Are States (Es)Cheating You?

by Walter Nagel, Donald Griswold, Jeremy Abrams, and Derek Young

Walter Nagel, Donald Griswold, and Jeremy Abrams are attorneys with Crowell & Moring LLP. Derek Young is a student in the Tax LL.M. program at Georgetown University Law Center.

Introduction

The current economic climate has driven many states to view unclaimed property as an important source of revenue to help fill large budget deficits.[1] With the collective budget gaps of the states for fiscal 2013 estimated at $55 billion,[2] it is easy to see why unallocated money — in the form of unclaimed property — has been viewed by the states as "the functional equivalent of loose change found between a couch's cushions."[3] However, unlike the nickels and dimes under most couch cushions, the loose change in the states' custody totals approximately $35 billion to $40 billion.[4] Knowing that only about one-third of unclaimed property is ever returned to its original owner,[5] states have aggressively applied their escheat powers to pocket the other two-thirds.

To cash in on this non-politicized source of revenue, states have gone beyond ramping up enforcement efforts; some have started amending their statutes to *expand* the scope of liability. Those states have been auditing companies more aggressively over longer lookback periods and expanding the scope of what constitutes unclaimed property. Also, states have been targeting gift cards because it is unlikely they will — or even can — be returned to their true owners, leaving the states with a windfall.[6]

Those measures have been extremely successful for the states. In Delaware, the most aggressive escheat state, unclaimed property accounts for a whopping 12 percent of the state's total revenue, making it the third largest revenue source.[7] The aggregate numbers show Delaware is not the only state benefiting, however, as the nationwide total of unclaimed property in the states' control has risen over the last decade. To raise additional revenue, some states have gone a step further, securitizing unclaimed assets and borrowing against those assets. Some states have even used eBay to liquidate the contents of unclaimed safety deposit boxes![8]

Part I of this article briefly provides some background information about unclaimed property. Part II examines aggressive audit techniques, long lookback periods, and shorter dormancy periods used by states, and it briefly introduces Delaware's voluntary disclosure program, which provides limited relief for companies that enter the program before the upcoming June 30, 2013, deadline. Part III discusses the treatment of gift card balances as unclaimed property.

I. A Brief History of Unclaimed Property Law

The roots of modern day unclaimed property law can be traced to the doctrines of escheat and *bona vacantia*. The concept of escheat began in Roman law.[9] It allowed the emperor to claim the estate of an heirless decedent. That concept was adopted in

[1]Christopher Jensen, Same Schaunaman, and Doan Nguyen, *Unclaimed Property Due Diligence: What Holders Need to Know* (2012).

[2]Phil Oliff, Chris Mai, and Vincent Palacios, "States Continue to Feel Recession's Impact."

[3]Robert S. Peters and Matthew J. Beintum, "Going Fishing: State Budget Deficits Drive an Expanding Net of Unclaimed Property Collections," 18 *Journal of Multistate Taxation and Incentives* 28 (2009).

[4]Laura A. Lane, "Unclaimed Property Compliance: A Tax Department Responsibility?"

[5]*See* Jensen, et al., *supra* note 1 at 29.

[6]*See, e.g.*, Wally Kennedy, "State Treasurer: Unclaimed Property 'Stockings' Could Hold Gift Cards," *The Joplin Globe* (Nov. 19, 2012) (saying that in 2012 Missouri held nearly $6.2 million in unclaimed gift card balances and returned only $107,000, or roughly 1.7 percent).

[7]Only revenue from personal income taxes and incorporation fees is larger.

[8]*See, e.g.*, Chase Snider, "Arkansas Auditor Putting Unclaimed Property on eBay."

[9]Teagan J. Gregory, "Unclaimed Property and Due Process: Justifying 'Revenue-Raising' Modern Escheat," 110 *Mich. Law Rev.* 319, 322 (2011).

feudal England and allowed the king to claim the real property of an heirless decedent.[10] Combined with an analogous English common law doctrine, *bona vacantia* — which applies escheat principles to personal property instead of real property — those historical "unclaimed property" laws were adopted in America.[11]

Though modern day unclaimed property law was born from those common law doctrines, there are two substantial differences.[12] First, in modern unclaimed property law there is a presumption of abandonment.[13] After a statutorily defined number of years (a dormancy period), unused property is considered to be abandoned and its holder is required to turn it over to the state. That means the law applies to everyone, not just heirless decedents. Second, the states do not receive title to the property; rather, they retain a custodial claim over it.[14] States get possession of the property only until the owner comes forward and claims it. In other words, the states act as a huge lost and found. Functionally, however, that difference is not as great as it seems given the states' ability to profit from unclaimed property because most unclaimed property is never returned to its owner. Also, even if the property is eventually reunited with its owner, many states collect and keep interest on the property during the period it is in the state's custody. In fact, the ability to profit from unclaimed property is so great that some states simply deposit the remitted property into their general funds, while keeping a small amount in trust to satisfy future claims.[15]

Although modern day unclaimed property law is very different from the common law doctrine of escheat, the term "escheat" is still often used to describe the process by which unclaimed property is remitted to the state. Throughout this article, the term "escheat" is used in its modern context, not to refer to the common law doctrine.

II. Methods States Use to Obtain Large Unclaimed Property Recoveries

States have made numerous changes to how they find unclaimed property and the period over which they will look for it — always with the goal of increasing state revenue. Part A describes aggressive audit procedures. Part B discusses how states are looking further back in time for unclaimed property in order to produce larger liabilities. Finally, Part C briefly discusses Delaware's limited relief from these provisions through participation in its voluntary disclosure program.

A. Aggressive Unclaimed Property Audits

Because of the state of the economy and the budgetary problems many states are facing, unclaimed property audits are being conducted much more frequently.[16] In addition to an increased number of audits, states are conducting those audits in a manner meant to generate additional revenue. More than 80 percent of the states are using third-party auditors to conduct unclaimed property audits.[17] Those contract auditors work for contingency fees, often 10 percent of the property recovered. That "bounty hunter" system increases the contract auditors' incentive to find unclaimed property . . . and a great deal of it. Employing contract auditors enables states to aggressively audit many companies without having to worry about the costs of administering those audits. That means states can — and in fact have an incentive to — conduct more unclaimed property audits.

Another common technique used by states is to audit a sample of years and then extrapolate a company's total unclaimed property liability based on that sample. The small sample of years is applied to the total lookback period, which can span decades. For example, in Delaware the state can potentially look back as far as 1981.

Application of this sampling technique can easily lead to erroneous results. Errors can stem from anomalous results in the sample years, or they can be the result of a company's growth. For example, a company may have vastly increased its size, revenue, focus of its business, and unclaimed property liability since 1981, but unless the company has available records dating back 30-plus years, Delaware can apply a current sample to the entire lookback period. That can result in an overstated unclaimed property assessment. A company may feel pressure to pay that erroneous assessment, however, in order to avoid penalties and interest. Those additional amounts often can be as large as the assessed liability. That pressure is magnified because the company bears the burden of proving the assessment is incorrect — something extremely difficult to do when records do not exist.

Auditors often apply sampling techniques even if the owners of the property are unknown,[18] and even

---

[10]*Id.*

[11]*Id.* The reader may be excused for confusing the Latin *bona vacantia* (literally "vacant goods") with the French *bonnes vacances* because we suspect that aggressive unclaimed property auditors may earn very "good vacations" and other rewards from their happy employers!

[12]Michael I. Saltzman, "Providing Protection in State Unclaimed Property Audits," *Tax Notes*, Dec. 18, 2000, p. 1599.

[13]*Id.*

[14]*Id.*

[15]Gregory, *supra* note 9, at 323.

[16]Lane, *supra* note 4, at 2.

[17]Peters and Beintum, *supra* note 3, at 29.

[18]That is despite that "if the owners are not known, it seems unlikely that reunification could occur." Gregory, *supra*

(Footnote continued on next page.)

if there are actual data available for the auditors to analyze. That can lead to devastating results for corporations. For example, in *McKesson Corp. v. Cook*, the auditors used the extrapolation method even though data were available for previous years.[19] The auditors' use of that extrapolation method turned what the company believed was a $19,337 liability into a $4.5 million liability![20]

Unless the company has available records dating back 30-plus years, Delaware can apply a current sample to the entire lookback period.

In sum: States are using auditing techniques that are designed to produce larger unclaimed property liabilities that companies feel pressure to pay, even if the amount is incorrect.

B. Longer Lookback Periods and Shorter Dormancy Periods

The aggressive audit techniques being applied by states can produce large unclaimed property liabilities when combined with the trend to shorten dormancy periods and lengthen lookback periods.

A dormancy period is the length of time that must elapse before property is considered abandoned. The shorter the dormancy period, the quicker the state can get its hands on your customer's (or employee's or shareholder's) money. So, for example, in 2010 New Jersey shortened the dormancy period for traveler's checks from 15 years to three years, and it attempted to apply this shortened period retroactively. In *American Express Travel Related Services, Inc. v. Sidamon-Eristoff*, the U.S. Court of Appeals for the Third Circuit affirmed the district court's enjoinment of the retroactive application of this provision, but the dormancy period still remains three years.[21] This means that unused travelers checks now must be turned over to the state five times faster than they previously had to be.

note 9, at 326. So that benefits the states while violating one of the policy rationales supporting modern unclaimed property law: The idea that more owners will be reunited with their property if it is all held by one entity.

[19]*McKesson Corp. v. Cook*, Del. Ch. Ct., Case No. 4920, filed September 25, 2009. Those data, however, were not accounting records. It was in the form of confirmation letters. McKesson was unable to find invoices to match $2.9 million of alleged unclaimed property in the sample selected, so it sent confirmation letters to vendors, and of the responses received, the vendors claimed that only $19,337 was owed.

[20]*Id.*

[21]669 F.3d 359 (3d Cir. 2012).

At the same time, states are using long lookback periods so that companies subject to the aggressive auditing procedures now being implemented have to be concerned about potential liabilities dating back, in some cases, over two decades. In fact, a Conference Board survey of businesses that were audited found that one-third of the respondents were subject to a lookback period of 20 or more years, and almost half of the respondents were subject to a lookback period of at least 15 years.[22] And in the case of companies that have failed to previously file an unclaimed property report, most states do not have a statute of limitations, potentially subjecting those companies to liabilities dating to the incorporation of the company![23]

Long lookback periods pose unique challenges to companies under audit. First, if the lookback period extends further back than the company's document retention policy, the company may be unable to refute the auditor's findings. Second, companies have to be concerned that the auditor will audit a small sample of years and extrapolate any liabilities assessed over a lengthy lookback period. That can, in essence, multiply anomalous liabilities and lead to a large (and incorrect) assessment. Ultimately, the company may have a difficult time contesting the assessment and carrying its burden of demonstrating that the audit results are incorrect.

The result is that states are forcing companies to cede property to them sooner, and in much larger amounts, than before. That leads to compliance problems, and if audited, large obstacles when contesting the audit results. Long lookback periods, combined with aggressive audit procedures, result in large unclaimed property liabilities.

C. Delaware's Voluntary Disclosure Program: Some Relief From Lengthy Lookbacks and Aggressive Audits

In Delaware there is finally available to corporations some additional limited relief from extremely long lookback periods and years of costly and intrusive audits. Delaware's voluntary disclosure agreement (VDA) program was signed into law on July 11, 2012, and amended on January 30, 2013. Under the terms of the VDA program, companies can work with the administrator of the program and forensic accountants to determine what potential liabilities exist. Then, the company will provide the administrator with documentation the parties agree represents the amount of property that must be reported

[22]Joseph O. Blanco and Michelle A. Andre, "Expanded Liability in Unclaimed Property: Are States Going Too Far?"

[23]That is the case in Delaware, where liability can stretch to the statute's inception in 1981.

and delivered to the state. That allows a company to receive shortened lookback periods and avoid audits, interest, and penalties.[24]

The Delaware VDA program allows for two different reduced lookback periods based on when a company participates in it. First, companies that enter the program before June 30, 2013, and either pay or begin a payment plan before June 30, 2015,[25] are required only to report property issued in 1996 or later. Second, companies that enter the VDA program between June 30, 2013, and June 30, 2014, and pay or begin a payment plan before June 30, 2015, are required to report property issued in 1993 or later. Both lookback periods are shorter than under Delaware's previous VDA program, which required all property issues in 1991 or later to be reported.

III. Unused Gift Card Balances as Unclaimed Property Subject to Escheat

To increase revenue further, states are also adding new types of property to the list of property that is subject to their unclaimed property laws. One huge source states have been targeting is unused gift card balances. That addition is not arbitrary. The gift card market is enormous. In 2011 alone, $99 billion worth of gift cards were sold in the United States.[26] Gift cards are also appealing to states because it is almost impossible to determine the rightful owner of a gift. That means that the state will ultimately end up permanently retaining a much higher portion of gift cards than of other forms of unclaimed property.[27]

New Jersey is an example of a state that recently began collecting gift card balances as unclaimed property. In 2010 New Jersey added "stored value cards" to unclaimed property that is subject to escheat.[28] The definition of stored value cards is broad and includes gift cards, rebate cards, store cards, or anything similar. Also, the law (since modified) contained a retroactive "place of purchase" presumption, under which card issuers would be required to collect the purchaser's address. If the card was not used within two years, it was to be deemed abandoned and was to be turned over to New Jersey if the purchaser is from New Jersey or, if the purchaser's address is unknown, if the card was purchased there.

In 2012 the U.S. Court of Appeals for the Third Circuit affirmed a district court's preliminary injunction preventing New Jersey from retroactively enforcing that new law, but upheld the shorter escheat period.[29] A few months later, the New Jersey State Legislature responded by repealing the place of purchase presumption and limiting the stored value cards that can become unclaimed property to those issued after July 1, 2010. For most gift cards issued after July 1, 2010, that have not been used in five years, 60 percent of the value must be turned over to the state.[30] For general purpose reloadable cards, however, the full value must be turned over to the state. The law still requires issuers of stored value cards to collect at least the ZIP code of the purchaser, but that requirement will not take effect until July 1, 2016.

The complexity of the law is compounded by four exemptions to the general rules regarding when gift cards must be turned over to the state. Those exemptions apply to (1) cards distributed as part of a reward program or a charitable program as long as no monetary consideration is received in exchange for them; (2) cards donated or sold below face value to charitable, nonprofit, or educational organizations; (3) cards redeemable for admission to events or venues, or for goods or services in conjunction with admission to events or venues; and (4) cards issued by issuers who issue less than $250,000 worth of cards each year.[31] Also, there is a catchall provision that allows the state treasurer to grant discretionary exemptions.[32]

There is great variation among the states regarding how and when gift card balances are considered abandoned and subject to escheat.

Although inclusion of gift cards in a state's unclaimed property laws has become typical, there is great variation among the states regarding how and when gift card balances are considered abandoned and subject to escheat. Some states, such as California, do not include gift card balances in property subject to their unclaimed property laws, provided that the gift cards do not have an expiration date.[33]

[24]Both the secretary of state and the state escheator must waive their ability to audit once a company enters the VDA program. However, that waiver does not apply if there is evidence of fraud or willful misrepresentation.

[25]The original VDA program called for payment by 2014 in order to receive a 1996 lookback period, but on January 30, 2013, Delaware HB 2 extended the date payment must be made by (or a payment plan must be entered into by) for one year.

[26]*See* Gift Card Market Size.

[27]*See supra* note 6.

[28]*See* Public Law 2010, chapter 25.

[29]*New Jersey Retail Merchants Assoc. v. Sidamon-Eristoff*, 669 F.3d 374 (3d Cir. 2012).

[30]*See* N.J. Rev. Stat. section 46:30B-42.1.

[31]N.J. Rev. Stat. section 46:30B-42.1e(1)-(4).

[32]*See* N.J. Rev. Stat. section 46:30B-42.1f.

[33]Cal. Civ. Proc. Code section 1520.5.

That, presumably, is more in line with the modern rationale (if not the feudal rationale) supporting unclaimed property laws. If we assume that unclaimed property laws were created to increase the odds of reuniting owners with their property, it makes sense for the property to be held by the entity that is most likely to accomplish that goal. For many types of property, that is the government because it provides a central location the property owner can search. Gift cards are different, however, because the owner's personal information is usually unavailable, which makes it nearly impossible for the owner to be identified and reunited with her property. But if the gift card value remained accessible for use by the customer at the retailer who sold it, it is possible that the holder could use it even after enough time elapsed for it to be presumed abandoned.

Although the specifics of each state's law concerning gift cards is different, the inclusion by most states of gift cards as escheatable property is sure to produce a collective windfall to the states, given the size and growth of the gift card market.

Conclusion

In the poor economic climate, states are looking for alternative avenues of raising revenue and correcting budget shortfalls. The states view unclaimed property as an excellent target because it does not require raising tax rates, a politically sensitive issue even in a normal economy.

Have the states gone too far in their expansions of the scope of escheat laws and in aggressive auditing techniques? Put another way, are states using escheat laws to cheat taxpayers out of funds they should be able to retain?

Although unclaimed property may not be a hot-button political issue, the states' increasingly aggressive escheat collection methods produce costs of their own. Those costs are ultimately borne by companies that must comply with long lookback periods and defend against highly aggressive unclaimed property audits targeted at producing large liabilities. Companies must now engage in thoughtful and informed planning. That is especially true for companies that hold property that, like gift cards, is high in aggregate value and has low likelihood of being reunited with its owner. The new developments in unclaimed property law are designed to produce large liabilities, but with thoughtful planning or creative theories, companies can prevent and contest them. Audits can be long and costly, and companies need to respond vigorously to them. ✰