



Contingent Fees for Refund Cases Why Not?

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Recently, tax services firm Ryan LLC reopened the question of whether advisors should be allowed to enter into contingent fee arrangements for certain matters before the Internal Revenue Service (IRS). The rationale for banning such arrangements is not so obvious, especially as there are already a number of measures (severe penalties) in place to help keep tax compliance in check. This article briefly describes the Ryan lawsuit, the types of arrangements in question, the history of the treatment of such arrangements and why, Constitutional arguments aside, the restrictions on these contingent fee arrangements shouldn't be necessary.

The Ryan Lawsuit

In a not often seen move, on April 11, 2012, Ryan LLC, together with its CEO and COO, filed a federal lawsuit against Treasury Secretary Tim Geithner and IRS Commissioner Douglas Shulman in the U.S. District Court for the District of Columbia seeking a declaratory judgment that the provisions of Circular 230 prohibiting contingent fee arrangements for preparing and filing certain refund claims violate both the petition clause of the First Amendment of the Constitution (right to petition the government for a redress of grievances) and the due process clauses of the Constitution (right to obtain a refund of taxes paid). The gist of the Constitutional arguments is that the ability of certain taxpayers to retain advisors to prepare and file certain refund claims, as well as the ability to obtain representation to pursue their statutory right to a refund of tax overpayments, is "arbitrarily" and "irrationally" impaired under the provisions of Circular 230 that prohibit contingent fee arrangements. The suit further alleges that by imposing restrictions on contingent fee arrangements, the IRS overstepped its authority to regulate the practice of certified public accountants (CPAs) (5 U.S. Code Section 500) and severely restricted CPAs' ability to practice before the IRS.

Background

The Process of Refund Claims

To understand the issue, let's take a look at refunds claims and what is generally required. The IRS is generally authorized to refund overpayments of tax ——— that is, taxpayer money in the hands of the government. The process is that, under IRC Section 7422(a), taxpayers are required to file refund claims with the IRS before they can file suit for a refund. Generally, taxpayers have three years from the filing of the return, or two years from payment of the tax, to file their refund claim (which should include all of the grounds and support for the claim). If a claim is not properly filed, the IRS can simply reject the claim, regardless of the merit of the case. In the usual course, a revenue agent will review the claim and either accept or disallow the claim in full or in part. If the claim is disallowed, the taxpayer can request a conference with the IRS Appeals Office. If no conference is requested, or the Appeals Officer agrees with the revenue agent's determination, the IRS will issue a statutory notice of claim disallowance. The taxpayer then has two years from the date the notice of disallowance is mailed to begin a refund suit.

Taxpayers often need advisors to assist them in filing refund claims because the tax rules are so complicated and always changing. This situation is often distinguished from strategic tax planning and normal-course compliance (which is planned for and anticipated in annual budgets). Refund claims arise for a number of other reasons (carrying back losses, correcting errors, clarifying facts, etc). Depending on the complexity of the issue and the effort involved in dealing with the IRS, such claims can be

prohibitively expensive, even though the taxpayer is in the right. Many taxpayers, particularly those struggling in this economy, simply do not have the cash to fund such an endeavor, even if the cash is rightfully theirs. Taxpayers that do not have the upfront cash would, given the choice, often prefer to enter into a contingent fee arrangement, whereby they would not have to pay the advisor's fee until the cash was received from the government.

Contingent Fee Arrangements

In general, a contingent fee is 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 or is sustained by the IRS or in litigation. Contingent fees are also defined to include fees based on a percentage of a refund reported on a return, fees based on the percentage of taxes saved or fees dependent on the specific result achieved. Prior to the revision of Circular 230 in 2007, contingent fee arrangements were only prohibited for preparing original returns. Back then, contingency fees were allowed for services provided in connection with refund claims if the practitioner reasonably anticipated that the claim would receive "substantive review" by the IRS. Subsequently, Circular 230 was revised (TD 9359, 11/5/2007) to generally prohibit practitioners from entering into contingent fee arrangements for services rendered in connection with any matter before the IRS, including the preparation and filing of claims for refunds after a taxpayer has filed its original tax return, but before the IRS has initiated an audit of the return.

Why Not Allow Contingent Fees for Refund Claims?

The initial rationale for imposing a restriction on contingent fees was that it helped to support voluntary compliance with the federal tax rules by discouraging return positions that "exploited the audit selection process." In addition, much of the literature from the 2007 time period cites overall concerns about attorney and auditor independence and alludes to the notion that contingent fees are just "bad." This general premise that contingent fees result in greater instances of tax avoidance seems to be largely unsupported. In fact, back in September 2007, a study was conducted on contingent fees and tax compliance by professors John Phillips and Richard Sansing from University of Iowa and Yale University, School of Management, respectively. They examined the effect of banning contingent fees for tax return preparation services. While their study did not specifically focus on refund claims, their finding was that, contrary to the popular belief that contingency fee arrangements will make providers more likely to take aggressive tax return positions, providers were actually less likely to be aggressive when contingent fees are allowed. Under this theory, contingent fees breed accuracy because they incentivize tax advisors to better understand a taxpayer's specific facts and profile, whereas a flat fee incentivizes the provider to get through the return as quickly as possible, taking risky positions (to get future business) without properly vetting such positions. Variable pricing would seemingly lead to greater accuracy, as tax providers would presumably spend more time on issues when they are being compensated for such efforts.

Whether or not the study reflects reality, there is no question that there are many punitive mechanisms in place to prevent taxpayers from filing improper refund claims, including penalties under IRC Section 6676 for filing frivolous claims; accuracy-related penalties under IRC Section 6662 (including penalties for negligence or disregard of the rules, substantial understatements of taxes, substantial misstatements of valuations, or gross valuation misstatements); penalties for fraud under IRC Section 6663; and penalties for tax return preparers where there is an understatement due to unreasonable positions or to willful or reckless conduct under IRC Section 6694.

From the perspective of the taxpayer, Ryan's due process argument may be the one that elicits the most sympathy. Why should taxpayers who do not have the upfront cash be precluded from pursuing their right to obtain a refund of their own money? There is something fundamentally troubling about a rule that inhibits a taxpayer's ability to get at its cash (which is in the hands of the government for one reason or another). Possession is nine-tenths of the law... but when the tax rules are so complex and the refund process so daunting, when the IRS has possession of funds and the taxpayer is not well funded, that taxpayer's only hope of pursuing a refund may be through the use of a contingent fee. This can tilt the game in favor of those with the means and resources to play, and it discriminates against those without ---- a tough result for the many people and businesses coping with the current economy when there are already penalty provisions on the books to chill this behavior. This of course must be balanced against the IRS's legitimate goal of preventing the filing of frivolous refund claims by taxpayers and their advisors who seek to game the system for financial windfall.

Alvarez & Marsal Taxand Says:

While the constitutional arguments in the Ryan case are debatable and there are differing opinions on whether a ban on certain contingent fees in refund cases is really needed, it will be interesting to watch the progression of the case and see whether there may be broader implications for other types of contingent fee arrangements. In the meantime, taxpayers should keep in mind that there are still a few areas under Circular 230 that expressly provide for the use of contingency fee arrangements. Such arrangements can be charged for:

- Services rendered for most state and local tax matters;
- The IRS's examination of or challenge to an original tax return;
- The IRS's examination of or challenge to an amended return or refund claim or credit where the claim or return was filed within 120 days after the receipt of written notice or written challenge to the original return;
- A claim for credit or refund filed solely for the determination of statutory interest or penalties assessed by the IRS;
- A claim under IRC Sec. 7623 (providing rewards for whistleblowers who report tax law violations to IRS); and
- Any judicial proceeding arising under the IRC.

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