

Managing Louisiana Local Sales and Use Tax Contract Audits

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The complexity of Louisiana's decentralized sales and use tax regime and the difficulties of navigating local sales and use tax audits are well known. The reliance of many Louisiana localities on private auditing firms, often operating under contingent payment agreements, can compound the issues associated with these audits exponentially, especially in the context of multi-parish audits. This article explains the Louisiana laws governing the use of local contract auditors and explores some problems that arise in complex multi-parish audits.

Louisiana comprises 65 parishes, only one of which does not impose a sales or use tax. Within those parishes, there are approximately 189 tax recipient bodies. State law requires that there be only one sales tax collector per parish, so the sales and use taxes levied by each taxing

authority in a parish are collected by a single collector.¹ Typically, the sheriff or parish school board is designated as the collector. Many parish sales and use tax departments lack the resources to employ a staff of full-time auditors, so they rely on private auditing firms. The increasing level of outsourcing and commercialization of this essential government function raises concerns about protection of taxpayer information privacy and preservation of taxpayer rights. Taxpayers should understand the parameters of what contract auditors can and cannot do when dealing with a for-profit enterprise one step removed from the government agency itself.

The Uniform Local Sales Tax Code, which governs the administration of local sales and use taxes, permits a local taxing authorities to contract with the Department of Revenue, another political subdivision of Louisiana such as a parish tax collector, or a private firm to audit for compliance with local sales and use tax ordinances.² When contracted to do so, the private auditing firm may examine or investigate the taxpayer's place of business; tangible personal property; or the books, records, papers, vouchers, accounts, and documents.³ As discussed below, compensation for a private auditing firm must be at an hourly rate, plus reasonable expenses, but this limitation does not necessarily foreclose arrangements that could be viewed as contingency arrangements.⁴ All such contracts must be approved by the majority of the affected taxing authorities in the parish.⁵

¹ La. Const. Art. VII, section 3(B)(1); and La. Rev. Stat. section 47:337.13(A).

² La. Rev. Stat. section 47:337.26(A)-(B).

³ La. Rev. Stat. section 47:337.26(B).

⁴ *Id.*

⁵ *Id.*

The contract auditor statute⁶ places several limits on private auditing firms and the contracting parish. For example, the lead auditor must possess:

- an active CPA license;
- a bachelor's degree with a minimum of 18 hours of accounting;
- an active certified tax examiner's certificate issued by the Louisiana Association of Tax Administrators; or
- a minimum of six years' experience in the field of state or local sales and use tax.⁷

The contracting parish's local collector must notify the taxpayer of the intent to audit before the exam and the notice must explain the nature of the collector's relationship with the auditing firm.⁸ Among other things, the notice must:

- describe the nature of the audit;
- identify the firm or individual that will initiate the audit;
- advise the taxpayer of its right to review and to receive a copy of the contract;
- if the audit is conducted by a private firm, the notice must advise the taxpayer whether the payment of compensation to the private firm is contingent on the collection of tax or in any other way dependent on the outcome of the audit;
- summarize remedies available to contest audit findings; and
- describe interest, penalties, and costs, including audit costs, for which the taxpayer may be liable.⁹

During the audit, the taxpayer must be notified of the contact information of each auditor assigned to the audit and the private auditing firm must provide the taxpayer with access to an original or a copy of the audit contract specifying the terms under which the audit firm was engaged.¹⁰ Because the nature of the contract's fee structure may provide insight into how the auditor will proceed and because

the contract may contain impermissible terms, a taxpayer should always request a copy of, and review, the private auditing firm's contract with the collector.

Permissible Fee Structures and the Potential for Conflicts

As noted, the tax collector is required to contract with the private auditing firm on an hourly basis, plus reasonable expenses.¹¹ The rate restriction is often thought of as a prohibition on contingency fee contract audits, but the law and its legislative history can be read as prohibiting rates from being contingent on recovery but not payment.¹² As a result, a contract that pays the auditor a percentage of the amount collected, for example, 30 percent of collections, is prohibited. But a contract that makes payment contingent on recovery, for example, an hourly rate capped at 40 percent of the amount collected, appears to be permissible.

While the prohibition on contingent rate audits resolves some of the problems generally associated with this type of audit, the ongoing use of contingent recovery audits still causes public policy concerns. Regardless of the best intentions of the individuals involved, a contingent recovery arrangement nonetheless creates real or apparent conflicts of interest and has the potential to result in aggressive assessments. The general issues presented by contingent fee audits are well documented.¹³ Nevertheless, this article briefly discusses how those issues present themselves in the context of Louisiana local sales and use tax audits.

⁶ *Supra* note 2.

⁷ La. Rev. Stat. section 47:337.26(C)(4).

⁸ La. Rev. Stat. section 47:337.26(D)(1).

⁹ *Id.*

¹⁰ La. Rev. Stat. section 47:337.26(D)(2).

¹¹ La. Rev. Stat. section 47:337.26(B).

¹² See Louisiana Attorney General Opinion No. 09-0035B (Apr. 14, 2009).

¹³ See generally, American Institute of Certified Public Accountants, "Contingent Fee Audit Comments" (May 14, 2013); National Association of State Legislatures, "Resolution Concerning the Use of Contingent Fee Arrangements in Tax Audits and Appeals" (Sept. 30, 2011); and Tax Executives Institute, "State and Local Tax Policy Statement Regarding Contingency Fee Audit Arrangements" (July 24, 2017).

Implicit in the applicable statutes, the goal of an administrator in auditing a taxpayer is to ensure that the correct amount of tax is collected and remitted to the locality.¹⁴ A contingent recovery audit is at odds with that public policy goal because it has the tendency (whether in actuality or in appearance) to encourage an auditor to extract a settlement or issue a larger assessment so the auditing firm receives its fees. In Louisiana local sales and use tax audits, the general perception is that this is achieved through assessments that border on arbitrary or in which the applicable tax law is interpreted aggressively, beyond the reasonable expectations of taxpayers based on the law and published guidance. Auditors may develop “creative” assertions that may force the taxpayer to pay the same tax to multiple jurisdictions, in reliance on Louisiana’s poorly drafted cross-crediting statute.¹⁵ Moreover, the private auditing firm has no incentive to inform the taxpayer of overpayments or exempt transactions. Such disclosures would be more likely to happen in a tax system based on collector commitment to educating taxpayers for compliance and properly administering tax laws.

It is also common for the auditor to issue preliminary workpapers in a manner that prevents the taxpayer from reviewing them and resolving issues before a notice of proposed assessment is issued or the tax collector files suit

to recover the tax.¹⁶ For example, some private auditing firms are known to issue audit findings after or at the same time as the findings are transmitted to the collector for assessment. When that occurs, and the auditor’s assessments are not premised on theories of liability grounded in the law, the result often is essentially a re-audit of the taxpayer conducted during the ensuing litigation. Developing the facts during litigation can be extremely costly to a taxpayer and there is no procedural mechanism for a taxpayer to hold the tax collector responsible for those costs, even though they were largely the result of the collector’s failure to supervise the contract auditor.

At least one large contract auditor known to operate in Louisiana is owned by a private-equity firm that appears to also own companies that may compete with taxpayers the contract auditor is engaged to audit. The existence of those affiliated entities has the potential to create a conflict of interest, in fact or in appearance, to the extent it encourages the auditing firm to audit competitors and thereby to potentially achieve a competitive advantage.¹⁷

All of the public policy concerns discussed above are compounded in Louisiana local sales and use tax audits because many private auditing firms contract for reduced hourly rates based on the number of localities involved in the audit. This practice may encourage a tax collector or the contract auditor to provide audit leads to other tax collectors to increase the number of jurisdictions involved in the audit.

Assessment of Audit Costs

Taxpayers are frequently surprised at receiving assessments that include, what appear to be, unreasonably high audit costs along with tax, interest, and penalties. It is important to review assessments of audit costs

¹⁴ See *Sears, Roebuck & Co. v. Parsons*, 401 S.E.2d 4, 5 (Ga. 1991) (Holding that a contingent fee audit contract was void as against public policy and stating: “The people’s entitlement to fair and impartial tax assessments lies at the heart of our system, and . . . 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.”).

¹⁵ La. Rev. Stat. section 47:337.86 provides that a business that collects and remits taxes to the wrong parish may file refund claims to give notice to affected parishes that they should determine the proper recipient parish among themselves. There is, however, no clear mechanism for forcing the parishes to do this and allegedly incorrect recipient parishes may not be part of the audit and may not agree with the auditor. This encourages contract auditors to propose multiple assessments alleging that the taxes were remitted to the wrong parishes, forcing the business to file refund claims that are frequently handled inconsistently by parish recipients and file refund claims that are not automatically cross-credited against the correlative assessments. This puts businesses in a situation in which they bear all the burdens of non-centralized local tax administration without any of the benefits. If the tax period to which the related refund is prescribed, a taxpayer could end up paying the tax again to the auditing parish.

¹⁶ If the tax collector fails to properly review the audit workpapers, it could generate a due process challenge. See *Hubbell Inc. v. City of Bridgeport*, Dkt. No. 304607 (Conn. Super. Ct. 1996), *aff’d* 692 A.2d 765 (Conn. 1997) (“An agreement for an auditor’s or assessor’s compensation may impact more than credibility, at least where, as here, there is no genuine and independent review by an official who is untainted by such terms for compensation.”).

¹⁷ Were this to occur, in theory, it could expose the taxing jurisdiction to antitrust litigation in some instances.

in light of the applicable rules when the audit is conducted by a contractor. A locality that employs a private auditing firm may assess audit costs against the taxpayer if the taxpayer failed to file a return or made a grossly incorrect report.¹⁸ “Grossly incorrect” means any report filed in which there is a substantial understatement of tax for any tax period.¹⁹ The understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return or \$10,000.²⁰ No audit costs may be assessed on any portion of an underpayment regarding which a taxpayer has made a grossly incorrect report if the taxpayer shows that there was a reasonable cause for the underpayment and that the taxpayer acted in good faith.²¹ If the collector contracts with a private auditing firm, the collector may not assess audit costs that exceed 30 percent of the additional tax due.²²

If a tax collector tries to assess audit costs, the taxpayer should verify that the amount of any proposed assessment complies with the tax laws. The taxpayer should assert the reasonable cause and good-faith exception to any assessment of audit costs regarding a grossly incorrect report.

Audit Leads, Information Sharing, And Data Security Issues

Local contract audits also raise significant concerns regarding the use of taxpayer data. Ostensibly, the contract auditing statute makes clear that private auditing firms are subject to taxpayer confidentiality laws.²³ Louisiana’s primary taxpayer confidentiality statute prohibits the disclosure of “information obtained from any examination or inspection of the premises or property of any person in connection with the administration and enforcement of the tax laws of this state or a political subdivision.”²⁴ But, as with

similar laws in other states, Louisiana’s statute contains more than 40 exceptions. Those exceptions include:

- publishing statistics classified to prevent identification of any return or report and the items thereof;²⁵
- using reports filed with a locality under one ordinance in an action to enforce another ordinance of the locality;²⁶
- providing information to another jurisdiction that provides similar information on a reciprocal basis, for example, an information sharing agreement;²⁷ and
- a sales and use tax commission that contracts with the locality for collection of tax from disclosing information to the locality’s internal auditor.²⁸

Thus, the protections of confidential taxpayer data in Louisiana — while not insignificant — are far from comprehensive.

The contract auditor statute contains rules regarding the use by, and sharing of, confidential data by private auditing firms. The rules regarding audit leads are of interest because, as noted, many tax collectors have an inherent incentive, through reduced hourly rates, to expand the scope of a local sales and use tax audit to multiple taxing jurisdictions. We have seen several instances in which clients found themselves suddenly the subject of contract audits by multiple parishes at once even though the parishes, by law, administer their tax systems independently. In contrast, simultaneous, multi-parish audits rarely happen when parishes employ their own auditing staffs.

Audit leads provided to a tax collector by a private auditing firm are subject to the taxpayer confidentiality requirements.²⁹ After the taxpayer has disclosed confidential information to the auditing firm, audit leads by the firm to other local collectors are prohibited.³⁰ That means that a contract auditor is free to expand the scope of the audit by providing audit leads to other taxing

¹⁸ La. Rev. Stat. section 47:337.75(A).

¹⁹ La. Rev. Stat. section 47:337.75(B)(1).

²⁰ *Id.*

²¹ La. Rev. Stat. section 47:337.75(C).

²² La. Rev. Stat. section 47:337.75(D); and La. Rev. Stat. section 47:337.26(E).

²³ La. Rev. Stat. section 47:337.26(C).

²⁴ La. Rev. Stat. section 47:1508(A)(2).

²⁵ La. Rev. Stat. section 47:1508(B)(2).

²⁶ La. Rev. Stat. section 47:1508(B)(3).

²⁷ La. Rev. Stat. section 47:1508(B)(5).

²⁸ La. Rev. Stat. section 47:1508(B)(14).

²⁹ La. Rev. Stat. section 47:337.26(C)(2)(a).

³⁰ *Id.*

jurisdictions until it begins receiving confidential information from the taxpayer. While that would seem to protect taxpayers, applicable law also states that information provided by the auditing firm to the local collector may be shared by the collector with other collectors if the collectors maintain written reciprocal exchange agreements.³¹ So there is nothing to prevent the tax collector from sharing the taxpayer's information with other tax collectors.

At the conclusion of the audit or the termination of related legal proceedings, the private auditing firm must return all original information provided by the taxpayer in conjunction with the audit and must not retain copies.³² All taxpayer-related information derived, compiled, or generated by the private auditing firm, including audit schedules, working papers, and copies of information received from the taxpayer, must be delivered to the tax collector.³³ But the tax collector and the private auditing firm may enter into a written agreement authorizing the private auditing firm to act as agent for the storage and safekeeping of documents otherwise required to be maintained by the tax collector.³⁴

While the state and localities likely have a significant focus on data security, the ability of private auditing firms to maintain confidential taxpayer data is much less clear. Moreover, private auditing firms may have a monetary incentive to retain taxpayer data or use it for unauthorized purposes, such as generating audit leads. Some private auditing firms appear to be engaged in the business of selling data analytics services to state and local governments. The extent to which those firms are leveraging taxpayer data to provide those services is unclear. As a result, a taxpayer has no certainty its confidential data — which may include customer names, product pricing, and other sensitive information — will be protected. For those reasons, a taxpayer should consider requiring the taxing jurisdiction or tax collector to enter into a confidentiality agreement at the outset of the audit.

Also, private auditing firms have an incentive to collect taxpayer data that is unrelated to the audit. For example, it is common for a private audit firm conducting an audit for a single locality to issue an information request for all the taxpayer's transactions in Louisiana or in the country, even though the majority of the information requested is not required for reasonable tax administration. A taxpayer confronted with an overreaching information request should carefully tailor its response to avoid providing information that is unrelated to administration of the tax at issue.

Conclusion

The use of private auditing firms by Louisiana's local taxing jurisdictions raises significant concerns regarding the protection of taxpayer information, the preservation of taxpayer rights, as well as the proper function of government in a tax system in which the onus of compliance is initially borne by the taxpayer. It is critical that taxpayers believe the system is fair.

Private auditing firms, particularly those operating under contingent recovery contracts, may have or appear to have financial incentives to issue higher or more aggressive assessments and, perhaps may be incentivized to use methods that make it more difficult or less likely for taxpayers to contest those assessments before the onset of litigation. As a result, a taxpayer may be forced to redo the audit during litigation at its own considerable expense.

A taxpayer that receives a notification of a local Louisiana sales and use tax exam by a contract auditor should request and review the tax collector's contract with the private auditing firm to determine whether it is permissible and consistent with the law. Because local tax collectors are known to share taxpayer data and audit leads and the private auditing firm's ability to keep that taxpayer's data secure is unclear, in appropriate circumstances, a taxpayer should request that the taxing jurisdiction enter into a confidentiality agreement and narrowly tailor its responses to audit information requests to provide only the information necessary for the reasonable

³¹ La. Rev. Stat. section 47:337.26(C)(2)(b).

³² La. Rev. Stat. section 47:337.26(3)(a) and (b).

³³ La. Rev. Stat. section 47:337.26(3)(a).

³⁴ La. Rev. Stat. section 47:337.26(3)(c).

administration of the auditing jurisdiction's tax. A taxpayer should pay close attention to the mail as the audit winds down, because the auditor may not provide much, if any, notice before it submits the audit to the local tax collector, and the collector may issue a notice of intent to assess shortly thereafter. Finally, a taxpayer should be aware of the financial incentives built into private auditing contracts and be prepared to vigorously contest proposed assessments premised on novel and not clearly applicable interpretations of the tax laws. ■

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