Unclaimed Property - Who Ate My Gift Card Balance?

Workforce Webinar
National Unclaimed Property Practice, BDO USA, LLP

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Agenda

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Agenda

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5. Mitigation Strategies
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8. Gift Cards – Tax Deferral
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Overview - Gift Cards Within the Retail Industry

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Overview – Gift Cards:

- 93% of U.S. customers either purchase or receive a gift card annually(1).
- Approximately $750 million of gift cards went unredeemed in 2014(2).
- Online gift card sales are growing at approximately 29% per year(3).
  - As the number of online gift card sales increase, more owner information will be provided/available.
- Approximately 40% of gift card recipients do not use the total value of the card(4).
- Around two thirds of American consumers have purchased at least one gift card (5).

{1-3} - (http://partners.giftcards.com/statistics)
{4-5} – (http://www.giftcardgranny.com/statistics)

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Overview – Gift Cards:

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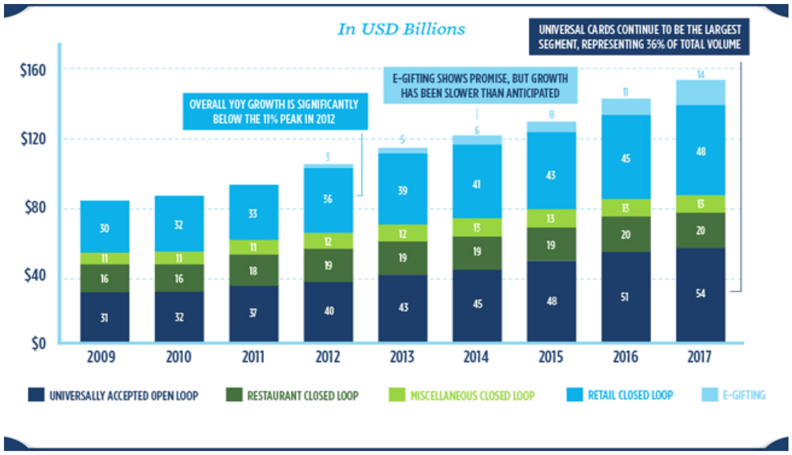

Unclaimed Property Overview

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Unclaimed Property Overview: What is Unclaimed Property?

- Generally intangible personal property for which there has been no owner activity for a specified period of time ("dormancy period").
- Examples of unclaimed property:
  - Uncashed payroll or commission checks
  - Uncashed payable/vendor checks
  - **Gift certificates/gift cards**
  - Customer merchandise credits, layaways, deposits, refunds or rebates
  - Overpayments/unidentified remittances
  - Unused/outstanding benefits (non-ERISA)
  - Miscellaneous income/bad debt expense accounts

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Unclaimed Property Overview: General Information

- All 50 states and the District of Columbia have enacted unclaimed property laws.
- The purpose of unclaimed property laws is to ensure the protection of abandoned property until the rightful owner is located. Moreover, states use any derivative funds earned on such property for the public good.
- The Supreme Court of the United States in Texas v. New Jersey, established the following unclaimed property sourcing rule:
  - First, to the state of the rightful owner's last known address, if known, or
  - Second, to the state of the holder's incorporation (commercial domicile for unincorporated entities).
- Dormancy Periods

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Gift Cards – Unclaimed Property

General Discussion

- If a gift card is unredeemed, it will be escheatable to a state unless there is an exemption.
- Generally, gift cards would be escheatable to the last known address of the owner; if the address is unknown, gift card funds are escheatable to the issuer's state of incorporation.
- Retailers must establish a way to track gift card's purchase, use, and outstanding balances, as well as the purchaser's information, in order to determine what is escheatable.
  - SVS, Value-link, Homegrown Systems, etc.

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Gift Cards – Exemptions

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Gift Cards – State Exemptions

- Approximately 40 states exempt, fully or partially gift cards, gift certificates and related property types from the purview of their escheat laws (Every State Is Different).

- Generally speaking – the following basic conditions need to be met:
  - No expiration dates
  - No dormancy fees
  - Cannot be redeemable for cash
  - Must be below certain dollar threshold

- Different classifications and inconsistent treatment between states (reloadable, non-reloadable, gift card, gift certificate, stored value card, etc.).

The above bullets are informational only – a detailed review of the gift card program(s), and various State exemptions, needs to take place before a final conclusion or recommendation can be made as to whether or not a specific card or transaction type qualifies for an exemption.

Gift Cards – State Exemptions

State	Exemption	Notation	Citation
Delaware	Partial	Less than $5 redeemed for food	No. 12 Del.C. §1198 (11xii)
California	Y	No dormancy fee, expiration date, etc.	Cal. Civ. Proc. Code §1520; Cal. Civ. Proc. Code §1520.5
Florida	Y	No dormancy fee, expiration date, etc.	Fla. Stat. §717.1045
Illinois	Y	No dormancy fee, expiration date, etc.	Ill. Rev. Stat. ch. 765 para 1025/10.6(a)(i)
Massachusetts	Y	Expiration date at least 7 years after issuance	Mass. Gen. L. ch. 200 §5D
New Jersey	N	N/A	N.J. Rev. Stat. §46:30B-6.
New York	N	N/A	N.Y. ABP. Law §1315
Pennsylvania	Y	No dormancy fee, expiration date, etc.	Pa. Stat. Ann. §1301.6.1
Texas	N	N/A	Tex. Prop. Code §72.1016(a)

The above table is informational only – a detailed review of the gift card program(s), and various State exemptions, needs to take place before a final conclusion or recommendation can be made as to whether or not a specific card or transaction type qualifies for an exemption.

Unclaimed Property Extrapolation

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Unclaimed Property Extrapolation

- Many states, including Delaware, use extrapolation techniques to establish a historic liability, at times dating back to 1991, in the event all records requested are not available and/or complete.
- The determination of whether or not to extrapolate may depend on factors such as:
  - Historical unclaimed property reporting practices
  - Filing history
  - Property types and amounts previously reported
  - Materiality of errors found for periods where records were reviewed
  - Record availability and reliability

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Exposure Quantification

Extrapolation – Gift Cards

Base years	Unredeemed/Inactive Residual GC Balance / Gift Card Sales/Issuances	= % X	Total GC Sales/Issuances (Prior Years)

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Example of the Impact of Extrapolation

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Year	Gift Card Sales	Gift Card Inactive	Prior Filed Gift Cards	Extrapolated Liability	Total Assessment
2010	$ 1,225,000.00	85,750	3,000		88,750
2009	$ 1,125,000.00	78,750	5,000	Use	83,750
2008	$ 1,050,000.00	73,500	2,000	Actual	75,500
2007	$ 1,000,000.00	70,000	1,200	Data	71,200
2006	$ 950,000.00	66,500	0		66,500
2005	$ 900,000.00	Documents Unavailable	No prior filed gift cards	64,884	64,884
2004	$ 850,000.00			61,279	61,279
2003	$ 775,000.00			55,872	55,872
2002	$ 750,000.00			54,070	54,070
2001	$ 650,000.00			46,861	46,861
2000	$ 590,000.00			42,535	42,535
1999	$ 570,000.00			41,093	41,093
1998	$ 500,000.00			36,047	36,047
1997	$ 450,000.00			32,442	32,442
1996	$ 400,000.00			28,837	28,837
1995	$ 360,000.00			25,954	25,954
1994	$ 315,000.00			22,709	22,709
1993	$ 100,000.00			7,209	7,209
Actuals	**$12,560,000.00**	**374,500**	**11,200**	**519,794**	**894,294**
Error Rate		*7.21%*			

Gift Card program started in 1993 - prior to which no gift cards or gift certificates were issued. DE incorporated entity.

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Mitigation Strategies

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Mitigation Strategies

- Voluntary Disclosure Agreements (VDA) – Agreement between the company and the state whereby the company comes forward with all unreported unclaimed property in exchange for the following:
  - Reduced look back period
  - Abatement of interest and penalties
  - Removal of audit risk
  - Control of workpapers

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Mitigation Strategies

- Exemption Matrix – Review of gift cards issued by company to isolate any transactions that would be exempt from reporting:
  - Address only
  - Subject to gift card program
  - Subject to specific state regulations

- General Compliance – Prospective filings for all property types; avoid interest and penalties, audit risk, etc.
- General Consulting – Consulting on all unclaimed property related matters including gift card management programs and related consulting.

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Gift Card Litigation

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Gift Card Litigation

State of Delaware ex rel. French v. Card Compliant LLC, et. al.

Facts

- Delaware Defendants are multiple retailers, incorporated in Delaware, that sell gift cards. Delaware Defendants did not keep any records of who purchased the gift cards. Without name and address information, the unredeemed gift card balances would be reportable to the Company's state of incorporation or formation.
- Delaware Defendants created contracts that identified the Card Compliant Defendants as the "holder" of these unredeemed gift cards in exchange for an annual fee. It appeared that the gift cards were issued out of the Card Compliant corporations; however, the Defendants were always the "holders" of the unused value of the cards.
- Card Compliant Defendants set up shell corporations incorporated in Ohio and Florida to "hold" the value of the unredeemed gift cards, because these states do not define unclaimed property to include unredeemed gift cards, and therefore this property was no longer reportable.
- Relator brought a qui tam action on behalf of Delaware against the Delaware retailers and Card Compliant, alleging that the various retailers outsourced their gift-card programs to a non-Delaware third party in order to circumvent Delaware Escheats Law.

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Gift Card Litigation

State of Delaware ex rel. French v. Card Compliant LLC, et. al.

Issue

- Case removed to federal court, then remanded back to state cord.

Conclusory Comments

- If Delaware's claims succeed, this type of outsourcing arrangement will be subject to scrutiny/challenge.
- The decision could have ramifications for internal gift card arrangements.

Update as of December 2015

- Defendant's Motion to Dismiss was granted in part and denied in part
  - Granted as it relates to certain holder-specific grounds
  - Denied the larger motions to dismiss that would have applied to all Qui Tam defendants

UCP - The Force Awakens

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UCP- The Force Awakens – DE VDA Program

- On February 19, DE sent approximately 200 letters to companies informing them to participate in its VDA program based on record of non-compliance or they may face being audited.
  - These letters are in addition to letters sent in September that were followed by audit notices in December.
- Targeted companies: middle market companies with annual revenues of $100M and above.
- Potential audit concerns are alleviated when entering into DE VDA program
  - Waives interest/penalties
  - Waives right to audit
  - VDA is 2 years vs. 3-7 year audit
  - VDA void criteria is more favorable

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UCP- The Force Awakens – DE VDA Program

VDA	Guidelines	Comments
Review of books/records	Internal	VS. Aggressive 3rd party auditors
Timeline	2 years	1-5 years less than audit
Reachback	1996	3 years reduction of prior SOS VDA program, 5 year reduction of audit reachback
Voids Included	90+ days	60 day difference of audit criteria
Interest?	No, waived	Audit – up to 25% interest
Right to audit	Waived	With certain conditions

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UCP- The Force Awakens – DE Audit Program

- On December 15, Delaware sent audit notices to companies that failed to participate in the VDA program after receiving a letter 2 months prior.
  - VDA letters sent September 15.
- Unlike VDA's, UCP audits are performed by third party auditing firms that work for a contingency fee and may include interest, penalties, and increased look-back.
- Companies at highest risk – incorporated in DE and/or significant operations in DE.

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UCP- The Force Awakens – DE Audit Program

Audit	Guidelines	Comments
Review of books/records	Aggressive third party contingency fee auditing firms	Kelmar Associates, LLC, UPCH, Audit Services US, Verus Financial, LLC, Treasury Services Group LLC, Discovery, Hertz & Herson, Innovative Advocates Group, Inc.
Timeline	3-7 years	
Reachback	1991	
Voids included	30+ days	
Interest?	25%	Uncertainty of application: automatic or case by case

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UCP- The Force Awakens – PA Audit Notice

- The Pennsylvania Department of Treasury has been sending out self-audit review audit notices to many public and private companies within the state.
  - Identification of potential property types, historical compliance, scope, etc.
- PA is trying to increase compliance/revenue.
- Failure to comply with notice requirements will likely result in full unclaimed property examination. Moreover, certain responses to the questionnaire may also elicit direct examination by the state.
- Targeted companies now include middle market companies that maintain annual revenues of $50M and above.

Gift Cards - Federal Tax Deferral

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Federal Tax Deferral - Background

- A taxpayer issuing a gift card receives an "advance payment" in exchange for the obligation to provide goods or services at a future date.
- The sale of a gift card is not immediately recognized as income for financial reporting purposes. However, it must generally be included in gross income for tax purposes.
- Although advance payments must generally be included in gross income upon receipt for tax purposes, the sale of a gift card may be deferred from immediate income recognition under two exceptions: Rev. Proc. 2004-34 and Treas. Reg. § 1.451-5:
  - One-year deferral method of Rev. Proc. 2004-34
  - Two-year deferral method of Treas. Reg. § 1.451-5
- Recent (2011) changes now allow for potential revenue deferrals related to:
  - Gift cards issued by gift card companies
  - Gift cards issued in exchange for inventoriable merchandise

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Federal Tax Deferral - Gift Card Sales (PAST)

- Today, gift cards are commonly sold by one entity, i.e. a gift card company that manages the gift card program, and redeemed by an affiliate party or unrelated third party under the service agreement.
- Historically, the Internal Revenue Service has taken an unfavorable position in informal guidance that an income tax deferral is not permitted under either Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5 in situations where the entity selling the gift card is not the one ultimately providing the goods or services in redemption of the gift card.
- However, on January 5, 2011, the Service issued a taxpayer-favorable revenue procedure Rev. Proc. 2011-18 as it relates to gift cards redeemable by the taxpayer or a third party.
- This revenue procedure provides clarity in the following ways:

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Federal Tax Deferral - Gift Card Sales (PRESENT)

- Rev. Proc. 2011-18 applies to an accrual-method taxpayer that receives an advance payment for an eligible gift card sale. The term "eligible gift card sale" means the sale of a gift card if: (1) the taxpayer is primarily liable to the customer, or holder of the gift card, for the value of the card until redemption or expiration; and (2) the gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer as payment for goods or services.
  - Rev. Proc. 2011-18 modifies Rev. Proc. 2004-34 to allow taxpayers to defer revenue from the sale of gift cards that are redeemable for goods or services of the taxpayer or a third party. Therefore, deferral is permitted even when the gift cards will be redeemed by a third party, related or unrelated to the selling entity, under a gift card service agreement.
  - One year deferral is now permitted.

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Federal Tax Deferral – Gift Cards Issued for Merchandise Returns (PAST)

- Today, many companies issue gift cards in exchange for inventoriable goods that have been returned or exchanged. This is common practice in the retail industry.
- Historically, the Internal Revenue Service has taken an unfavorable position in informal guidance that an income tax deferral is not permitted under either Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5 in situations where gift cards have been issued for the return of inventoriable goods.
- On January 5, 2011, the Service a taxpayer-favorable revenue procedure - Rev. Proc. 2011-17 as it relates to gift cards issued for returned merchandise.
- This revenue procedure provides certainty in this area and helps to reduce controversy in the following ways:

Federal Tax Deferral – Gift Cards Issued for Merchandise Returns (PRESENT)

- Rev. Proc. 2011-17 applies to taxpayers engaged in the trade or business of selling goods at retail that use an overall accrual method of accounting and issue gift cards in exchange for returned goods.
- Safe harbor method of accounting for the treatment of gift cards issued to customers in exchange for returned merchandise (potentially 1 or 2 year deferral) in the following situations:
  - First, the merchant may give the customer a cash refund in exchange for the returned goods. A taxpayer that pays an immediate cash refund for returned goods has incurred a refund liability under section 461 and therefore may reduce gross receipts for the amount of the refund. If the customer uses the refund to purchase a gift card, the taxpayer has received an advance payment from the sale of a gift card and may defer recognition of the income under either Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34
  - Second, a taxpayer may issue a gift card to a customer in exchange for returned goods. The Service will permit a taxpayer within the scope of Rev. Proc. 2011-17 to treat gift cards issued for returned goods as the payment of a cash refund and sale of a gift card. Hence, the tax payer may account for the sale of the gift card under Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34
  - One or two year deferral is now permitted

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New Guidance (TAM 201610017)

- Taxpayers receiving sales of gift cards that are redeemable for either goods or services may be under a mistaken assumption that they do not qualify for the two-year deferral method.
- Recently, the IRS National Office clarified in a technical advice memorandum (TAM 201610017) the availability of the two-year deferral method for such gift cards. Accordingly, taxpayers that are currently recognizing gift card sales upon receipt or on the one-year deferral method should review their accounting methods to determine whether an additional year of deferral is available for tax purposes.

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Method Change Procedures

- In situations where you wanted to change the revenue recognition method for tax purposes, you would need to file an accounting method change.
- Revenue Procedure 2015-13 - Exclusive procedures for automatic and advance consent change in method of accounting. New procedures for taxpayers under IRS exam enable Form 3115 requests to be filed at any time, with caveats.
  - Deferral method (via Revenue Procedure 2004-34) – Automatic
  - 1.451-5 (deferral of advance payments for goods) – Non-automatic

  - **Note - Revenue Procedure 2015-14 has the list of all automatic method changes**

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Questions?

Closing Remarks

Closing Remarks

- As more gift cards go unredeemed or the total value is not used, it is crucial for companies to understand their responsibilities related to unclaimed property and tax laws/regulations:
  - UCP laws and exemptions related to gift cards vary by states
  - Some states use extrapolation to establish historical liabilities
  - On-going litigation can change audit landscape

- There are numerous ways that companies can mitigate their risks:
  - Reduce Exposure
    - Gift Card Management Company
    - VDA
    - Compliance
    - Consulting
    - Exemptions
    - Feasibility

Conclusion

Thank you for your participation!

Certificate Availability - If you participated the entire time and responded to at least 75% of the polling questions, click the **Participation tab** to access the print certificate button.

Please exit the interface by clicking the red "X" in the upper right hand corner of your screen.

Biographies

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With 18 years of combined experience in state and local taxation, financial statement auditing, and operational auditing, Joe has worked with a broad range of the Firms' largest clients including manufacturing, retail, distribution, financial institutions, investment companies, and business services. He specializes in state and local tax issues with an emphasis on income/franchise taxation and unclaimed property compliance and consulting.

Joe leads BDO's National State and Local Tax Business Development and Marketing function. In this role, Joe touches many folks in corporate community through dedicated BDO Knows Webinar Series on various topics, Alerts, pressing notices and other educational outreach efforts. Joe also maintains a standing column with State Tax Notes entitled "A View from the Windy City" where he along with his colleagues discuss various state and local topics important to the taxing community at large. Recent articles have included: (a) State and Local Tax Due Diligence Exposures and Procedures, (b) Extension of Delaware's Friendlier Voluntary Disclosure Program, (c) Chicago Taxes Cloud-Based Services and Amusements and (d) Unclaimed Property Concerns for the Healthcare Industry. Mr. Carr is a frequent speaker at firm and organizational events on unclaimed property and other state and local topics.

In addition, Joe manages the SALT practice for Chicago office and heads up the firms National Unclaimed Property practice. He has had success in mitigating client escheat exposures in VDA and audit settlements before many state escheat divisions. Joe in concert with his colleagues works closely with clients to enhance their accounting practices, systems and ongoing efforts for operational efficiency through Accounting Assessment Reviews. This success is largely attributable to his deep understanding of accounting principles, transaction flow and unclaimed property law. Having evaluated financial and operational corporate risks, Joe offers clients facing escheat issues valuable accounting experience and an unique perspective in dealing with unclaimed property matters.

Prior to joining the Chicago office of BDO USA, LLP, Joe worked with KPMG LLP and Deloitte & Touche LLP in state and local tax and audit divisions respectively. In addition, Joe also managed the Internal Audit Division of a middle market food cooperative.

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Biography

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Nick Boegel comes to BDO with seventeen years of tax consulting experience. He has reviewed, researched and documented solutions for complex state and local tax issues in income and franchise, sales and use, payroll and employment, and property taxes and unclaimed property. He has expertise in identifying and serving multi-state client needs and performing creative tax and unclaimed property reviews to quantify potential savings via process improvements and prospective corporate restructuring projects.

As the firm's Midwest Unclaimed Property Practice Leader, Nick has established professional relationships with many of the state unclaimed property administrators in handling client matters, successfully negotiated voluntary disclosure agreements on behalf of clients and provided audit representation services. In addition, Nick has significant escheat planning experience.

Prior to joining the firm, Nick worked with PriceWaterhouseCoopers, Arthur Andersen, Deloitte, and Reinhart Consulting providing state and local tax compliance, consulting and planning services for public and private companies.

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Michael has more than 11 years of combined experience in abandoned and unclaimed property (AUP) and internal audit related matters. He possesses vast experience in handling large unclaimed property audit engagements for the nation's largest contract AUP firm in a variety of industries including healthcare, retail, manufacturing, oil and gas, entertainment, food and beverage, automobile, and hospitality. Mike leverages his extensive knowledge of the audit process, property types, and the rules and regulations associated with AUP to assist clients in mitigating exposure and proactively addressing its escheat issues.

Michael is based out of the Philadelphia office and specializes in audit defense, escheat planning, general consulting, and voluntary disclosure agreements (VDA), etc. He has established professional relationships with many state unclaimed property administrators and offers clients with a unique perspective in dealing with all unclaimed property related matters.

Prior to joining BDO, Michael worked with Kelmar Associates, LLC as a Senior Audit Manager in charge of unclaimed property audits contracted on behalf of various states. Michael also worked as a Team Leader in internal audit for ABC Supply Company.

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