Unclaimed Property and Escheat Services

July 22, 2016
Agenda

1. Unclaimed property background
2. Landscape updates/environment
3. Annual compliance
   - Challenges
   - Effective processes
Unclaimed property (UP) reporting (referred to as escheat) is a statutory requirement imposed by all US jurisdictions that creates an annual, and sometimes historical, reporting responsibility for every organization, regardless of industry, operations or size.

State statutes governing UP compliance for an organization are complex, vary by jurisdiction and can have an impact on the P&L if not properly and effectively adhered to.

Often, organizations may have a filing process in place that is lacking key portions of exposure, such as certain legal entities or property types.
Background

► No organization is exempt from reporting — it applies to all organizations, regardless of industry, even including nonprofits.

► Currently, 54 US jurisdictions have UP laws, which can vary significantly from one jurisdiction to another with respect to reporting due dates, pre-filing due diligence requirements and dormancy periods (the period of inactivity that must lapse before escheatment).

► The current environment is one of significant change with respect to enacted legislation in key states, implications of pending litigation and revisions to the Uniform Law adopted by a majority of the states.

► The property to be reported varies, ranging from payroll and accounts payable checks to the most complicated transactions within a client’s business model, such as customer billing discrepancies, accounts receivable credits and equity.

► Due to the established sourcing rules and the requirement of some states for negative reporting, organizations typically face a 50-state reporting obligation, regardless of physical presence. As a result of the varying sourcing rules, there can be additional implications related to the organization’s state of incorporation or formation.

► States are enforcing compliance through increased audit activity, often led by third-party auditors working on a contingent fee basis, with look-back periods up to 20+ years.

► Failure to report UP liabilities could result in additional interest and penalties, given look-back periods are generally extensive due to the lack of limitation statutes.
Landscape/environment

- Decision in landmark unclaimed property case, *Temple-Inland* Inc. v. Cook
- Significant implications for all holders
- Refer to EY Tax Alert
Annual compliance
Challenges

► Establishing and adhering to sound UP policies and procedures across the organization can require consideration and adaptation of accounting policies for underlying property types, such as write-off policies within billing systems or bank reconciliation processes.

► Streamlining an effective data gathering process from various business units, enterprise resource planning (ERP) systems and functional areas within the organization.

► Limited in-house knowledge or resources for administering the unclaimed property compliance function, with risk of institutional knowledge loss upon attrition.

► Underutilizing reporting software due to lack of training or knowledge beyond basic functionality.

► Overreporting UP by not considering available exemptions and deductions, such as business-to-business, payroll, de minimis, gift cards/merchandise credits and other items.

► Establishing and maintaining a proper audit trail though policies and document retention so as to enable the organization to rebut the presumption of abandonment for specific transactions.

► Challenges associated with mergers/acquisitions can include inheritance of predecessor UP liability or difficulty integrating new operations into centralized consistent filing process.

► Systems upgrades and conversions should always be evaluated with UP point of view to avoid loss of data and potential red flag areas.
Annual compliance
Effective process

- Health assessment
- Client profile
- Data confirmation
- Exemption analysis
- Due diligence letters
- Reconciliation

File report online

- Post-filing owner mailings
- Audit trail preparedness
- Reconciliation
- Notice and state correspondence follow-up

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State & Local Taxation

Federal district court rules Delaware’s estimation method used to audit and assess unclaimed property violates substantive due process

On June 28, 2016, the US District Court for the District of Delaware (Court) issued its opinion in Temple-Inland, Inc. holding Delaware's executive action of auditing and assessing a multistate corporation's unclaimed property violated substantive due process because the state's actions, when taken together, "shocks the conscience." Most notably, the Court held that the state's use of the existence of unclaimed property in the base year to infer the existence of unclaimed property in the reach-back year without replicating the characteristics and qualities of the property within the sample, creates significantly misleading results. This highly awaited opinion will significantly affect unclaimed property audits involving estimations not only by Delaware but other states as well.

Background

A long history of US Supreme Court opinions — commonly referred to as the Texas cases — sets forth the priority rules for determining which state has priority claims to escheat unclaimed property. Under the primary rule established by the US Supreme Court, the state of the owner's last known address as shown by the books and records of the holder of unclaimed property (holder) has the first opportunity to escheat the unclaimed property. If the holder's records do not include an address for the owner, the secondary rule developed by the US Supreme Court applies and gives the right to escheat to the state of incorporation of the holder. As Delaware is one of the most popular locations in the world to incorporate, many corporations find themselves subject to unclaimed property audits invoked by the state.

Under Delaware law (Del. Code tit. 12, Section 1155), the state is allowed to use estimation in unclaimed property audits, specifically allowing the use of reasonable estimation, when records of unclaimed property are unavailable or inadequate. The state has not enacted any statutes or regulations establishing record retention requirements for unclaimed property. Instead, the Delaware Department of Finance relies on standard record retention policies.

Temple-Inland, Inc. (Temple-Inland), a manufacturer of corrugated packaging, is a Delaware corporation with its principal place of business in Texas and its primary operations in Texas and Indiana. In 2008, Delaware audited Temple-Inland for deficiencies in reporting and escheating unclaimed property for the prior 22-year period. In the audit notice, Delaware's Audit Manager stated, "I'm sure all records are being retained under standard retention policies," which the state later said was typically seven years. Further, the audit notice stated that the unclaimed property should be reported to the state in accordance with the priority rules set forth in the Texas cases. Delaware used a contract auditor to audit two bank accounts from which Temple-Inland used to issue checks for accounts payable and payroll. Temple-Inland produced complete records back to 2003 for accounts payable and 2004 for payroll, all unclaimed property reports filed in Delaware from 1998-2008, a couple of reports for years prior to 1998, and two audit reports for Texas covering 1985 to 2005. For years in which records were not available or incomplete, the contract auditor used an estimation method to calculate the amount of unclaimed property. Notably, the contract auditor's estimation methodology relied heavily on property escheatable
only to other states to increase the amount of unclaimed property owed to Delaware.

Following the audit, Temple-Inland was assessed a $2.1 million liability. Temple-Inland challenged the assessment, and before the Court argued that Delaware's audit violates substantive due process and the takings clause and the ex post facto clause of the US Constitution. The state countered by asking the Court to abstain from ruling in this case, considering the issue more appropriately to be considered by a Delaware state court.

**Court's ruling**

The Court ruled in favor of Temple-Inland on its substantive due process claim but rejected its takings clause and ex post facto arguments, and declined the state's request to abstain from issuing a ruling.

**Substantive due process**

An executive action — in this case Delaware's audit and assessment of Temple-Inland's unclaimed property liability — will violate substantive due process protection when it "shocks the conscience," the meaning of which varies based on factual context. While the Court found a lack of clear precedent addressing whether a state's executive action with respect to unclaimed property shocks the conscience, the Court "found several aspects of [Delaware's] actions troubling." Most notably, the state waiting 22 years to conduct an audit, avoiding the otherwise applicable statute of limitations, failing to notify holders that they would need to retain unclaimed property records for an unspecified amount of time in order to defend against unclaimed property audits, applying Del. Code. tit. 12, Section 1155 for a prolonged retroactive period "for no obvious purpose other than to raise revenue," and failing to follow the fundamental principles of estimation when the characteristics of the sample are extrapolated across the whole, which puts Temple-Inland at risk for liability on the same property among multiple states. The Court found that these executive actions, when considered in combination, shock the conscience.

The Court found the statute of limitation a critical issue. In general, the State Escheator has three years from the date a report is filed to bring an action to enforce a payment of a deficiency (increased to six years if the deficiency is greater than 25% of the amount of the abandoned property), and can bring an action "at any time" if no report is filed or if a false or fraudulent report is filed. Thus, in order to issue assessments for years 1986 to 2002 (outside the six-year limitation period), Delaware must show these assessments fall within the "at any time" exception. The state assumed that Temple-Inland failed to file reports for those years. Regarding this assumption, the Court found two plausible reasons for why the reports could not be found, both of which would bar the state's action. First, Temple-Inland had no unclaimed property and, based on state guidance, which consistently advised that only financial institutions had to file a negative report (i.e., no unclaimed property), did not file such reports. Second, Temple-Inland had unclaimed property and filed reports but cannot prove such because, in compliance with its own record retention policy, destroyed the records after 10 years. Moreover, the state cannot produce these reports as it has not kept copies of all the unclaimed property reports filed with it. Thus, the state has put the burden on holders to produce these reports, but it failed to warn holders of the consequences of failing to keep all of their unclaimed property reports for an unlimited period.

In regard to the 22-year retroactive application of Del. Code tit. 12, Section 1155, the Court found that
such application violates substantive due process as it "shocks the conscience." In reaching this conclusion, the Court considered whether the length of the retroactive period is appropriate given the reason why it is being applied retroactively. Here, the state's purported reason for apply Del. Code tit. 12, Section 1155 retroactively — to raise revenue — does not withstand scrutiny. The state cannot show that, through its application of Del. Code tit. 12, Section 1155, there is a one-to-one shift between the burden on the plaintiff and the benefit to owners of unclaimed property. Rather, the state collects more money through the use of Del. Code tit. 12, Section 1155, but owners of unclaimed property are not entitled to share in that increase. Moreover, the state's actions do not reinforce the viability of its unclaimed property program. In this instance, unclaimed property owners are not at risk of being unable to recover their unclaimed property because the state's unclaimed property fund is not experiencing a financial shortfall. Lastly, the Court held that the state's use of estimation will not make it easier for owners to be reunited with their abandoned property, and instead, may make it harder because the state's estimation method does not identify the owner.

Turning to estimation, the Court explained the use of estimation has routinely been upheld as long as it is properly performed, which occurs "when it is based on the principle that the unclaimed property in the reach-back years has 'all the same qualities and characteristics' as unclaimed property in the base-years;" and that a due process violation will arise when the estimation methodology creates misleading results. While Delaware acknowledged this principle, the Court found that it failed to apply it. For periods in which records did not exist, the state estimated for all states and used property for all states, not just for Delaware. Moreover, the state did not dispute that, under the primary rule of the Texas cases, it cannot escheat any checks from the base years with payees in other state. Delaware, however, estimated that Temple-Inland owed it unclaimed property by extrapolating those checks into the reach back years. The Court found the state's actions were premised on the logic that it did not need to extrapolate the characteristics of the property on which the estimation is based, because, if the records do not exist, then the address is unknown. This logic, the Court found, "stretches the definition of address unknown property to troubling lengths … [and] is contrary to the fundamental principle of estimation." Accordingly, the state's use of the existence of unclaimed property in the base year to infer the existence of unclaimed property in the reach-back year, without replicating the characteristics and qualities of the property within the sample, creates significantly misleading results.

Lastly, the Court determined that, because the state uses the same property already escheated to another state in the base years to infer the existence of unclaimed property in the reach-back year, Temple-Inland is being compelled to escheat the same estimated property to two states, in violation of the Texas cases.

**Other arguments — unlawful taking, ex post facto, and abstention**

The Court rejected Temple Inland's and Delaware's other arguments. The Court found that the state used Del. Code tit. 12, Section 1155 to identify a specific fund of money, which, if not unclaimed property, is a legitimate property interest protected by the takings clause, and that its estimation methodology "could be so inaccurate as to sweep into its final assessment property that is not in fact abandoned, but rightfully belongs to [Temple-Inland]." Nevertheless, the Court found that the proper use of estimation can satisfy the state's burden that the property is unclaimed, noting that "[e]stimation is properly employed when it balances the competing interests between an unlawful taking by the state and improper windfall for holders." Thus, the use of a reasonable estimation of a holders unclaimed property liability is not an unconstitutional taking. In this case, however, neither party presented evidence as to whether the state's estimation was reasonable.

The Court also rejected Temple-Inland's ex post facto argument (i.e., imposes a punishment for an act that was not punishable at the time it was committed), finding the provision applies in criminal proceedings, and that the Delaware General Assembly did not intend for Del. Code tit. 12, Section 1155 to act as a criminal punishment.

Lastly, the Court declined to abstain from ruling in the case based on the doctrine set forth in *Pullman*, 4
finding such abstention is not appropriate here because Del. Code tit. 12, Section 1155 is not ambiguous as it "clearly provides that the State Escheator has the authority to require a holder to pay the amount the State Escheator 'reasonably estimates' to be due and owning." The fact that it does not require a precise determination but allows a reasonable estimate does not render the statute ambiguous.

Implications

The Court's ruling in Temple-Inland, if it stands, will significantly affect unclaimed property audits and Voluntary Disclosure Agreements (VDAs). Key takeaways from this decision include the following:

-- **Change in the estimation calculation:** Estimation as calculated historically by Delaware or other states, inclusive in part of all escheatable property regardless of addressable state or exempt status, will not continue "as-is" and the calculation itself will change. Clarity on what the future calculation model will look like is forthcoming, given the Court's lack of finite guidance on what constitutes a "reasonable" estimation and reliance on Delaware to determine the way forward. At this time, it doesn't appear that the theory of estimation is entirely off the table for holders.

-- **Potential effect on other states:** The effect on other states with similar calculation models (i.e. New York and New Jersey) may include the ability to change those models and introduce the possibility of multi-state extrapolation, which is similar to apportionment within state and local tax and will have ramifications related to the prior Texas cases.

All organizations or holders should consider the effect of this ruling on their own unclaimed property footprint and strategy, as it will significantly affect those currently working through exposure related to Delaware unclaimed property audits or VDAs, and on other states and annual compliance efforts.

Other considerations affected holder should keep in mind include:

-- **Organizations currently under an audit or participating in a VDA with the state of Delaware or any other state:** There will be a change in the method under which the estimation calculation is performed, as the long-standing method of extrapolation utilized has been ruled unconstitutional at the very least for Temple-Inland and likely for other similarly situated holders. Strategic discussion and analysis is required urgently to assess the planned progression of the audit or VDA. The approach will depend upon where in the life-cycle of the audit or VDA process the holder currently is. This decision most certainly does not halt the addressable accounting record review efforts currently on-going as part of such audits or VDA work.

-- **Organizations considering a Delaware or other state VDA or organizations that have previously settled an audit or VDA related to Delaware or another state as a state of incorporation:** Strategic discussion is required to assess what, if any, action should be taken. This decision, coupled with specific fact patterns, could change the course of an organization's path forward.

-- **All organizations (whether complying annually or not with unclaimed property requirements):** Every organization should give immediate consideration to the annual reporting requirements imposed not only in Delaware but by all US jurisdictions and the existing internal procedures around identifying, tracking, remediating, and reporting unclaimed property. The examination and discussion of look-back periods, including applicable statutes of limitations, within this case furthers the critical need for an all-inclusive annual reporting function.

While uncertainties remain, including the potential for appeal to the Third Circuit by either party, as well as continued proceedings in the Court, the Court's assertion that Delaware's estimation process violates substantive due process creates a historic, landmark update in the unclaimed property environment, requiring immediate attention by the holder community.
ENDNOTES


3 Del. Code tit. 12, Section 1158.

4 Railroad Commission of Texas v. Pullman Co., 312 U.S. 496 (1941) (federal court abstains from ruling where the state statute is unclear and susceptible to an interpretation by a state court that could narrow or eliminate the federal constitutional question).

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