



DECEMBER 7, 1787

# Delaware's Unclaimed Property Tug of War



Once considered a mundane ministerial function, virtually all states over the past decade have stepped up enforcement in an effort to re-unite unclaimed property with its owners.

## By Robert Peters

Delaware, the first state in the nation to sign the U.S. Constitution and the second smallest state and legal home to over one million organizations, is embroiled in controversy over one of the most misunderstood corporate provisions currently in existence ... unclaimed property.

The roots of unclaimed property laws date back as far as feudal times and the colonization of the early Americas. Over the years, states have defined, refined and dramatically modified the various unclaimed property laws. While in feudal times the escheat of property related primarily to tangible real and personal property, today all 50 states and U.S. territories have provisions on their books requiring entities that are in possession of certain intangible unclaimed property to remit the amount to the states after the expiration of an inactivity or dormancy period.

These time provisions can vary widely, ranging from one year for uncashed payroll checks, to between three and five years for other forms of intangible property, such as unredeemed gift cards, uncashed dividend payments and credit balances.

Once considered a mundane ministerial function, virtually all states over the past decade have stepped up enforcement in an effort to re-unite unclaimed property with its owners. There is also a hidden objective; use unclaimed

property collections to offset budget deficits that otherwise would require tax increases or spending cuts to close. As of 2012, the National Association of Unclaimed Property Administrators estimates that unclaimed funds in excess of \$41 billion are available to supplement most states' general funds.

Delaware, in particular, has gained national recognition for its assertive efforts to step up collection of unclaimed property. Despite being among the smallest states in the country, Delaware's unclaimed property collections have ballooned over the past decade to where only California and New York collect more per year.

Unclaimed property collections in Delaware make up the third largest form of state revenue behind only personal income and corporate franchise taxes. In 2013, these revenues are projected to exceed \$500 million, and the overwhelming majority of these collections go directly to the state's general fund. On average, less than 2 percent of collections are returned to the unclaimed property owner.

Yet, Delaware faces a major identity crisis. On the one hand, it promotes itself as a "corporate friendly state" going to great lengths to convince corporations of its unparalleled range of incorporation provisions, which include "modern and flexible corporate laws, highly-respected Court of Chancery, a business-friendly State Government and the customer service-oriented Staff of the Delaware Division of Corporations.

The state's success over the years speaks volumes; consider for example that last year alone, 133,297 businesses set up shop here. In a telling illustration by Leslie Wayne of *The New York Times*, "at last count, Delaware had more corporate entities, public and private, than people — 945,326 to 897,934."

Despite Delaware's stellar reputation as a great place for companies of all sizes and scale to incorporate, its business-friendly image has grown quite tarnished over the past decade. The largest public and private corporations that call Delaware their legal home are highly critical of its unclaimed property audit practices. The Council of State Taxation (COST) has given the state the grade of "F" in its State Unclaimed Property Practices Scorecard for its aggressive and excessive application of the unclaimed property provisions, all while professing that these practices were never intended to generate a windfall to a state.

Despite one of the major stated intentions of the unclaimed property provisions being to "reunite property owners with their lost or abandoned property," application of Delaware's estimation techniques assures that amounts remitted to the state are owed to no one and cannot be claimed by any owner — leaving the monies in the hands of the general fund.

A growing number of corporations that have fallen subject to audit are taken aback by Delaware's ability to deter-

mine liabilities as far back as 1981, unrestricted by a statute of limitations as would apply in any other government examination. Even the most sophisticated companies in the country that have a long history of filing unclaimed property reports with Delaware and other states find themselves encumbered with long and costly audits that can extend three-to-five years and result in \$10s of millions in liability.

Additionally, as indicated by legal authority Ethan Millar, of Alston and Bird LLP, the states often disregard contractual limitations on owner's rights to claim property, meaning that

*A growing number of corporations that have fallen subject to audit are taken aback by Delaware's ability to determine liabilities as far back as 1981, unrestricted by a statute of limitations as would apply in any other government examination.*

the state (including Delaware) can claim unclaimed property even when the property owner can no longer do so. Such has been the subject of litigation between Delaware and several major corporations.

In 2012, Staples Inc. paid \$8.9 million to settle an unclaimed property dispute with Delaware after the court ruled that unclaimed rebates issued in connection with the sale of merchandise constituted unclaimed property. Based on these facts it should come as no surprise that Executive Director of COST Doug Lindholm recently dubbed Delaware a "bully" in a *Forbes* magazine editorial.

### Kinder and Friendlier?

In response to what began as a whimper but has grown to a growl by Delaware's primary revenue source — Fortune 500 companies — Delaware enacted an unclaimed property voluntary disclosure program in 2012 (2012 Del. S.B. 258), which was intended in part to curb fears of large corporations considering re-

incorporating elsewhere, and in part to live up to its assertions of being "business friendly."

The state has done a reasonably good job of promoting the benefits of participating in the Voluntary Disclosure Agreement (VDA) program, which include:

- Limited look-back period to 1993, versus 1981 if audited (reduction of 12 years) for companies opting in before June 30, 2014;
- Waiver of interest and penalties (which can equal or exceed the liability if audited);
- No risk of audit by the state; and most importantly,

- The ability to self-control the process.

Equally important, unlike prior VDA programs that were administered by Delaware's Department of Finance, which also controlled the audit process (some analogized this as being akin to "a wolf in sheep's clothing"), the new VDA initiative is being managed by the Secretary of State, which has established itself among corporations as highly efficient and user-friendly.

In order to qualify for the benefits under the new VDA Program, companies are required to:

1. State their intention to participate in the program no later than June 30, 2014;
2. Not currently be under audit; and
3. Complete the final submission and report of past due obligations no later than June 30, 2015.

As revealed in a recent survey of financial executives conducted by Duff & Phelps and Financial Executives Research Foundation (FERF), *The State of*

*Unclaimed Property*, the response to Delaware's new VDA program was tepid at first. Within the first six months of it having been announced less than 50 companies indicated their intention to participate. Through June 30, 2013 — after a rash of publicity — more than 450 companies have stepped forward.

Though seemingly a large response, given that approximately one million entities call Delaware their legal home, and claims by Delaware's past unclaimed property administrator that less than 5 percent of these entities are compliant, there exists a vast expanse of companies that may not be fully aware of the potential implications or consequences of a Delaware audit.

The survey results offer some insight into the disparate views held by Delaware and companies that are organized in the state. Eighty-three percent of companies surveyed believed they are already compliant with all reporting/remittance of unclaimed property to Delaware and/or other states; and 75 percent indicated they were not likely to participate, even after being familiar with the program.

Among reasons offered for not participating in Delaware's VDA program: Companies needed to know more about the rules, as many were unfamiliar with the unclaimed property rules; and many believed they had no reporting requirement because they do not have a business presence (nexus activities) in the state.

On this second point, it is important to note that unlike income or sales tax, unclaimed property reporting requirements have no nexus requirement. Companies are required to submit reports based on location of their vendors, customers, third-party and employee addresses, not their place of business (first priority rule).

### The Unclaimed Property Conundrum

The survey results reveal that many companies face a conundrum when it comes to addressing unclaimed prop-

erty. For many there is a false sense of security that may come from the belief that the organization has a history of filing unclaimed property reports or has no presence in the tiny state of Delaware. Unfortunately such a perspective may fall subject to challenge.

Among other key survey findings:

- Due to estimation techniques, broad authority, limited case law and no statute of limitations, history has proven that even the most sophisticated company can be exposed to millions in unclaimed property liabilities or equally troublesome audits that can take anywhere from three-to-five years to resolve.

- Results confirm that of the companies selected for audit, 100 percent resulted in liability, with 65 percent resulting in a liability in excess of \$100,000.

- While Delaware (and other states) are encouraging companies to voluntarily come forward, they simultaneously are aggressively pursuing audits of organizations believed to be non-compliant. Delaware sent hundreds of letters to organizations, “reminding” them of the potential for past unclaimed property reporting obligations and suggesting participation in its VDA program.

The letters also included a warning (some would view as a veiled threat) that if the organization did not voluntarily come forward it could fall subject to a long and rigorous unclaimed property audit, with the added language in its final notice: “Companies that previously received a letter from me, including yours, were not included in the most recent round of Department of Finance audit notices. However, the Delaware Department of Finance is free to issue an audit letter at any time to any party. I strongly urge you to consider the opportunity to participate in the VDA Program as it is preferable to the possibility of an audit.”

## What to Do Now

The past audit activities of the State of Delaware and other jurisdictions — in addition to those of other states

— provide some clear guidance for companies:

### 1. Carefully Consider Whether or Not to File a VDA is in a Company's Best Interest.

All companies that are not currently under audit (even if audited in the past) and incorporated in Delaware should carefully consider whether or not filing a VDA would be advantageous. Even if a company believes it is compliant, filing a VDA can serve as a form of insurance in order to avert future audits and narrow the 30-year look-back estimation period in the event of an audit.

### 2. The Window of Opportunity is Still Open.

Though maximum benefit of Delaware's VDA program resulted from companies that stepped forward prior to July 1, 2013, there is still time to benefit from the favorable conditions offered under Delaware's program if an election is filed on or before June 30, 2014, including reducing the look-back period by 12 years, eliminating interest and penalties and averting audit risk.

### 3. Time is of the Essence.

Even though companies have until June 30, 2014 to indicate their consent to participate, the self-audit, review by state administrators and acceptance by the state has to be completed no later than June 30, 2015. For many organizations the actual time required to gather the information necessary to complete the submission and satisfy the procedures required by the state and its administrators (although less than prior VDA programs offered by the state) will still be quite extensive. Time and resources need to be committed to ensure the required deadline is satisfied.

### 4. Seek Outside Help.

The Secretary of State, through its administrators, has been quite clear that the new VDA program offers the opportunity to satisfy past obligations in a more efficient and friendlier manner than through the “rigors of an audit.” However, more

efficient does not mean lax, and the Secretary has issued specific guidelines and standards for all applicants to follow in completing the VDA process, available in detail at DelawareVDA.com. They further expect that companies indicating their consent will comply with these guidelines and agreed timelines, or risk their acceptance into the program being revoked; hence throwing them back into the audit lottery.

In a somewhat unprecedented move, the state also has strongly encouraged all applicants to seek the help of an outside advocate in managing the VDA process. Letters were sent to all applicants that did not indicate they were represented by an outside advocate advising that “several key legal and/or accounting issues are likely to arise in every VDA, and having the appropriate advocate to guide the company through these issues could potentially reduce its exposure, particularly for early years in which the company may not have retained the requisite records needed to report unclaimed property.”

They even have taken the bold step of providing a list of advocates that are representing other holders. Companies should at a minimum consider the advice of an advocate that has extensive experience with Delaware's VDA and audit process and procedures.

### 5. For Those That Do Not Step Forward.

Regardless of the reason, those companies that do not participate in Delaware (or other state VDA programs) should still nevertheless take care to conduct their own self-review to evaluate any potential for past liability, determine steps that can be taken to mitigate or reduce that liability and, most importantly, implement processes and procedures to gather, track and report unclaimed property on a going-forward basis. ☞

*Robert Peters is a managing director and national leader for Duff & Phelps' Unclaimed Property and Tax Risk Advisory practice.*