CALIFORNIA'S NEW ESCHEAT REPORTING REQUIREMENT ON INCOME TAX RETURNS

The information in this article is up to date as of Sept. 20, 2022.

A new trend in state and local tax reporting in California combines certain income tax and unclaimed property reporting requirements on 2021 and future business income tax returns to enhance compliance.

The increased compliance efforts of the California State Controller's Office (SCO) regarding unclaimed property will likely result in increased audit activity. CA Assembly Bill 466, which became effective on Jan. 1, 2022, authorizes the Franchise Tax Board (FTB) to share certain information with the SCO related to unclaimed property. Through this change, the state of California expects to increase awareness of and compliance with its Unclaimed Property Law.[1]

So what is changing? Well, the FTB will add the following questions to certain business entity tax returns:

1. Has this business entity previously filed an unclaimed property Holder Remit Report with the State Controller's Office? [Yes / No]
2. If "Yes," when was the last report filed?
3. Amount last remitted?

The FTB will be able to share the answers to these questions, along with the taxpayer's entity status and revenue range with the SCO. Once the SCO obtains this information, it may use it to identify companies it feels may not be in unclaimed property compliance for audit. This is significant for both in-state and out-of-state businesses because California assesses interest at a rate of 12% simple interest of the value of the property per year, from the date the property should have been reported.[2] In addition, the state may assess penalties and/or fines up to $50,000.[3]

With the recent California escheatment law changes, accounting, tax and legal professionals are left wondering how will the sharing of this information be used to drive compliance? Will businesses be subject to audit based on their answers to questions on the return, or will they be automatically audited for unclaimed property if selected for income tax audit? Will every unclaimed property audit result in an income tax audit – or vice versa? What if a business never filed unclaimed property in California before? How does merger and acquisition activity affect such reporting? Does it matter if the parent or any of the subsidiaries are incorporated in California? How many years back does this change affect? What if a business does not have records that go back 13 years or to their first day of business? Should a business be reserving for these liabilities? How does a business mitigate the risk and comply with the changes? Are other states adopting similar information sharing methods for unclaimed property compliance? These are just some of the questions looming from the law change.

This article explores the details of the recent California law changes in AB 466 and AB 2280, and particularly how these changes set a "new" trend in unclaimed property compliance that may spread like wildfire in other states. We analyze the jeopardy that such information gathered will allow for more targeted audits, piggy-back audit risks and contingent fee auditor arrangements, as well as mitigation opportunities proposed by California's voluntary disclosure agreement (VDA) program.

1 Cal. Civ. Proc. Code §§ 1500 et seq.

2 Id. at §1577.

3 Id. at §1576.

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UNCLAIMED PROPERTY INTRODUCTION

All states have laws governing the reporting and remittance of abandoned property, which is also referred to as unclaimed property or property subject to escheatment (escheat). Unclaimed property laws require companies (the holders) that hold abandoned property to report property to the appropriate jurisdiction after the time prescribed by the state has passed. This period of time required for property to age prior to escheatment varies by jurisdiction and is commonly referred to as the dormancy period. Unclaimed property laws were put into place to help ensure property is returned, or reunited, with the rightful owner. States believe they are in a better position to unite abandoned property with the rightful owner, as opposed to the companies that held the reported property prior to escheatment. Property held by states, and any interest earned on said property, may be used for the betterment of the public.

The determination of which state has jurisdiction over unclaimed property is made using the "priority rules" set forth by the U.S. Supreme Court in *Texas v. New Jersey*.[4] The first priority rule declares that any property where the owner's last known name and address is provided is subject to escheatment in that specific state. The second priority rule comes into effect when the address is not known; at which point property is reportable to the company's state of incorporation (or, generally, the state of commercial domicile for an unincorporated entity).

Unclaimed property may include various types of intangible property, as well as some tangible personal property, depending on state law. Common types include uncashed payroll or commission checks; uncashed vendor checks; unresolved voided checks, unredeemed gift certificates and gift cards; customer credits, layaways, deposits, refunds and rebates; overpayments and unidentified remittances; and accounts receivable credits, including credits that have been written off and recorded as income or expense (for example, bad debt and miscellaneous income).

Most unclaimed property reviews are comprised of two types of liability: (a) liability where actual researchable records exist, i.e., "base period liability and/or address property liability" and (b) liability derived through estimation where no or unsupportable records exist, i.e., "the projection period or estimation years". The two types of liability (address property & estimation) are largely due to the fact that the average state unclaimed property look back period is 13-15 years while general IRS and banking guidelines only require organizations to retain records for an approximate seven-year period. This creates a potential gap of six–eight years where estimation would be utilized. California's look-back period is 10 years plus dormancy period (e.g., typically three years for most property types).

States enforce their unclaimed property laws through audits conducted by either state representatives, or, more commonly, through third-party contingent fee-based auditors. Estimation is commonly done to establish liabilities for the period of time where holders cannot provide complete and researchable records for testing. The combination of the length of the audit period, lack of available records, lack of what an auditor may deem as "sufficient support" and extrapolation methods used often lead to assessments well in excess of what a company believes is owed or has appropriately accrued for.

States have always maintained that unclaimed property laws are a function of consumer protection. California estimates that less than 2% of businesses comply with its escheatment laws. But it is not news that unclaimed property collected from corporate holders is a major source of revenue for some states. According to SmartAsset, there are more than $49 billion in unclaimed funds waiting to be claimed. The National Association of Unclaimed Property Administrators reports that states net out an additional $3 billion each year after returning more than $3 billion to owners each year.

While much of the funds are held in custody for the rightful owner, where unclaimed amounts are estimated, of course, no owner is associated with the funds. Those funds can immediately be transferred to plug state budget shortfalls or finance particular projects without raising taxes.[5]

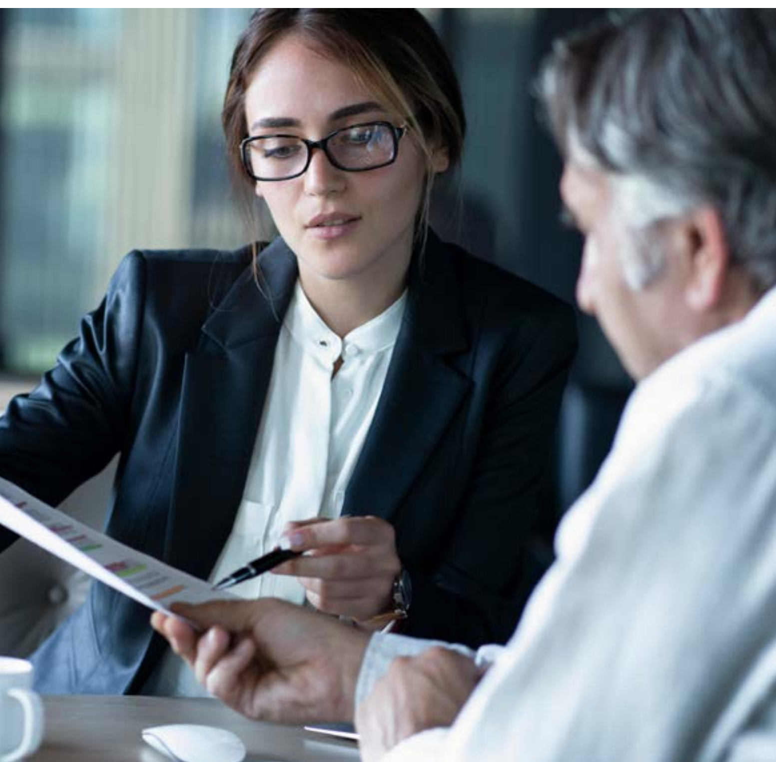
4 379 U.S. 674 (1965).

5 See Fitch Ratings, Fitch Rates Delaware's $301MM GO Bonds 'AAA'; Outlook Stable, https://www.fitchratings.com/site/pressrelease?id=999170 (Feb. 10, 2016) (noting that abandoned property typically accounted for over 10% of Delaware's general fund revenues in fiscal year 2015 and was expected to increase. Accord, *Temple-Inland*, 192 F.Supp.3d at 532 (citing Delaware's own recognition that unclaimed property was a "vital element" in the state's operating budget).

CALIFORNIA AB 2280 – PROPOSED VOLUNTARY DISCLOSURE PROGRAM[6]

To complement the state's enhanced compliance efforts embodied in AB 466, on Feb. 16, 2022, CA Assembly Bill 2280 (AB 2280) was introduced with the aim of providing a long-awaited means for businesses to come into compliance, interest-free, through the creation of the California Voluntary Compliance Program (VCP),[7] and was signed by Governor Newsom on Sept. 13, 2022. A business holding unclaimed property (holder) who wishes to report past due unclaimed property may request to enroll in the program. Acceptance into the program is at the SCO's discretion; however, the following situations would make holders ineligible:

- Holder is currently under examination or has received a notification from the SCO of a pending examination.
- Holder is the subject of a civil or criminal prosecution related to compliance with the Unclaimed Property Law.
- Holder has been notified by the SCO of an interest assessment under the Unclaimed Property Law in the last five years and it remains unpaid. (Note: paying the interest assessment would allow the holder to once again request enrollment.)
- The SCO has waived interest against the holder under the Unclaimed Property Law within the last five years.[8]



As part of the VCP program, the SCO will waive interest under the program if a holder does all of the following:

- Enrolls and participates in the SCO's unclaimed property educational program within three months of enrollment in the VCP.
- Completes a review of books and records going back 10 (report) years.
- Complies with due diligence requirements to notify owners of reportable unclaimed property not less than 30 days from submitting the VCP filings.
- Files an initial report within six months of enrollment into the VCP. (Note: an extension of time up to 12 months would be possible at the SCO's discretion providing for a total of 18 months' time to complete VCP from date of enrollment.)
- Files a final report seven months to seven months and 15 days after the initial report, along with full payment.

It should be noted however, the SCO can reinstate interest if the holder does not report, pay and deliver all reportable property within the required timeframes.

6 Please note that this bill is proposed at the time of this writing and may be passed before we can update this article. It is expected that the bill will pass in 2022 at this time.

7 AB 2280 is effective Jan. 1, 2023. In addition to establishing a VCP, the bill also provides for the following: (a) limits interest to $10,000 if a holder files a report – after the initial report and before payment or delivery is made for property that may not be subject to escheat – that is not in substantial compliance with statutory requirements, (b) allows the SCO to waive interest payable if the holder's failure to report in substantial compliance with specified requirements is due to reasonable cause, (c) invalidates certain finder's fee agreements and requires certain agreements to include information about the nature and value of the property, that the SCO is in possession of the property, and the address where the owner can directly claim the property from the SCO, and (d) exempts records and information obtained by the SCO pursuant to the Uniform Property Law from disclosure under California Public Records Act, including financial records obtained during examinations, records related to statements of personal worth or personal financial data and personal information. See AB 2280 for more information.

8 Notwithstanding the foregoing, if a holder acquired or merged with another entity within the five-year period, the holder may request to enroll in the program for the purpose of resolving unclaimed property that may be due and owing to the state as a result of the acquisition or merger.

A LOOK AT OTHER STATES

Information Sharing

Just like taxes, unclaimed property laws and enforcement vary by state. This adds to the complexity in identifying unclaimed property and properly determining the correct state to escheat property. As described above certain states are sharing information internally among various agencies. In addition, there are certain states that also share information with sister states. Sharing of information, particularly information from a tax return was blessed by the U.S. Supreme Court way back in 1911. The Court held, in *Flint v. Stone Tracy Co* (220 US 107), that the filing and public inspection of corporate income tax returns does not violate the unreasonable search and seizure clause of the Fourth Amendment or the self-incrimination of the Fifth Amendment of the Constitution. So without Constitutional protection, the sharing of information or prohibition thereof was left to the states. Most states have implemented some type of limitations or permissions related to sharing information with other state agencies or other states. Common information shared among or between states includes tax returns, audit information, correspondence between the state and taxpayer, business implications and settlement agreements. As we have seen in California, information about compliance with a different agency can even be requested and shared. Examples of information sharing agreements include:

1. Federation of Tax Administrators Exchange of Information Agreement.
2. Southeastern Association of Tax Administers (Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina and South Carolina).
3. The Streamlined Sales Tax Information Sharing Agreement (23 full-time members and some associate members).

Given the above, it is likely that other states in time will adopt a similar process as California for collecting data on income tax returns to measure compliance with its unclaimed property laws. This is a paradigm shift for taxpayers/holders that will require more diligence and proactive measures in addressing a business's escheat policies and procedures, current and historical reporting, and M&A transaction implications, amongst other concerns prospectively.

Piggyback Audits and Contingency Fees

In the past, audits of any nature were conducted by the agency in charge of the content at issue. Revenue Departments have well-trained staff and managers and handle thousands of audits on a relatively consistent basis. But times change and private enterprise soon realized that there is money to be made by representing state agencies in the audit space. Unclaimed property is no exception.

Historically, most states had little to no involvement in unclaimed property audits. However, that started to change 20 years ago, and private enterprise jumped into the void and began selling their services to states generally on a contingency basis. It was not unexpected that the audits conducted by third-party auditors became a bit more aggressive and battle lines over issues were established. The third-party auditors routinely took their half of all 50/50 issues.

At first, most controversial issues were resolved short of litigation during the settlement/resolution phase. However, over the last 10 years, holders have pushed back and taken the more unreasonable positions to court – often successfully. One area that taxpayers have pushed back on is rewarding the third-party auditors on a contingency basis. Many states have now replaced or provided an alternative to the contingency fee plan with an hourly fee plan. However, issues remain, as third-party auditors potentially make more money the longer audits go on. And we all know that unclaimed property audits seem to last a long, long time (e.g., three-five years in many cases).

Further, once the third-party auditors got involved, they saw an opportunity to expand their services. No longer were audits limited to a single state. The third-party auditors solicited additional states to join the audit. Their message was simple: we are auditing XYZ company for state W, why don't you join the audit at no cost unless we find you some unclaimed property. This offer proved to be too good for most states to pass, and soon every audit by the third-party auditors became a multistate audit with up to 25 to 30 states involved. This creates a much bigger burden and potential liability for holders.

The SCO addresses contract auditor payment in proposed regulations that are expected to be adopted by providing:

> At the discretion of the State Controller, a contract with a third-party auditor may specify that the auditor is to be compensated on a time and materials basis, as percentage of the amount recovered by the third-party auditor, or in any combination thereof. However, any compensation to the third-party auditor shall not be withheld from any recovery obtained by reason of an audit.[9]

California also provides in a 2019 request for proposal (RFP) its general invoicing and payment provisions for third-party contract auditing firms. This may be indicative of potential contingency fee arrangements prospectively. That RFP provides in relevant part as follows:

> For services satisfactorily rendered, and upon receipt and approval of invoices, the State agrees to compensate the Contractor for actual service performed in accordance with the following fees:
>
> a. The rates paid to the Contractor by SCO will be ten and one-half percent (10 1/2%) of the value of property processed and delivered to SCO by the Contractor. The Contractor must, within 18 months of receipt of the authorization letter, file a Holder Notice Report with SCO in accordance with the requirements of CCP section 1530 and, file a Holder Remit report with property remittance in accordance with the requirements of CCP section 1532.
>
> b. The percentage of compensation to be paid to the Contractor on all property not delivered within the time specified will be reduced to nine percent (9%). The rate will be reduced in accordance with this schedule unless an extension of time to complete the examination has been granted by the Controller for good cause.[10]

Record Retention and Extrapolation

Another issue relating to unclaimed property audits is the long lookback periods ranging from 10-15 years in most states. California's look-back period is 10 years plus dormancy (three years for most property types).[11] However, even a 13-year look-back period can be unbelievably burdensome. How many businesses, large or small, have complete books and records (check registers, void lists, credit registers, etc.) going back 13 years? Even if the records exist, are the records researchable? Technological advances have made most record retention systems obsolete after seven to ten years. Can you imagine the data storage space needed to account for every voided check issued in 2008?

Unfortunately, the unclaimed property system adopted by most states and sanctioned by the U.S. Supreme Court anticipates a holder's inability to maintain historical records. It is called extrapolation. Similar to a sample in a sales tax audit, the auditors create an error ratio based on the books and records that the holder does possess. That error ratio is then used to create an estimated unclaimed property in the years where books and records are missing. Often the error ratio is derived by the value of unclaimed property in the sample period over gross revenue. That ratio is then applied to gross revenue in each of the years missing sufficient books and records to create an unclaimed property amount. It is unclear how California will calculate and apply extrapolation techniques on future audits and voluntary disclosures and whether it makes a difference if California-domiciled. Notwithstanding, it is expected that California will apply some form of extrapolation to years in the look-back period where insufficient records or no records exist.[12]

9 See generally Article 6: Regulations Governing the Activities of Third-Party Auditors Who Are Hired by the Controller Sec. 1203 (proposed 2/11/22, open for public comment between 7/11/22 – 7/26/22) via SCO website https://www.sco.ca.gov/Files-UPD/NoticeProposedAmendmentRegulationsThirdPartyAuditors.pdf. Please note that these regulations are proposed at the time of this writing and may be passed before we can update this article.

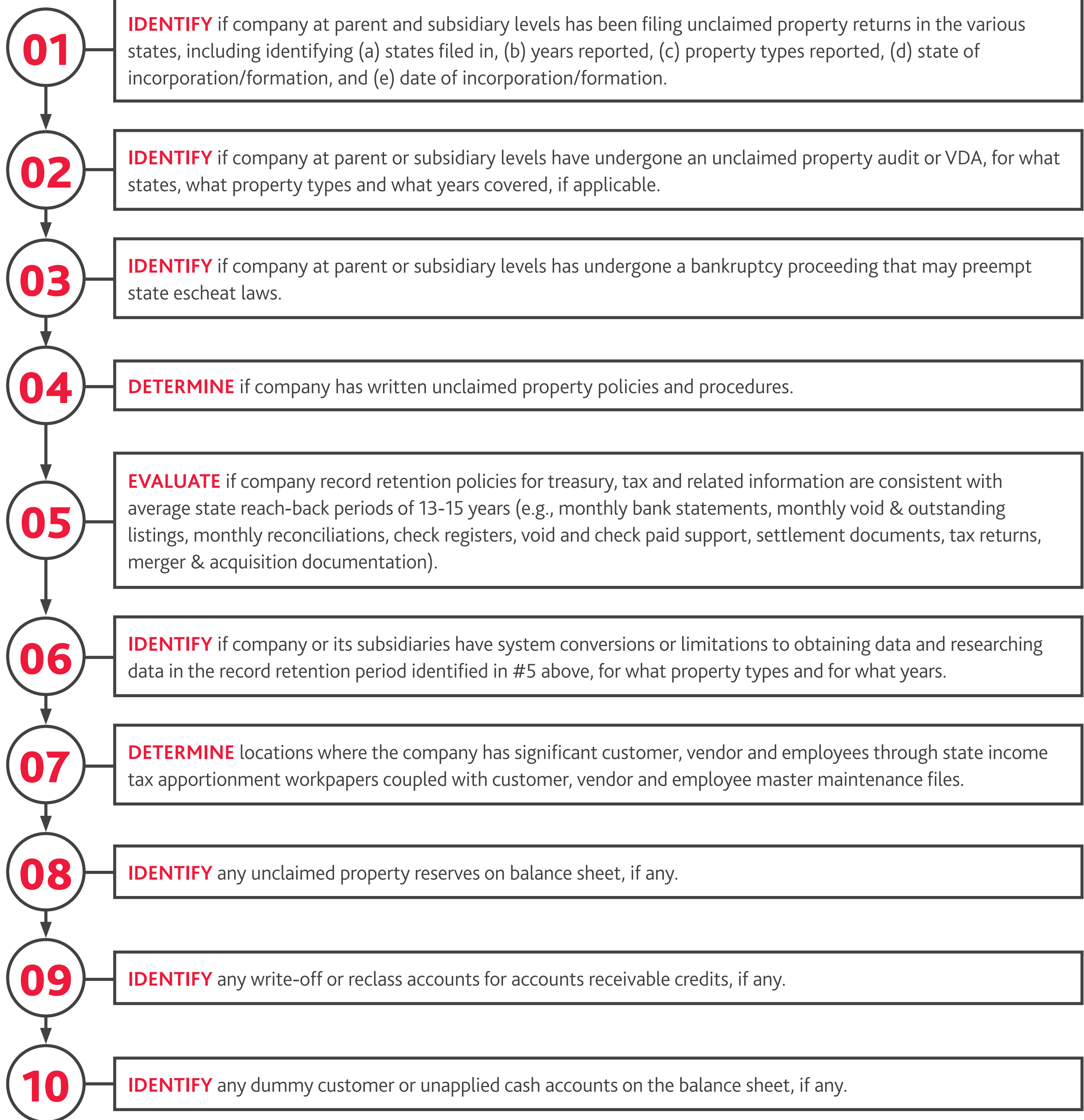
10 REQUEST FOR PROPOSAL (RFP) (Primary) Number EUPD90319 AGENT(S) TO IDENTIFY, EXAMINE, PROCESS, AND COLLECT UNCLAIMED PROPERTY (August 5, 2019), and published on their website.

11 See generally AB 2280 (proposed 2/16/22). See also Audit Look-Back periods obtained from 2021 California multistate audit letters/recent Kelmar auditor workpapers which appears to be adopted as administrative policy. However, see 2 CCR § 1175 (7 year plus dormancy record retention applies to years after such property is reported, or would have been reported.

12 See generally California Policies and Procedures Applicable to State-Authorized Unclaimed Property Examinations Conducted by Third-Party Auditors page 6-7 (September 2003, updated 2020); See also generally Article 6: Regulations Governing the Activities of Third-Party Auditors Who Are Hired by the Controller Sec. 1220 (proposed 2/11/22, open for public comment between 7/11/22 – 7/26/22) via SCO website https://www.sco.ca.gov/Files-UPD/NoticeProposedAmendmentRegulationsThirdPartyAuditors.pdf

HOW DO HOLDERS ADDRESS RISKS AND REQUIREMENTS?

Holders should approach unclaimed property by taking the following **"Top 10" steps to understand risk profile**, how to mitigate risks appropriately (if any) and comply with ongoing California and other state escheat laws:



01 **IDENTIFY** if company at parent and subsidiary levels has been filing unclaimed property returns in the various states, including identifying (a) states filed in, (b) years reported, (c) property types reported, (d) state of incorporation/formation, and (e) date of incorporation/formation.

02 **IDENTIFY** if company at parent or subsidiary levels have undergone an unclaimed property audit or VDA, for what states, what property types and what years covered, if applicable.

03 **IDENTIFY** if company at parent or subsidiary levels has undergone a bankruptcy proceeding that may preempt state escheat laws.

04 **DETERMINE** if company has written unclaimed property policies and procedures.

05 **EVALUATE** if company record retention policies for treasury, tax and related information are consistent with average state reach-back periods of 13-15 years (e.g., monthly bank statements, monthly void & outstanding listings, monthly reconciliations, check registers, void and check paid support, settlement documents, tax returns, merger & acquisition documentation).

06 **IDENTIFY** if company or its subsidiaries have system conversions or limitations to obtaining data and researching data in the record retention period identified in #5 above, for what property types and for what years.

07 **DETERMINE** locations where the company has significant customer, vendor and employees through state income tax apportionment workpapers coupled with customer, vendor and employee master maintenance files.

08 **IDENTIFY** any unclaimed property reserves on balance sheet, if any.

09 **IDENTIFY** any write-off or reclass accounts for accounts receivable credits, if any.

10 **IDENTIFY** any dummy customer or unapplied cash accounts on the balance sheet, if any.

Based on the steps above and corresponding answers, evaluate California income tax statement attachments and feasibility review with escheat consultants and attorneys experienced in these matters to determine scope/materiality of unclaimed property risk. It is often not about what is actually owed but rather an exercise in bookkeeping that can demonstrate what a Holder does not owe. If the risk is determined to be material or shows little to no escheatment compliance, steps can be taken in state VDA (e.g., the new California VDA) or amnesty programs to relieve the risk without penalty or interest in most cases.

CLOSING COMMENTS

In general, unclaimed property affects all companies, no matter what size, industry or state incorporated in, headquartered in or operated in. The heart of the issue is embedded in accounting practices, systems and record retention. The "top 10" list above is a helpful guide to addressing these and other escheatment issues. In that spirit, California taxpayers (those headquartered in state and out-of-state companies maintaining California income tax nexus) should evaluate feasibility studies to determine risk level if escheat has not been addressed before or some of the other complicating factors exist (e.g., system conversions, turnover, high customer/vendor volume, gap in record retention to state reach-back periods).

So this leaves us with the biggest of the questions we opened with, which is how this "new" trend will be used by the state? It is no secret that the sharing of information between California's Franchise Tax Board and Controller's Office in this fashion will identify holders that have not filed unclaimed property or have under reported escheatment (e.g., missed property types, acquisitions) with California. This information can be stripped from the returns along with a business's sales information, apportionment factors, company contact information and other information useful for evaluating audit selection. It is highly likely that California will use this process to develop a comprehensive unclaimed property database of audit targets. Moreover, as years pass and more data is collected, California will be able to perform data analytics on the data and establish benchmarking and target businesses more strategically.

Given the ease of aggregating such data and the effect it can have on enhanced compliance efforts, it would seem this "new" trend has potential to be widely adopted by more states over time and perhaps beyond areas of unclaimed property as well. As part of this shift and as states continue to conduct audits and demand compliance, holders should aim to ensure that they comply with state laws without paying more than their fair share.

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