auditors, the North Carolina Supreme Court held that the contract was not void as against public policy. Likewise, although the Pennsylvania Commonwealth Court concluded that the due process argument had not been timely raised, it found that because the legislature did not prohibit contingent fee agreements in the context of tax audit and collection as it had done in some other situations, such as providing real estate valuation services, such agreements did not violate public policy.

Similarly, the Kansas Supreme Court reversed a taxpayer-favorable decision and earlier decisions that had voided contingency fee compensation arrangements. In Dillon Stores v. Lovelady, 855 P.2d 487, 491 (Kan. 1993), an accounting firm was hired to identify property tax filers with a high probability of either omitting or undervaluing their taxable personal property. The court found that the county was authorized by law to employ the private accounting firm. The court distinguished two of its earlier decisions, rendered in 1908 and 1939, which rejected the use of “tax ferrets” on the basis that statutory authority was absent. It also rejected its earlier decisions’ view that those contracts violated public policy, stating that the “tax ferret’ metaphor is not applicable to contemporary situations.

However, the 1908 decision, in finding that the use of contingency fee tax auditors was a violation of public policy, appropriately appreciated the lessons of history: “The experiences of the past, however, have been such that it is impossible to contemplate any civilized community, with a knowledge of its history, reviving the odious practice.”

In Hubbell Inc. v. City of Bridgeport, Nos. 304607 and 304608 (Conn. Super. Ct. 1996), aff’d, 692 A.2d 765 (Conn. 1997), a Connecticut taxpayer challenged a personal property tax assessment performed by a private firm hired by the city. The contractor was paid a flat fee of $375 per account, plus 25 percent of additional taxes assessable by the city arising from the contract auditor’s efforts. The trial court left little doubt as to its scathing view of contingency fee arrangements. It found the testimony of a principal of the contractor to have little credibility and the audit method used by the contractor “so indefensible and its interest in distorting data so evident that the evidence and testimony it presented is not worthy of belief.”

In dicta, the court strongly suggested that due process is violated even if the assessment was subject to a de novo review “where, as here, there is no genuine and independent review by an official who is untainted by such terms for compensation.” The Connecticut Supreme Court affirmed, but explicitly declined to address the trial court’s dicta.

In another case, Yankee Gas Co. v. City of Middletown, No. X07-CV960072560S (Conn. Super. Ct. 2001), the Connecticut Superior Court reviewed an agreement between a municipality and a private audit firm — having the same principals as the firm involved in Hubbell — for personal property revaluation audits in which the audit firm’s compensation was based on a percentage of the additional tax revenue collected as a result of the audits, and the municipality could not compromise any claims for taxes discovered by the firm without involving the firm in discussion. The court found that the agreement violated due process. It relied on Tumey v. Ohio, 273 U.S. 510, 532 (1927), in finding that “the risk of a due process violation is inherent” when the person determining the tax liability has “a direct financial interest in the amount of tax assessed.”

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25 MacDougall, 49 P.2d at 667, 669.
26 State, ex rel. Coleman, 95 P. at 394.
28 Id. at 15.
29 Yankee Gas Co., No. X07-CV960072560S at 32-33. The court appeared troubled by the private auditing firm’s failure to be certified in revaluation (a statutory requirement), its inexperience in utility property valuation (the assessed companies were utilities), and subcontracting to individuals also lacking in requisite experience. Further, instead of subcontracting for audit services, as provided in its consulting agreement, the subcontractors were required to perform a particular study based on only a single valuation method. The (Footnote continued on next page.)
Louisiana has long provided for revenue collectors to employ private counsel to assist in tax collection and to receive a percentage of the haul directly from the taxpayer.\textsuperscript{30} The Court of Appeal, however, recognized that an award of attorney fees is penal in nature and rejected the Department of Revenue’s collection of attorney fees when the taxpayer entered into a multiyear settlement and obtained a refund.\textsuperscript{31}

There is a lack of consensus among states regarding the propriety of ferrets. However, there appears to be a trend toward court acceptance of the practice despite the potential danger for abuse.

**Government Restrictions on Contingent Fee Arrangements**

When the shoe is on the other foot, the government has strenuously — and in a wide range of contexts — limited or prohibited contingency fee compensation arrangements. For example, the IRS’s Circular 230, which regulates the practice of attorneys, CPAs, enrolled agents, enrolled actuaries, and appraisers appearing before it, provides generally that “a practitioner may not charge a contingent fee for services rendered in connection with any matter before the [IRS].”\textsuperscript{32} Moreover, the breadth of the Circular 230 prohibition has expanded over time, in part to conform to concerns of attorney and auditor independence.\textsuperscript{33}

One of Circular 230’s limitations on the use of contingency fee arrangements is for pre-examination refund claims made “solely in connection with the determination of statutory interest or penalties”; practitioners cannot file refund claims for tax amounts on a contingent fee basis.\textsuperscript{34} A challenge to the tax refund claim restriction is pending before the District of Columbia district court, on the basis that the restrictions exceed Treasury’s authority under the federal law authorizing Treasury’s right to regulate practice before the IRS.\textsuperscript{35}

South Carolina, which by statute has substantially adopted Circular 230, has ruled that practitioners could be suspended or disbarred from South Carolina administrative tax practice if they violate Circular 230’s contingency fee limitations.\textsuperscript{36} South Carolina regulators, focusing on an accounting firm’s use of impermissible contingent fee arrangements in connection with its promotion of some tax-advantaged investment strategies, even considered barring the entire firm from representing taxpayers before the DOR.\textsuperscript{37} The DOR eventually sought to disbar 14 of the firm’s professionals.\textsuperscript{38}

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\textsuperscript{31}Bridges v. Lyondell Chemical Co., 938 So. 2d 786 (La. Ct. App. 1st Cir. 2006).

\textsuperscript{32}31 C.F.R. section 10.27(b)(1). Contingent fee is defined under section 10.27(c)(1) as “any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the [IRS] or is sustained either by the [IRS] or in litigation. A contingent fee includes a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved, or that otherwise depends on the specific result attained. A contingent fee also includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client’s fee in the event that a position taken on a tax return or other filing is challenged by the [IRS] or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.”

Exceptions to the bar against charging contingency fees apply if the services relate to the IRS’s examination of, or challenge to (i) an original tax return or (ii) an amended return or claim for refund or credit when the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to, the original tax return. 31 C.F.R. section 10.27(b)(2). Contingency fees can also be charged for refund claims filed regarding interest or penalties assessed by the IRS and in judicial proceedings. 31 C.F.R. section 10.37(b)(3) and (4).

\textsuperscript{33}The IRS explained:

The Treasury Department and the IRS continue to believe that a rule restricting contingent fees for preparing tax returns supports voluntary compliance with the Federal tax laws by discouraging return positions that exploit the audit selection process. Additionally, a broader prohibition against contingent fee arrangements is appropriate in light of concerns regarding attorney and auditor independence. The recent shift toward even greater independence, including rules adopted by the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board, also support expanding the prohibition on contingent fees with respect to Federal tax matters. 71 F.R. 6421 (2006).

\textsuperscript{34}31 C.F.R. section 10.27(b)(3).

\textsuperscript{35}Ryan LLC v. Geithner, Civ. No. 1:12-cv-00565 (D.D.C. 2012). Morrison & Foerster represents the plaintiffs in this case. In Loving v. IRS, 917 F. Supp. 67 (D.D.C. 2013), the court held that the federal statute, 31 U.S.C. section 330, did not authorize the IRS to regulate “preparing and signing tax returns and claims for refund, and other documents for submission to the Internal Revenue Service.” Practice, according to Loving, meant “presenting a case” before the IRS.


\textsuperscript{38}See Stein v. South Carolina Dep’t of Revenue, 2005-CP-40-027111 (S.C. Common Pleas 2005), which enjoined the DOR from disbarment proceedings against one of the 14 KPMG professionals, since he never represented any South Carolina taxpayers.
Arizona passed legislation restricting the ability of cities and towns to outsource tax auditing functions to private companies if payment would be made on a contingency fee basis. However, Revenue Discovery Systems, a company providing services to 750 municipalities, opposed the bill, claiming that it “establishes a government-run monopoly.” Proposed California legislation would have prohibited contingent fee payment structures and imposed a penalty with no prepayment right of review on those who violated the prohibition. One stated rationale for the bill was that contingency fee arrangements provide “a strong incentive to play fast and loose with rules.”

Minnesota, on the other hand, proposed legislation in 2011 to authorize the revenue commissioner to enter into a two-year contract with a third party under a “performance-based compensation system” to “enhance the state’s ability to identify and collect tax revenues from taxpayers that are using abusive transfer pricing schemes.” Another Minnesota bill from the same 2011-2012 session would have required the revenue commissioner to contract to “improve the success rate and the return on investment” of auditors, but would have explicitly prohibited contingency contracts.

Pennsylvania recently enacted legislation prohibiting the use of third-party auditors paid on a contingency fee basis in field audits. In the public accounting arena, restrictions against contingency-based compensation in connection with the audit, attest, or assurance function is the global norm. Also, most states prohibit contingent fee agreements in connection with government lobbying activities.

### Third-Party Transfer Pricing Audits

Although perhaps not a traditional contingency fee audit situation, states have outsourced routine audit analytical functions to third parties with a

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41SB 342; California FTB, “Analysis of Amended Bill, SB 342” (2011); California Senate Governance & Finance Committee, “SB 342 Bill Analysis.”
42California Governance & Finance Committee SB 342 Analysis, supra note 41.
43Minnesota HF 904.
44Minnesota HF 174.
45Pa. Act No. 71 of 2013 (SB 591, PN 1328).
46See, e.g., Public Company Accounting Oversight Board Rule 3521 (“A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission.”); American Institute of Certified Public Accountants Code of Professional Conduct, ET sections 302, 503; Financial Reporting Council’s Auditing Practices Board, Para. 96; Ethical Standards 5 (governs practice in United Kingdom); International Ethics Standards Board for Accountants Draft Code section 290.
47New Jersey’s Legislative and Governmental Process Activities Disclosure Act prohibits entering into agreements if a governmental affairs agent receives compensation that “is made contingent upon the success of any attempt to influence legislation, regulation or governmental process.” N.J.S.A. section 52:13C-21.5. Numerous challenges have been made over the years regarding the viability of contingent fee agreements in the lobbying context. See, e.g.:

- **Hogston v. Bell**, 112 N.E. 883, 885 (Ind. 1916), which distinguished between contingent fee agreements in which services are rendered before a legislative body and agreements in which the fee was contingent on the success in obtaining the legislation, and concluded that the former was valid, but the latter was “so tainted with illegality as to render it void,” and further concluded that the contract in question was valid because success could also result from the attorney’s actions without legislative action;
- **ACT Realty Co. v. Rotemi Realty Inc.**, 863 So. 2d 334 (Fla. Dist. Ct. App., 3d Dist. 2003), which held that under **Hialeah Gardens, infra**, the real estate contract with the school district on a contingent fee basis was void as a matter of public policy; dissent states that the court’s decision is contrary to **Robert & Co. v. Mortland**, 33 So. 2d 732 (Fla. 1948), which had held that contracts whose fees are contingent upon securing contracts from public officials are not illegal on their face; a finding of illegality must be based upon the fact that the result was induced by favors or corrupt means;
- **City of Hialeah Gardens v. John L. Adams & Co.**, 599 So. 2d 1222 (Fla. Dist. Ct. App., 3d Dist. 1992), which held that contingency contracts for influencing public officials were against public policy, citing **Tool Co. v. Norris**, 69 U.S. 45 (1865); and
- **Wechsler v. Novak**, 26 So. 2d 884 (Fla. 1946).

performance-based compensation model. A prominent example of that is in the transfer pricing area. Several states listed on the Chainbridge Software LLC website as past and present clients — Alabama, Minnesota, California, Connecticut, Kentucky, Louisiana, Maine, New Jersey, Rhode Island, and the District of Columbia — contracted indirectly with Chainbridge, a company that patented ComplianceLinks, promoted as a “system and method for analyzing tax avoidance.” Chainbridge reported that in the last nine years it performed “over 70 IRC section 482 audits,” approximately a third of which were for New Jersey. However, Chainbridge’s CEO said that 60 percent of the 70 audits were settled and that 10 percent were vacated.

Interestingly, the patent application asserts that “states are not normally equipped to go up against large corporations” and that “an independent party, with expertise in the tax field, may scrutinize individual corporate taxpayers’ tax liability and execute an accurate and detailed transfer pricing analysis more efficiently than tax collecting entities.” However, computerized economic or statistical modeling based on third-party data — which appears to underlie Chainbridge’s “audit” — is not a substitute for a true transfer pricing study that comports with the IRC section 482 requirements, regardless of the number of computer operations, processes, and drawings the “invention” details.

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49U.S. Patent No. 7,716,104 (U.S. Patent & Trademark Office May 11, 2010). The patent abstract explains the patented system as follows: “A taxpaying entity’s financial information may be analyzed and used to compute a set of one or more financial ratios based at least in part on the entity’s return on assets, capital, sales, and/or operating expenses. Those ratios may be compared to corresponding ratios for related firms operating in a predefined industry to identify whether the taxpaying entity engages in tax avoidance. The level of the taxpaying entity’s tax avoidance may be calculated from analysis of the taxpaying entities’ controlled transactions. An adjusted tax liability may be produced after re-distribution, re-apportioning, or re-allocation of income, deductions, credits or allowances.”
52U.S. Patent No. 7,716,104.
53Chainbridge Software LLC claims that its economist’s reports “provide detailed explanations of how the IRC section 482 regulations were applied, and numerous references to specific sections of the IRC section 482 regulations are made throughout.” (Cook, “Chainbridge CEO Responds to Third-Party Audit Letter,” supra note 50.) Also surprising is the use of criteria to determine whether “tax collection is desirable”: “Very low tax adjustments may not be pursued because they may not be worth the effort, while very large tax adjustments may not be pursued because they may lead to great resistance and expensive litigation with the taxpaying entity.” U.S. Patent, supra note 52.
54David M. Katz, “State Insecurity: Faced With Alarming Budget Shortfalls, States are Pursuing Corporate Tax Dollars in New and Aggressive Ways,” CFO.com, Apr. 1, 2011. This article reports that ACS was to be paid 16 percent of the tax revenue recovered up to $30 million and 14 percent thereafter with a cap of $9 million.
55Id.
57Id.
58Id.
60Id.
appealed or other challenges would lead the OTR to abandon its transfer pricing efforts, but it may encourage Chainbridge to modify its patented model to conform to Treasury's regulations.

While Chainbridge's CEO maintains that it is hypocritical for taxpayers to be able to use transfer pricing experts while states cannot, he fails to appreciate that taxpayers with intercompany transactions have little choice but to have costly transfer pricing studies prepared, because states routinely question those transactions and taxpayers generally have the burden of establishing that the intercompany pricing is appropriate. In practice, states already have a potent arsenal of weapons to use against taxpayers when they believe intercompany transactions are abusive: business purpose; economic substance or sham transaction doctrines, which are applied to ignore intercompany transactions and/or force combinations; and addback provisions.

Paying substantial fees to a contractor to identify audit targets and having dueling transfer pricing "studies" under IRC section 482 (assuming that Chainbridge's reports qualify, which is a stretch given what occurred in Microsoft), does not seem to be the best use of states' limited resources. New Jersey may have reached that conclusion; the Division of Taxation is reportedly not renewing its contract with Chainbridge to provide transfer pricing services.

The Massachusetts Senate recently rejected a proposal to authorize hiring contingent fee auditors using "computer technology and data mining to detect fraudulent returns." One senator voiced his objection to the provision and stated that "an auditor should remain purely objective. The purpose of a tax audit should only be to verify that the tax as reported by the citizen of the commonwealth is correct, [and] there should be no sort of incentive to find incorrect reporting."

Further, transfer pricing adjustments are generally made through states' discretionary adjustment provisions, which should be used only to address unusual situations and should require a heightened degree of scrutiny, making the use of a third-party ferret particularly questionable.

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65 Id.
68 Id. Originally, the case had been brought in state court, but it was removed by defendants to federal district court. However, the federal court dismissed the case without prejudice due to the lack of subject matter jurisdiction under the federal Tax Injunction Act (TIA), 28 U.S.C. section 1341. Washer & Refrigeration Supply Co. Inc. v. PRA Gov't Servs. LLC, No. 2:09-CV-1111-WKW (M.D. Ala. 2010). The court rejected the defendants' argument that the TIA did not apply since they are private parties, finding that "the question is whether the 'relief requested . . . will enjoin, suspend or restrain a state tax assessment.'"

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Third-Party Tax Audits

Most states have their own tax departments and do not retain third-party auditors to perform routine audit functions. However, counties and municipalities that lack those resources may turn to bounty hunters to fill the void.

One example involves Alabama counties and municipalities. Although Alabama provides that the contract and assessments resulting from the contract will be void and unenforceable.

Ongoing litigation in Alabama is challenging the use of a contract auditing firm, PRA Government Services, LLC d/b/a Revenue Recovery Systems and Alatax (RDS), by approximately 250 Alabama municipalities and counties. Plaintiffs allege that because RDS was paid on a contingency fee basis and was involved in both determining and collecting the taxes, RDS was in violation of the Alabama Code section 40-2A-6(a).

Recently, the Alabama Circuit Court refused to dismiss the complaint, finding that the taxpayer plaintiffs had a right to seek a declaration of their rights under Alabama's Taxpayer Bill of Rights and were not first required to exhaust their administrative remedies because they were not seeking a review of the amount of an assessment, but rather its efficacy. The court also rejected RDS's claim that the plaintiffs' due process claims should be dismissed because RDS is a private entity and not an arm of government.

Third-Party Unclaimed Property Audits

In unclaimed property audits, the use of contract auditors has become routine, with some particularly deleterious results for businesses. Although unclaimed property assessments are not tax assessments, the impact of an unclaimed property third-party contract audit to a business's bottom line can be devastating, particularly given the aggressive
audit techniques used lately by some contract auditors. Further, the confidentiality protections afforded to taxpayers may not exist under unclaimed property statutes and, unless a confidentiality agreement is swiftly put in place after the initial contact, there is little to stop a ferret from using the information it gleaned during another state audit and notifying other states that a business may be ripe for an unclaimed property audit.

An example from Delaware involving McKesson Corp. highlights the plight of businesses subject to scrutiny by third-party auditors in the escheat context. In *McKesson Corp. v. Cook*, No. 4920-CC (Del. Ch. 2009), the company sued Delaware after it received an assessment of more than $4.5 million for unclaimed property — inventory for which vendors never issued invoices — that allegedly had not been remitted for the years 1989 through 2003, based on an audit performed by a third-party auditor, Kelmar Associates. The complaint alleged that the position taken by the auditor — that inventory consisting of excess quantities or free goods shipped without any intent of receiving payment was subject to escheat — was unprecedented.69

Even though McKesson could establish that most of its vendors were located outside Delaware officials and the Division of Revenue (and therefore under U.S. Supreme Court priority rules would be subject only to escheat by the state of the vendors’ last known addresses), the auditor included the entire estimated amount in its assessment to McKesson.70 Legislation was enacted in 2010 to create a limited exemption for property that a merchant holder receives from a vendor without invoice and to confirm that the state was even authorized to use estimation techniques to determine unremitted unclaimed property.71 The case was reportedly settled, leaving for another day the propriety of the assessment based on a third-party auditor’s use of estimates.

Another day may come soon. Select Medical is challenging the use of estimation techniques by the same third-party unclaimed property auditor, Kelmar.72 Select Medical participated in a voluntary disclosure program offered by Delaware and it remitted unclaimed property to Delaware for 1997 through 2001.

Delaware — as it often does on the heels of a voluntary disclosure submission — proceeded to audit Select Medical. Although Select Medical made its

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69Complaint in *McKesson* at paras. 23 and 55.
70Id., at paras. 81, 100, 103, and 104.
71SB 272.