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STATEMENT OF ASSOCIATED INDUSTRIES OF MASSACHUSETTS BEFORE SENATE CHAIR JOAN B. LOVELY, HOUSE CHAIR PETER V. KOCOT AND MEMBERS OF THE JOINT COMMITTEE ON STATE ADMINISTRATION AND REGULATORY OVERSIGHT IN STRONG SUPPORT OF S.1710, AN ACT TO ELIMINATE CONTINGENCY FEE AUDITORS.

On behalf of Associated Industries of Massachusetts (AIM), the state's largest nonprofit, nonpartisan association of Massachusetts employers, I am Bradley A. MacDougall, Vice President for Government Affairs. AIM, which represents employers in virtually every sector of the Massachusetts economy, wishes to express strong support for S.1710, An Act to Eliminate Contingency Fee Auditors.[1] AIM urges the committee to provide S.1710 with a favorable report.

AIM's mission is to promote a healthy business climate supportive of private-sector job creation throughout Massachusetts. We advocate for fair and equitable public policy, and provide relevant, reliable information and excellent services on behalf of our thousands of members throughout the Commonwealth.

S.1710 is a legislative priority for AIM. We seek to improve the state's administration of audits, enforcement, litigation and dispute resolution of tax laws. Massachusetts currently allows the use of contingent fee auditors, most notably for abandoned property issues .

S.1710 would eliminate the ability for any state agency or constitutional officer to enter into contingent fee contracts with tax auditors and experts for the purposes of determining the liability of any taxpayer for any tax or defending the state department of revenue's or state treasurer's position during the course of a dispute, mediation or litigation.

What is abandoned property? 'Abandoned property' includes all intangible and tangible property held for a period of time by someone who is not the rightful owner, such as dormant bank accounts, un-cashed payroll checks, unclaimed insurance policy or retirement benefits, or personal belongings left at a funeral home, hospital, hotel, gym, etc.[2]

AIM is very concerned about the impact of aggressive collection and audits of abandoned property on the state's business climate. The use of contingent auditors adds an unfair financial, administrative or compliance burdens for businesses of this state, particularly if such costs are not

[1] https://malegislature.gov/Bills/189/Senate/S1710
[2] Definitions: http://www.mass.gov/treasury/unclaimed-prop/regulations/402-definitions.html and Regulations: http://www.mass.gov/treasury/unclaimed-prop/regulations/ M.G.L. https://malegislature.gov/Laws/GeneralLaws/PartII/TitleII/Chapter200A

transparent and the underlying public policy is not intended to raise revenue. In the tax arena, Massachusetts is considered unfriendly to businesses despite the numerous tax cuts enacted over the past decade because of the way our tax laws are administered. We are bringing our concerns to your attention in the hopes this state won't continue to suffer the same fate with respect to abandoned property.

As background, over 15 years ago, AIM worked collaboratively to improve the state abandoned property by working closely with Treasurer Shannon O'Brien.[3] In 2000, the legislature passed and Governor Paul Celucci signed H.5365 amending Chapter 200A of the Massachusetts General Laws. S.1710 seeks to improve upon those reforms by seeking a more fair and equitable way for the Commonwealth to administer and enforce such laws by banning the use of contingent auditors. The Treasurer's drive to reform the state laws was driven by a belief that abandoned property "should not be about generating money for the state." [4] The Commonwealth's current use of contingent auditors is an aggressive and unfair mechanism where "contract" auditors are incented to maximize tax liability in order to boost their fees. 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. This undermines the public trust in government.

Also, the Senate has already taken action to prevent the Department of Revenue (DOR) to engage in contingent fee audits. During the FY14 Senate budget debate, legislators chose to strike out section 28 (Addendum #1) of the outside sections that would have enabled the DOR to engage with contingent contract agreements for tax revenue maximization.[5] At the time, John Regan, Executive Vice President for Government Affairs argued that "The proposal was bad public policy," and "An auditor should have no financial stake in the outcome of an audit. The conflict of interest is readily apparent and should trouble policy makers concerned about tax fairness and Massachusetts reputation for its tax climate."

AIM's arguments during that debate are most relevant for this legislation:

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[3] May 8, 2001 testimony by Eileen P. McAnneny, Senior Vice President for Government Affairs "On behalf of A.I.M., let me begin by commending the Treasurer and her capable staff for working diligently to improve the process of reporting abandoned property. A.I.M. is delighted that Treasurer O'Brien recognized early in her tenure the need to reform past practices of handling abandoned property. The Treasurer convened a Task Force to comprehensively review the whole issue of abandoned property and after several meetings to discuss solutions, filed legislation that made several important changes to Chapter 200A, the law governing abandoned property. The treasurer worked hard to make sure the legislation was enacted and when enacted, that it was fairly implemented."

[4] http://www.mofo.com/resources/publications/2009/10/massachusetts-high-court-rejects-retroactive-esc_

[5] http://blog.aimnet.org/AIM-IssueConnect/bid/91463/Senate-Budget-Omits-Dangerous-Contingent-Contract-Provision

- Like the United States Internal Revenue Service (IRS), the Massachusetts Department of Revenue (DOR) must administer and enforce the tax code impartially. Any enforcement must ensure confidence and trust that the tax code is being applied fairly to each taxpayer. To do otherwise undermines public confidence in the tax system and in government in general. The risk of abuse creates a perception of unfairness that colors taxpayers' relationships with administrators and creates an atmosphere of mistrust that hinders compliance.

- This provision, which allows the groundwork for the Massachusetts Department of Revenue to hire financially incentivized contractors, would directly violate the fair and consistent application of the Massachusetts tax code. Transforming tax auditors into "bounty hunters" creates an inherent conflict of interest; commission-based fees potentially 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 purpose of a tax audit should be to verify that the tax reported is correct – nothing more. Contingent based auditing threatens a fair and impartial evaluation of tax.

- 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.[6] Experience elsewhere tells us that in practice, auditors in these types of arrangements tend to subordinate tax law, code and precedent to presenting the highest possible liability and forcing the taxpayer to negotiate down. They may "cherry pick" audit targets and ignore taxpayer errors that would result in lower assessments. A contingent-fee auditor is disincentivized to enter into a settlement discussion or act objectively in an effort to reach an appropriate compromise with the taxpayer.

- In states that have these arrangements there are often breaches of confidentiality.[7]

- The National Conference of State Legislatures (NCSL) Task Force has passed a resolution calling on governments to end the use of contingent fee arrangements.[8] Some competitor states such as North Carolina and Ohio have advanced legislation to ban state revenue agencies from using contingent auditors. The U.S. Securities and Exchange Commission (SEC) has explicitly ruled that the use of contingent fees in tax matters for audit clients is prohibited.

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[6] COST http://www.cost.org/uploadedFiles/About_COST/Policy_Statement/Government%20Utilization%20of%20Contingent%20Fee%20Arrangements%20in%20Tax%20Audits%20and%20Appeals.pdf

[7] Tax Analyst http://www.ryan.com/Assets/Downloads/Articles/This_Gun_for_Hire.pdf

[8] NCLS http://www.ncsl.org/documents/standcomm/sccomfc/ContingencyFeeAuditResolution.pdf

The American Institute of CPAs Standards and Code of Professional Conduct prohibits performance of an audit which reviews financial statements to be paid on a contingent fee basis. (Rule 302.)

- This provision appears to violate in spirit or letter not only the current law banning application of "individual production quotas or goals" to DOR employees "involved in tax collection activities,"[9] but also the state's independent contractor law and 3-prong test, and the Pacheco law governing "privatization contracts" under which "a non-governmental person or entity agrees with an agency to provide services."

- Contrary to what some proponents have stated, there is nothing in the proposed language limiting application of this process to any particular class of taxpayers; not to restrict its use to the identification of fraud.

- This language further erodes the confidence the business community has in the administration of tax policy in the Commonwealth. Tax rates aside, Massachusetts is consistently ranked at the bottom among all states, by national tax groups and by publications such as CEO Magazine and CFO, for tax code administration, audits, and the timeliness of legal adjudication of tax disputes. This notoriety is an economic disadvantage we should address, not something we should make worse.

To highlight these points, directly below is a recent example from an AIM member company on why Massachusetts needs to ban contingent fee auditors:

> *"Two of the challenges that come to mind regarding our experience with the contingent auditors are the duration of the examination and lack of an audit tolerance or reasonableness standard. The contingent auditors lacked any sense of urgency since they can afford to drag it out and continue to dig until they find something to criticize. In our case, the audit began in the summer of 2013 and we continue today (2015) to research and correspond on audit requests.*
>
> *Whereas a typical non-contingent fee audit could be wrapped up fairly quickly if relatively clean, there is just no incentive for this to occur with a contingent fee audit. Along these same lines, there is no concern about the workload thrust upon company personnel. For companies that just can't afford to allocate the required resources to support the audit, it provides quite a bit of leverage for an auditor to encourage a one-sided settlement.*

[9] Sec 7 of Chapter 14 http://www.malegislature.gov/Laws/GeneralLaws/PartI/TitleII/Chapter14/Section7

> *Another aspect to such an audit is the lack of an audit tolerance, otherwise known as a "materiality threshold." The audit is designed to result in a monetary award, so no dollar amount is considered too small to pursue. In our case, we have gone back and forth with the auditors to explain $57 and $27 transactions from several years ago. Non-contingent fee audits would generally have a "reasonable assurance" standard that is the audit is designed to provide reasonable assurance that the reporting is accurate. In my observation, the contingent fee auditors are working with an "absolute assurance" standard. As evidence, we were given a list of 500 items to research and told that if any item was not satisfactorily explained, we would also be required to research and explain 1,000 more items. The older the items that are being researched, some 15-20 years back) the more likely it is the documentation is not perfectly maintained – and the easier it is for the contingent fee auditor to conclude that the item was not satisfactorily explained.*
>
> *While Massachusetts has reformed the underlying abandoned property laws, the Commonwealth is still an outlier for its enforcement and audits where some can last 7-8 years and cost $500,000-$1,000,000 to defend against."*

For the committee's further review, AIM urges members to review the Council on State Taxation (COST) survey and the U.S. Chamber of Commerce report on the abandoned property. These reports highlight many of the ongoing concerns with contingent auditors. Some highlights from the COST survey include:

- "My company has had an unclaimed property policy in place for decades, and we have reported to all states for decades… But from the beginning of this exam, the approach is that we don't comply and we're hiding that non-compliance somehow."
- "Kelmar is requesting huge amounts of data, some of which is not generated in normal course of company operations and thus – to the extent the request is reasonable – is generated by our IT group via special project printouts."
- "More than 3,700 man hours of internal resources were needed to respond to audit requests."
- "We have not received any sampling workpapers from Kelmar… [however], in regard to [audit cost], we are already well over the $1,000,000 mark."
- Over 67% said they have considered reincorporating outside of Delaware due to that state's use of contingent fee auditors

These and other comments are instructive around the methodology employed by the contingent fee unclaimed property auditors, and how they cause taxpayers to incur substantial costs on prolonged audits.

The U.S. Chamber of Commerce's Institute for Legal Reform's report *Unclaimed Property: Best Practices for State Administrators and the Use of Private Audit Firms*[10] which identifies a series of "best practices" for unclaimed property administrators to use when hiring private audit firms, including:

- Prohibiting contingency fees;
- Requiring all state contracts for private audit firms to be subject to an open competitive bidding process;
- Requiring all such contracts to be posted on the unclaimed property administrator's website; and
- Prohibiting the delegation of state authority to private audit firms for substantive decision-making, such as legal theories.

Thank you for taking AIM's views into account and urge the committee to provide S.1710 with a favorable report. Please feel free to contact me if you have any questions or need any further information.

[10] http://www.instituteforlegalreform.com/uploads/sites/1/BestPractices.pdf

Addendum #1

SW&M FY14 Outside Section

Contingent Contracts and Agreements for Tax Revenue Maximization

SECTION 17. Chapter 14 of the General Laws is hereby amended by inserting after section 3A the following section:-

Section 3B. (a) Notwithstanding any general or special law to the contrary, the commissioner may enter into contracts or interdepartmental service agreements for the purpose of identifying and pursuing increased tax revenue collections. The payments or oversight costs or fees related to this section may be paid from the revenues collected, under standards established by the commissioner, without further appropriation, and the comptroller shall establish accounts and procedures to accomplish the revenue generation purposes of this section. Under such standards, compensation may be added to the amount of the tax and collected as a part thereof by the contractor or agency and may be deducted and retained by the contractor or agency from the amount of tax collected or paid by the commonwealth.

(b) The commissioner shall notify, in writing, the house and senate committees on ways and means 60 days before entering into any contract or interdepartmental service agreement authorized under this section.

(c) The commissioner shall, as part of the commissioner's annual report under section 6, list all agencies, individuals, companies, associations or corporations with whom the commissioner has agreements for identifying and pursuing increased tax revenue collections during the fiscal year and the amount of taxes collected by and the compensation paid to each such agency, individual, company, association or corporation.

Current Language in M.G.L.:

Office of the Comptroller (Chapter 29: Section 29E) Maximum reimbursement for project costs

Section 29E. Notwithstanding any general or special law to the contrary, the comptroller may enter into contracts or interdepartmental service agreements for the purpose of identifying and pursuing increased revenue collection, cost avoidance, the maximum reimbursement opportunities for certain federally assisted and other programs of the commonwealth and any other reimbursements of

overpayments or other revenues. The contractor payments, or oversight costs or fees related to this section shall be paid from the revenues or reimbursements collected, or as otherwise considered appropriate by the comptroller, without further appropriation, and the comptroller shall establish accounts and procedures within the affected departments as the comptroller considers appropriate and necessary to accomplish the revenue generation purposes of this section. The comptroller shall notify, in writing, the house and senate committees on ways and means 60 days before entering into any contract authorized under this section. The comptroller shall report on said projects as a part of the comptroller's annual report under section 12 of chapter 7A.

DOR Authority to Collect "Unpaid Taxes" (Section 3A of Chapter 14**)**

Section 3A. For the purposes of collecting certain taxes, the commissioner is authorized to enter into agreements with one or more private persons, companies, associations or corporations doing business in the commonwealth to provide collection services within and outside the commonwealth with respect to unpaid taxes. No such agreement shall be entered into unless proposals for the same have been invited in accordance with regulations governing the procurement by state agencies of contracts of similar value. All such proposals shall be opened in public. The commissioner may reject any or all of such proposals. The commissioner shall not assign the account of any taxpayer to a private collection agency until such taxpayer has been sent a notice at least thirty days prior thereto, of the intention of the commissioner to so assign the collection of such unpaid taxes of such taxpayer. Any such agreement may provide, in the discretion of the commissioner, the manner in which the compensation for such services wil be paid. Under standards established by the commissioner, such compensation shall be added to the amount of the tax and collected as a part thereof by the contractor; deducted and retained by the contractor from the amount of tax collected; or paid by the commonwealth from the amount of tax collected without further appropriation therefor.

The commissioner shall, as part of his annual report under section six list all private persons, companies, associations or corporations with whom the commissioner has agreements for collection services during the fiscal year and the amount of taxes collected by and the compensation paid to each such person, company, association or corporation.

Addendum #2

Senate Budget Omits Dangerous Contingent Contract Provision

Posted by Brad MacDougall on May 24, 2013 4:23:00 PM

Sometimes a budget is significant more for what it omits than what it includes.

That's the case with the $34 billion spending blueprint approved Thursday by the Massachusetts Senate, which wisely chose to pass its budget without a proposal to allow the Department of Revenue to hire outside tax auditors and pay them a portion of what they recover.

The budget proposal also replaces two existing health care assessments with a new Employer Responsibility levy and does way with the Health Insurance Responsibility Disclosure (HIRD) form as Massachusetts prepares to replace its 2006 health care reform with the federal Affordable Care Act.

A conference committee will now hammer out differences between Senate and House versions of the budget for the Fiscal Year that begins July 1.

Senators adopted an amendment from Senator Michael Rodrigues, D-Westport, that struck the so-called "contingent contracts" provision that had been added to the budget in an outside section. Rodrigues noted on the Senate floor that the National Conference of State Legislators, the Securities and Exchange Commission and the American Institute of Certified Public Accountants all reject the use of contingent contracts.

The AIM Taxation Committee had urged the Senate to reject the provision.

"The proposal was bad public policy," said John Regan, Executive Vice President of Government Affairs at AIM.

"An auditor should have no financial stake in the outcome of an audit. The conflict of interest is readily apparent and should trouble policy makers concerned about tax fairness and Massachusetts reputation for its tax climate."

Addendum #3

Unclaimed Property Audit Lawsuit Filed Against Kelmar: You Do the Math
posted on: Monday, June 9, 2014

Mark McQuillen, president of **Kelmar Associates, LLC**, was misinformed when he was quoted as saying "I've never been sued" on May 26—less than one week *after* suit was filed against Kelmar and three Delaware state officials in a **Delaware Federal District Court**. *See* 72 *State Tax Notes 455* (May 26, 2014). While the timing of this statement was an unfortunate – but likely honest – mistake, the lawsuit filed by Temple-Inland Inc. asserts the conduct of Kelmar in conducting an **unclaimed property audit** on behalf of the state of Delaware was anything but.

According to the complaint, Temple-Inland was initially asked to pay over $2 million to the state based on the "fatally flawed" extrapolation methodology used by Kelmar to calculate Temple-Inland's liability (and Kelmar's paycheck from Delaware). While the demand was reduced to $1.38 million after the plaintiff initiated administrative review, the result and details of how they got there remains alarming. Of note, Kelmar estimated that nearly $1 million was due to Delaware for the seven-year period of 1986 through 2003 after identifying a single unreported check for $147.30 during a subsequent six-year period (Complaint ¶ 84). The complaint contains countless examples of voided and reissued checks (even checks that escheated to other states) that were used in Kelmar's extrapolation formula. Ultimately the result for Temple-Inland was a demand from Delaware alone of over $100,000 escheatable for prior year's accounts payable, despite having only around $15,000 escheatable to all other states on these accounts for a five year period actually reviewed.

Based on these practices, Temple-Inland asserts that Kelmar and the state auditing officials have unconstitutionally applied the amendment to Delaware Escheat Law allowing for estimations of unclaimed property liability to years prior to its enactment in violation of the *Ex Post Facto* Clause. Along those same lines, the state penalized Temple-Inland for failing to maintain records for periods*prior* to 2010, when a substantive document retention requirement was imposed in the state (*see*S.B. 272 § 4). Nonetheless, Temple-Inland asserts that the methodology used by Kelmar violates federal common law, the Full Faith and Credit Clause, Commerce Clause and Takings Clause of the U.S. Constitution.

Practice Note: While Delaware has settled every suit raising these questions and has an economic incentive to keep them from reaching what would likely be an adverse decision to the state's (and Kelmar's) financial interest, the discussion should not end there. Temple-Inland Inc. had a long history of solid compliance with the unclaimed property laws across several states, yet still was the target of a flawed and likely unconstitutional audit by Kelmar on behalf of the state of Delaware. The company was forced to hire counsel and litigate against Kelmar's questionable practices. While two new Delaware bills have been introduced in an effort to eliminate unclaimed property contingent fee auditing practices (S.B. 215 and S.B. 228), holders should stand firm in opposition to Kelmar's aggressive extrapolation methods and keep their fingers crossed that Temple-Inland Inc. goes the distance in court. Either the court house or the state house need to fix the problem.

This article was written with contributions from Eric Carstens.

Addendum #4

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Firm Fights Back Against Alleged Unconstitutional Unclaimed Property Audit
By Aaron R. Lancaster on September 22nd, 2014 Posted in Unclaimed Property

As we've noted previously, state unclaimed property administrators are getting creative in their efforts to restore their states' battered finances. Now companies are getting equally creative in their efforts to fight back.

Earlier this summer, Temple-Inland, Inc. ("Temple-Inland"), a subsidiary of International Paper, filed a lawsuit against three Delaware state unclaimed property officials and the state's outside audit firm, Kelmar Associates, LLC ("Kelmar") (Kelmar was voluntarily dismissed from the suit in July). The lawsuit alleges that the methodology Kelmar employed to audit Temple-Inland, including the extrapolation methodology used to estimate Temple-Inland's unclaimed property obligations, was unconstitutional.

According to the suit, Delaware estimated that Temple-Inland had more than $2 million in total unclaimed property obligations, despite that Kelmar identified only $147.30 in property that should have been escheated to Delaware during the period covered by the audit (1981-2008). Although the audit showed that Temple-Inland was in substantial compliance with Delaware unclaimed property law for the years for which Temple-Inland had records (2003 and beyond), Kelmar nevertheless estimated Temple-Inland's liability for years that records no longer existed (pre-2003), applying a recordkeeping requirement enacted in 2010 that Temple-Inland claims cannot be applied retroactively.

In July, Temple-Inland moved for summary judgment, arguing, among other things, that estimations of escheat liability are improper because a state's right to escheat is derivative of the property rights of the actual owner. If the actual owners' property rights cannot be conclusively established, according to Temple-Inland, then the state has no rights to the property either.

Concurrently with Temple-Inland's filing of its motion for summary judgment, Delaware moved to dismiss the complaint, arguing that estimates of escheat liability always have occurred and the amendments to its statute allowing reasonable estimates where records are unavailable was simply to codify existing practice.

Oral arguments will be held on the motions for summary judgment and to dismiss on October 1.

Coming hard on the heels of the U.S. Chamber of Commerce's (the "Chamber") recently issued unclaimed property best practices, Temple-Inland's lawsuit could be a harbinger of things to come, with corporate America showing a newfound desire to fight back against what the Chamber and Temple-Inland lawsuit allege are abusive practices by private audit firms.

Addendum #5

American Institute of Certified Public Accountants – Statement on Contingent Fee Audit Arrangements

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