Deloitte.

Navigating the unclaimed property environment

By Tara Mastroserio and Michael Plaia,
Deloitte Tax LLP

Introduction

Unclaimed property is an evolving area of state compliance that creates strategic and operational challenges for many companies. As states adopt new laws and regulations, the need for companies, including corporations, limited liability companies (LLCs), partnerships, and nonprofits—regardless of industry, operations, or size—to understand their reporting obligations has become increasingly important. Having a proper understanding of states' varying and complex compliance requirements is also increasingly important as states continue to pursue unclaimed property collections as a source of revenue through increased compliance enforcement efforts. Noncompliance can result in hefty assessments of interest and penalties by the states if companies are not properly identifying and timely reporting their unclaimed property.

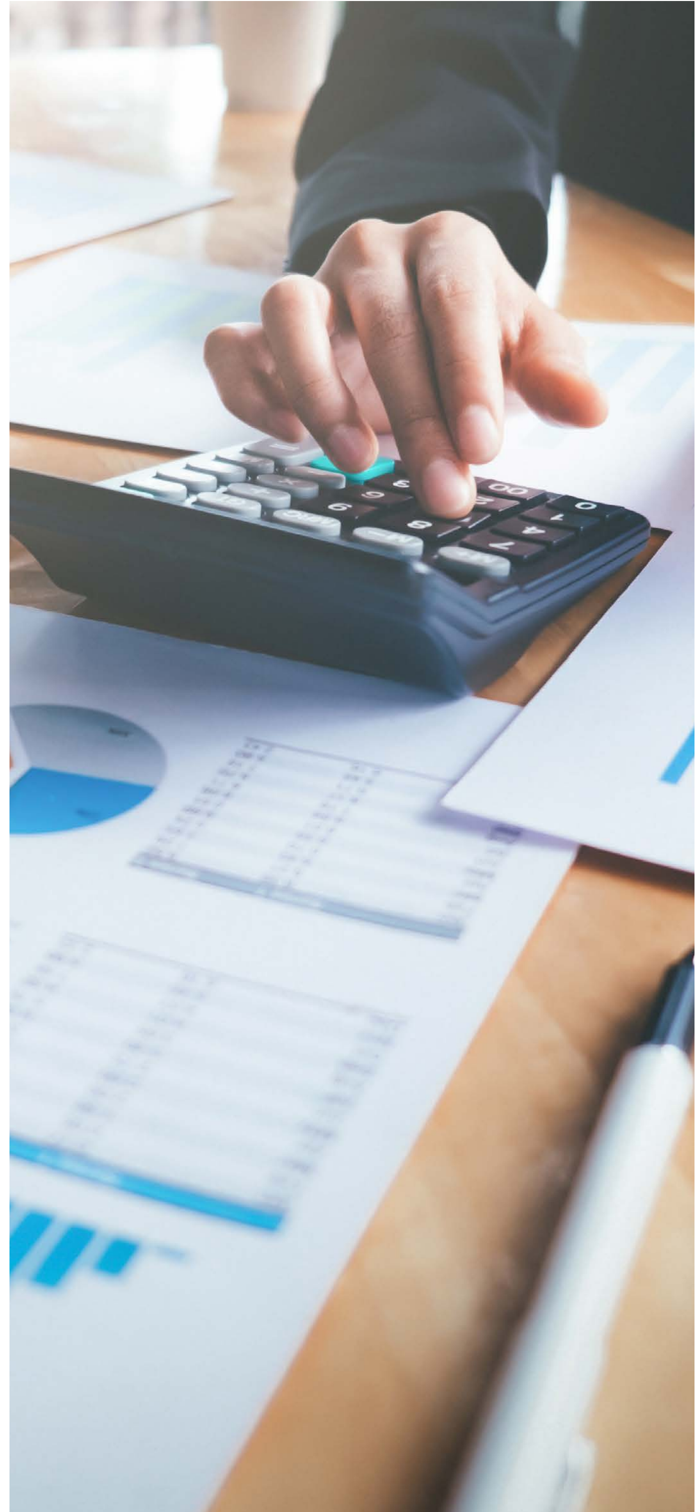
Unclaimed property background

In general, unclaimed property is any unresolved obligation generated in a company's business operations that is owed to a third party, such as a customer, vendor, or employee. Fifty-five US jurisdictions, including states, the District of Columbia, and territories ("states" or "jurisdictions"), currently have filing obligations, with many even requiring negative reports (i.e., a confirmation by an officer of the company that its records have been reviewed annually to confirm that no amounts are owed to the jurisdiction).

The priority rules established by the US Supreme Court in Texas v. New Jersey, 379 U. S. 674, 675 (1965) instruct companies on how to determine the state to which unclaimed property must be reported.

- First priority rule: Property is sourced and reported to the state of the owner's last known address as shown on the company's books and records.
- Second priority rule: If the owner's address is unknown, or the owner is located in a foreign jurisdiction, the property is reportable to the company's state of formation.

When thinking about unclaimed property, it is not only important to consider the numerous ways that obligations to third parties may arise during a company's business operations but also to understand when the unresolved obligations will become due and reportable to the states. The dormancy period represents the period of time between an obligation arising and when that amount becomes reportable to a state. Each state's dormancy period differs based on the type of property being reported (e.g., accounts payable, accounts receivable, payroll, or royalties) and the period of time between the last owner contact with respect to the specific property at issue and the period of time each state allows companies to hold the property before transferring it into the custody of the states.



Unclaimed property risks

All companies, regardless of industry, will generally have unclaimed property reporting obligations. While certain industries have industry-specific property types that would be typically reported, such as suspense accounts and royalties (oil and gas), payroll and gift cards (retail), and death benefits (life insurance), certain property types like vendor checks and customer credit balances are generally applicable across all industries.

Certain factors can increase the likelihood that a company has a higher risk of having unclaimed property exposure. Here are two examples:

- Companies with a history of mergers and acquisitions, especially stock acquisitions, whereby the historical unclaimed property exposures of the acquired companies become the buyers' liabilities to resolve.
- Companies that have grown quickly over the past decade that started with a basic accounting system and underwent subsequent software conversions and may not have retained all of the records from the prior systems.

While unclaimed property liabilities may arise in the accounting department, responsibilities for compliance and audits are often passed to the tax department given the similarities between state tax and unclaimed property compliance. Frequently, there is no "owner" within an organization for the unclaimed property compliance function. The actual responsibility is often "lost" within an organization, which can result in higher risks of having unclaimed property exposure related to noncompliance. This lack of ownership also contributes to a lack of understanding of essential unclaimed property concepts such as the relevance of last activity dates only being applicable to certain property types, how to calculate dormancy based on each state's differing dormancy periods for different property types, and available exemptions offered by a limited number of jurisdictions that could potentially be applied to mitigate exposure.

Companies must understand states' complex unclaimed property reporting requirements and properly identify and report all types of reportable property that are generated in a company's business operations to protect against exposure under state audits. Often, certain property types are inadvertently overlooked that can trigger audit examinations by states, especially given the increased amount of data mining being performed by states and third-party audit vendors utilized by states. Here are two common examples:

- A publicly traded company's transfer agent is reporting securities-related property types (e.g., dividends, unredeemed shares) in the name of the company, but the company itself is not reporting general ledger property types such as vendor and payroll checks and customer credit balances.
- A company is reporting the more widely understood property types such as uncashed payroll checks but is not reporting a more commonly misunderstood property type such as customer credit balances or unapplied cash receipts.

Unclaimed property audit examinations by states commonly have a lookback period of the prior 10 report years, which, after consideration of the three- or five-year dormancy periods of many states for most property types, means the audits involve the examination of periods dating back 13 or 15 years. In our experience, most companies do not retain complete accounting records for a 15-year period (especially when companies have been acquired) to prove the actual property owed to each of the jurisdictions. This can be problematic because the company's state of formation is often entitled to levy an assessment for the years of the lookback period for which records do not exist. In such instances, an error ratio is calculated based on the presumption of unclaimed property liabilities across all jurisdictions for the available periods of records ("base period") divided by a financial measure such as annual revenues for the base period. The error ratio is then applied against the same financial measure for the years of unavailable records to extrapolate an estimated assessment by the state of formation under the second priority rule.

In addition to these extensive lookback periods, state auditors and, if applicable, their audit vendors routinely shift the burden of proof to the companies undergoing examinations to justify that transactions qualified for review are not deemed reportable. In an audit examination context, this can include analyzing all checks that were voided 30 days or more after issuance to validate that the checks were either replaced or the underlying obligations were not owed. Depending on the company or industry, this may result in tens of thousands of checks requiring remediation, which can put a strain on company resources.

Delaware's Voluntary Disclosure Agreement (VDA) program

Many companies have historically formed their legal entities in Delaware. Under the second priority rule of sourcing unclaimed property, unknown and foreign addressed properties are reportable to a company's state of formation, including estimated amounts for periods where complete records under an audit or VDA are not available. This means Delaware is entitled to estimation for any entity formed in the state that does not have complete records under an audit or VDA. In fiscal year 2021, Delaware added approximately 300,000 business entities, bringing the total business entities registered in the state to about 1.8 million at year end.[1] For the same fiscal year, Delaware collected $449 million of unclaimed property,[2] and unclaimed property has consistently been the state's third-largest source of revenue for decades, eclipsed only by individual income tax and corporate franchise tax. By comparison, Texas's unclaimed property fund received $793 million in gross revenues in fiscal year 2021 and entering the 2021 calendar year, Texas was considered the world's ninth-largest economy by gross domestic product.[3]

Historically, Delaware has offered a VDA program for companies to come forward and report past due property with an abatement of interest and penalties.

Prior to 2012, the lookback period for a Delaware audit extended back to 1981 while the lookback period of the legacy VDA program, managed by the Delaware State Escheator, extended back to 1991. The latter has since evolved with the enactment of a series of Senate and House bills over the past decade. Delaware has made numerous impactful changes to its VDA and audit examination programs.

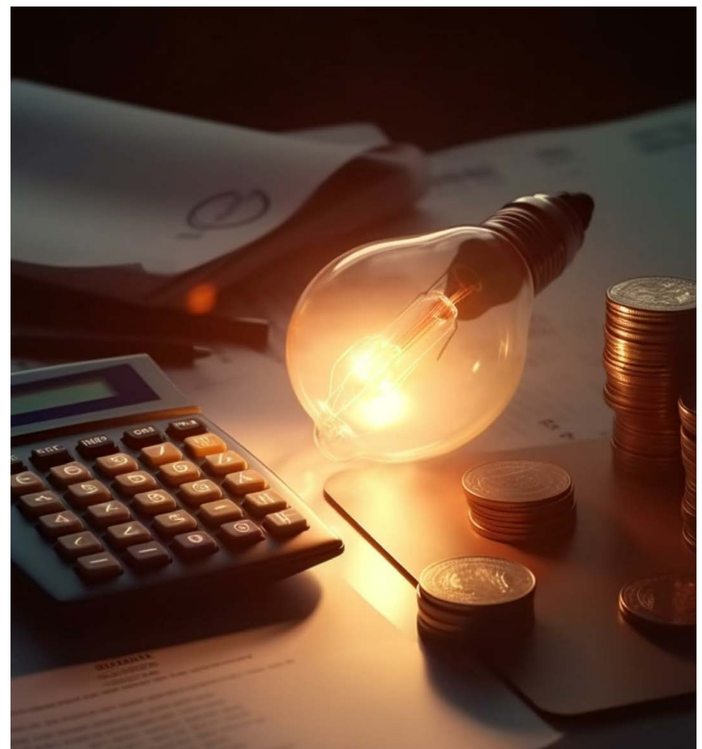
Some of the more significant changes include the following:

- In 2017, SB 13 was enacted and further restructured Delaware's unclaimed property laws by creating a rolling lookback period of 10 report years for both VDAs and audits. An expedited audit option for companies already under audit was added, requiring that the audits be completed within two years. In addition to the modifications to the VDA program, SB 13 added the right for Delaware to conduct compliance reviews—a review of one report year that has already been filed with the state (if the state believes that the filing may be inaccurate).
- SB 104 was enacted in 2021, making the expedited audit option permanent and adding that if a holder decides to opt out of the expedited option, the holder will automatically be subjected to a minimum 20% nonwaivable interest assessment.
- Most recently, SB 281 was enacted on June 30, 2022, which added the verified report request to Delaware's unclaimed property compliance enforcement program, giving Delaware the right to request that a company certify a previous report year's filing (or lack thereof) is accurate. If the state is not satisfied with the responses received, a compliance review can be conducted.

Delaware can send an audit notice to a company without inviting the company to join the VDA program under the following circumstances:

- Where a company has completed a VDA prior to 2012
- Where Delaware joins as a participating state in a multi-state audit initiated by other states
- Where a company does not respond to either a verified report or a compliance review request
- Where information is received under Delaware's False Claims and Reporting Act

Companies formed under the laws of Delaware should be aware of the state's various methods of compliance enforcement and may wish to undertake a self-review process. Companies do not need to wait to receive an invitation to join Delaware's VDA program.



California Voluntary Compliance Program

On September 13, 2022, California Assembly Bill 2280 (AB 2280) was signed into law, offering holders a Voluntary Compliance Program (VCP) for the first time in more than 20 years. The VCP allows the state to waive the interest (12% per annum) on past due property.

Companies are eligible for the VCP if all of the following apply:

01. They are not already under audit or have received notice of an audit by California or by a third-party audit firm on behalf of California.

02. They are not subject to a civil or criminal prosecution involving unclaimed property compliance.

03. They are not in possession of an unpaid interest notice within the last five years, or have successfully argued for an interest waiver in the five years preceding their application to the VCP.

When a company is considering enrolling in the California VCP, it is important to note the following requirements:

01. The VCP lookback period is a minimum of 10 years, but it is the state's expectation that companies review all periods of available books and records.

02. Completion of a training program is mandatory within three months of being accepted to the VCP.

03. Due diligence letters need to be issued no less than 30 days prior to submitting a company's preliminary Holder Notice Report under the VCP.

04. The preliminary Holder Notice Report is due within six months after notice of acceptance into the VCP by the state.

05. The Final Holder Remit Report and payment is due seven months and 15 days from the filing of the preliminary Holder Notice Report.

Recent audit trends

States have conducted unclaimed property examinations for decades. Audits may be conducted by states' auditors but are more commonly conducted by third-party audit vendors, who are hired by one or more participating states. These audit vendors may be paid on a contingency fee basis, meaning the audit firm receives a percentage of its findings. Some states pay hourly fees to the vendors instead of contingent fees. Many states have also more recently focused on "self-audit" programs, whereby companies are asked to perform a self-review of their records, focusing on a single state.

While many of the characteristics of a multi-state audit and a self-audit overlap (e.g., can be challenging to navigate, multifaceted requests for supporting documentation, due diligence requirements, complex laws based on the industry, and generally a 10-year report lookback period), there are some distinct differences. Multi-state audits usually take multiple years to complete with audit vendors requesting burdensome data and information that can take companies a long time to gather based on their systems and processes. Once the information is provided, the audit vendor will schedule potentially in-scope items (e.g., outstanding or voided checks, accounts receivable credit balances) for the company to research. The burden is on the company to provide sufficient documentation to the audit vendor to prove why an item is not deemed unclaimed property. It can be challenging for a company to gather documentation for items that are 10 to 15 years old even if books and records are available, leaving them potentially susceptible to large exposure amounts.

With the increase of data mining and a state's ability to obtain assistance from a growing number of audit vendors, single-state self-audits have been on the rise. The state typically sends a questionnaire that guides the company through a review of each potentially reportable property type. The company conducts a self-examination related to various property types and determines whether the company has any unpaid obligations to be reported. These audits usually take six months or less to complete with the company maintaining greater control of the process. The audit vendor may ask follow-up questions or request supporting documentation related to various items, but these self-audits are typically less intrusive than a multi-state audit examination. Many of these programs are assisted by the same audit vendors that are used for conducting states' audit examinations and typically do not include assurance that the same states will not audit the companies at a future date.

Conclusion

Ultimately, both compliant and noncompliant companies should be aware of the potential risks of state unclaimed property enforcement methods. Generally, companies will benefit from periodic and proactive reviews of their compliance processes and records so they can avail themselves of potential opportunities to remediate any identified exposures through VDA programs and other process improvements.

Deloitte Tax LLP contacts:

Tara Mastroserio
Senior Manager
Deloitte Tax LLP
Multistate Tax Services
New York
tmastroserio@deloitte.com
+1 845 648 5823

Michael Plaia
Manager
Deloitte Tax LLP
Multistate Tax Services
Los Angeles
mplaia@deloitte.com
+1 213 553 1720

End notes

01. Delaware Division of Corporations, "2021 annual report," accessed June 19, 2023.
02. Delaware Department of Finance, Delaware Fiscal Notebook, 2022.
03. Robert Allen, "TEXAS ENTERS 2021 AS WORLD'S 9TH LARGEST ECONOMY BY GDP," Texas Economic Development & Tourism, January 27, 2021; Texas Comptroller of Public Accounts, Texas Annual Financial Report, 2021.

This article contains general information only and Deloitte is not, by means of this article, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This article is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this article.

As used in this document, "Deloitte" means Deloitte Tax LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2023 Deloitte Development LLC. All rights reserved.