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In this installment of A View From the Windy City, the authors discuss the gross method and net method of calculating unclaimed property liabilities.

Accounting, tax, and legal professionals are left wondering about the impact on the calculation of unclaimed property given the ruling in *Temple-Inland v. Cook*[1] and the Uniform Law Commission's Revised Uniform Unclaimed Property Act (RUUPA).[2] Can more than one state extrapolate escheat liabilities for the same holder of property in overlapping periods? Does Delaware's historically applied bright-line standard of estimation solely sourced to one's state of incorporation/formation prevail? Or are we headed for a 50-state apportioned extrapolation calculation? Regardless of the answer, one has to ask: Does it even matter? Report all estimated liabilities to one state or report to all 50 — wouldn't the result be the same or very close?

This article explores the details of the gross method of estimating unclaimed property, and particularly how it contrasts with other state-sanctioned methods. We analyze the jeopardy that the varying methods impose upon holders, and identify some best practices to help minimize such exposure.

Unclaimed Property Introduction

All states have laws governing the reporting and remittance of abandoned property, also referred to as either unclaimed property or property subject to escheatment. Unclaimed property laws require companies (the holders) that hold abandoned property to report it to the appropriate jurisdiction after the time prescribed by the state has passed. This period

[1] *Temple-Inland Inc. v. Cook*, Civ. No. 14-654-GMS (D. Del. June 28, 2016).

[2] *See* Uniform Law Commission, Revised Uniform Unclaimed Property Act 2016.

required for property to age before 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 to, 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 before escheatment. Property held by states, and potentially any interest earned on said property, may be used for the betterment of the public.

The determination as to 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*.[3] The first priority rule declares that any property for which the owner's last known name and address is known to the holder is subject to escheatment in that specific state. The second priority rule comes into effect when the address is not known; at that 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 voids, 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 comprise two types of liability: (a) liability for which actual researchable records exist (that is, base period liability or address property liability) and (b) liability derived through estimation because no records or unsupportable records exist (that is, the projection period or estimation years). The two most common types of liability reviews (address property and estimation) arise largely because the average state unclaimed property lookback period is 13 to 15 years, while general IRS and banking guidelines require organizations to retain records only for an approximate seven-year period. This creates a potential gap of six to eight years for which estimation would be used.

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 for which 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 "sufficient support," and extrapolation methods used often leads to assessments well in excess of what a company believes is owed or has appropriately accrued.

States have always maintained that unclaimed property laws are a function of consumer protection. But it is not news that unclaimed property collected from corporate holders is a major source of state revenue. Between 2003 and 2013, state coffers of unclaimed property nearly doubled — from $22.8 billion to over $40 billion.[4] In fiscal 2015, over $7.7 billion was collected by states, and less than half of that, approximately $3.2 billion, was returned.[5]

While much of the funds are held in custody for the rightful owner, when unclaimed amounts are estimated, 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.[6] It is not surprising that an increasing

[3] *See Texas v. New Jersey*, 379 U.S. 674 (1965).

[4] Council On State Taxation, "The Best and Worst of State Unclaimed Property Laws: COST Scorecard on State Unclaimed Property Statutes," 2 (2013).

[5] National Association of Unclaimed Property Administrators.

[6] *See* Fitch Ratings, "Fitch Rates Delaware's $301MM GO Bonds 'AAA'; Outlook Stable," Feb. 10, 2016 (noting that abandoned property typically accounted for over 10 percent of Delaware's general fund revenues in fiscal 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).

number of states are beginning to focus on their own estimation practices.

What Is Unclaimed Property Estimation?

The method, or calculation (discussed in detail later), commonly used by states to estimate liability when records do not exist plays an important role in the materiality of the assessments owed and funds received by the states. Estimation is common in both unclaimed property audits and unclaimed property self-reviews (amnesty reporting agreements, voluntary disclosure agreements (VDAs), and so forth). In its most simplistic form, states use estimation to establish past-due underreported liability in accordance with the respective lookback period when records do not exist. Common state audit lookback periods and average property dormancy periods are shown for a sampling of states in the following table:

State	Records Request Period (audit)	Average Dormancy Period
Delaware	10 years + dormancy	5 years
New York	1992	3 years
New Jersey	15 years + dormancy	3 years
Pennsylvania	10 years + dormancy	3 years
Illinois	10 years + dormancy	3 years
Texas	10 years + dormancy	3 years
California	10 years + dormancy	3 years

The following factors complicate extrapolation calculations and can increase unclaimed property liabilities:

- mergers and acquisitions;
- ERP General Ledger system changes/ conversions;
- loss of electronic and manual records;
- personnel turnover;
- bank relationship changes;
- no "voided check" policies;
- accounts receivable write-off policies;
- other accounting practices; and
- record retention policies.

No matter what an organization's facts are, extrapolation can be a difficult process. And as noted, this may become more complicated over time.

Delaware's historical view, and perhaps the view of other states, was that only a company's state of incorporation/formation is entitled to amounts received in estimation used to establish an underreported historic liability in the absence of records. In more recent times, some states are enacting or contemplating estimation techniques in the form of a penalty for failure to keep records in accordance with state-specific unclaimed property record retention laws.[7] It is argued that this type of estimation does not violate the priority rules outlined in *Texas v. New Jersey* as the estimation is performed to establish a past-due liability for periods for which records do not exist. So can two states now extrapolate for the same property types in overlapping periods under the RUUPA (for example, a Delaware-incorporated entity headquartered in Illinois)? Are other states considering the same practice? Do the states even need a statutory change to accomplish the penalty estimation if they already have a "reasonable estimation" statute on the books?

[7] *See generally* Illinois RUUPA, 765 ILCS 1026/15-1006 and 1007 ("[E]stimation under this Section is a penalty for failure to maintain the records required by Section 15-404."). *See also* Utah RUUPA, Chapter 4a, 67-41-1006, Failure of person examined to retain records ("[E]stimation under this Section is a penalty for failure to maintain the records required by Section 67-4a-404.").

Estimation and RUUPA

The 2016 RUUPA is the latest revision to the Uniform Unclaimed Property Act. The revised act establishes a set of rules for unclaimed property and serves as a baseline for comparison between states. Only a handful of states have introduced, let alone enacted, the revised act, even in part. The RUUPA serves as a model for adoption into state legislation, to provide consistency regarding how states can take custody, sell, and administer unclaimed property, and how state claims can be recovered.

In the latest revision, the RUUPA provides that estimation is an allowable technique to establish historic liability in the absence of complete records in accordance with the respective state lookback period. It states:

> [T]he administrator may determine the value of property due using a *reasonable method of estimation* based on all information available to the administrator, including extrapolation and use of statistical sampling when appropriate and necessary, consistent with examination procedures and standards adopted under Section 1003(a) and in accordance with Section 1003(b).[8]

The RUUPA offers no specific guidance on the formulistic method (gross method, net method, or another method) that should be used to extrapolate unclaimed property liabilities.

The Gross Method of Estimation — The Mechanics

Delaware, *where over half of corporate America is organized*, has adopted an estimation method that is calculated using total liability, regardless of jurisdiction to which the specific property is owed, to establish historic liability through estimation in the absence of records. For obvious reasons, this has created some controversy as most companies do not agree that it is reasonable or fair to use a throwback-type rule to estimate exposures owed to Delaware, especially in cases in which the company conducts little or no business in the state. Similar arguments apply to other states that use the same method of estimation. This basis of estimation is what we refer to as the gross method. The table below shows a hypothetical example for how the gross method mechanics work in calculating unclaimed property liabilities.

In general, the following formula demonstrates that the gross method of estimation is all-encompassing to account for all states' potential unclaimed property liability.[9] The error rate calculated is then applied to sales (surrogate) for years in the audit review period when no records or unsupportable records exist. Holders typically receive a credit against the total amount of extrapolation owed for any previously reported amounts in the extrapolation period. The periods for both the numerator and the denominator must be the same (for example, base period).

$$\frac{\text{All State Address/Unknown Property + Foreign + Previously Filed All State Items}}{\text{Everywhere Sales (or other surrogate)}}$$

$$= \text{(error rate)}$$

Applying the formula to the example in the table, it's clear the state uses total unclaimed property in the numerator consisting of all state liability ($1.42 million). The denominator in this example is the sum of total revenue for the same period for which records were tested (approximately $3.5 billion). This creates a small error rate (0.04 percent) that is used to calculate estimated liability in the absence of records.

$$\frac{\$1{,}420{,}000 \text{ (All State Errors)}}{\$3{,}500{,}000{,}000 \text{ (Everywhere Sales)}}$$

$$= 0.04\% \text{ (error rate)}$$

[8] *See generally* Illinois RUUPA, 765 ILCS 1026/15-1006 and 1007 (emphasis added). *See also* Utah RUUPA, Chapter 4a, 67-41-1006.

[9] "[E]stimation under this Section is a penalty for failure to maintain the records required by Section 67-4a-404." *See* Del. Code Ann. section 1183 for further information.

Year	Company Sales	Total Unremediated Unclaimed Property — All States	Unremediated Unclaimed Property w/ Delaware Address	Extrapolated Liability Sourced to Delaware	Total Delaware Assessment
2016	$750,000,000	$250,000	$12,500.00	**Use Actual Data**	$12,500.00
2015	$700,000,000	$650,000	$5,500.00		$5,500.00
2014	$680,000,000	$320,000	$11,200.00		$11,200.00
2013	$675,000,000	$90,000	$8,300.00		$8,300.00
2012	$665,000,000	$110,000	$4,500.00		$4,500.00
2011	$550,000,000	**Documents Unavailable**	**Documents Unavailable**	$225,072.00	$225,072.00
2010	$625,000,000			$255,764.00	$255,764.00
2009	$600,000,000			$245,533.00	$245,533.00
2008	$550,000,000			$225,072.00	$225,072.00
2007	$540,000,000			$220,980.00	$220,980.00
2006	$525,000,000			$214,841.00	$214,841.00
2005	$510,000,000			$208,703.00	$208,703.00
2004	$495,000,000			$202,565.00	$202,565.00
2003	$475,000,000			$194,380.00	$194,380.00
2002	$460,000,000			$188,242.00	$188,242.00
Actuals	$8,800,000,000	$1,420,000	$42,000	$2,181,152.00	$2,223,152.00
Error Rate		0.04%			
Application of Penalties and Interest					$1,116,576
Total Delaware Assessment					**$3,339,728**

In this hypothetical example, the holder would be assessed approximately $2.2 million to Delaware, despite having only $42,000 in total property owed to Delaware for the base years (2012-2016).[10] Understanding the gross method is of the utmost importance as this is *now* the method some states use for estimation. This is the same method that was challenged in *Temple-Inland v. Cook*. It is also important to understand the alternative, the net method of estimation, as this may be the estimation of the *future*.

Net Method of Estimation — The Mechanics

The net method of estimation is similar to the gross method in terms of application. However, the net method calculates an estimated liability on a state-specific basis whereas the gross uses all property. This table is a hypothetical illustration of the net method and how this would contrast with the gross method.[11]

[10] Many extrapolation calculations will use "non-dormant" base periods to arrive at an error rate because these years are the most researchable for the holder. Regardless, the amounts in the base period that are non-dormant are not required to be escheated to the appropriate state until they become dormant.

[11] *See id.*

Year	Company Sales	Total Unremediated Unclaimed Property — All States	Unremediated Unclaimed Property w/ Delaware Address	Extrapolated Liability Sourced to Delaware	Total Delaware Assessment
2016	$750,000,000	$250,000	$12,500.00	**Use Actual Data**	$12,500.00
2015	$700,000,000	$650,000	$5,500.00		$5,500.00
2014	$680,000,000	$320,000	$11,200.00		$11,200.00
2013	$675,000,000	$90,000	$8,300.00		$8,300.00
2012	$665,000,000	$110,000	$4,500.00		$4,500.00
2011	$550,000,000	**Documents Unavailable**	**Documents Unavailable**	$6,657.06	$6,657.06
2010	$625,000,000			$7,564.84	$7,564.84
2009	$600,000,000			$7,262.25	$7,262.25
2008	$550,000,000			$6,657.06	$6,657.06
2007	$540,000,000			$6,536.02	$6,536.02
2006	$525,000,000			$6,354.47	$6,354.47
2005	$510,000,000			$6,172.91	$6,172.91
2004	$495,000,000			$5,991.35	$5,991.35
2003	$475,000,000			$5,749.28	$5,749.28
2002	$460,000,000			$5,567.72	$5,567.72
Actuals	$8,800,000,000	$1,420,000	$42,000	$64,512.97	$106,512.97
Error Rate		0.00121%			
Application of Penalties and Interest					$58,256
Total Delaware Assessment					**$164,769**

In general, the following formula demonstrates that the net method is an apportionment of liability to a particular state based on the direct unclaimed property connection (for example, unclaimed property activity) to that state.[12] The error rate calculated is then applied to sales (surrogate) for years in the audit review period when no records or unsupportable records exist. Previously reported unclaimed property should be factored into any result as a credit against estimation in same years. The periods for both the numerator and the denominator must be the same (for example, base period).

$$\frac{\text{DE Address/Unknown Property + Foreign + Previously Filed DE Items}}{\text{DE Sales or Everywhere Sales (or other surrogate)}}$$

$$= \text{(error rate)}$$

Applying the formula to the hypothetical example in the table, you see the net method uses Delaware-address property ($42,000) as the numerator in the calculation for the same base

[12] Note that “Application of Penalties and Interest” does not include penalties, although the state has discretion to impose them, but rather the 50 percent interest required under Del. Code. Ann. section 1183(a), Interest and Penalties. This can be abated via good cause, or if holder enters into the VDA program, no interest is applied. *See* Del. Code Ann. section 1183 for more information.

period of years 2012-2016.[13] The denominator is the same (approximately $3.5 billion). However, the error rate is drastically smaller (approximately 0.0012 percent) as a result of the decreased numerator liability.

$$\frac{\$42{,}000 \text{ (all state errors)}}{\$3{,}500{,}000{,}000 \text{ (everywhere sales)}}$$

$$= 0.00121\% \text{ (error rate)}$$

The total estimated liability in this example owed to Delaware is approximately $65,000 compared with the approximately $2.2 million being assessed under the gross method. Of course, there could be different results in actual application based on the holder's specific facts and circumstances. Companies need to take into consideration their relevant facts and circumstances as applied in both the gross and net methods, respectively. If a net method of estimation becomes the standard, it's likely that all states would seek to calculate an estimated historic liability and not just a holder's state of incorporation/formation.

States' Adoption of Net Method Extrapolation Calculation

Various states have applied the net method of extrapolation calculation over the years, including Florida, Ohio, and Texas, with Illinois the most recent. In *Temple-Inland*, Texas had, in fact, estimated unclaimed property based on outstanding payroll amounts to Texas employees for years in which records were available.[14] Delaware had estimated property reportable to Delaware based on the same payroll amounts. The court objected to such double-counting, finding, "It seems logical that if two states use the same property in the base years to infer the existence of unclaimed property in the reach back years, then a holder is being compelled to escheat the same estimated property to two states, in violation of the principles articulated in the *Texas* cases."[15]

Moreover, the court found that when estimation is involved, indemnification is not sufficient protection. This is because indemnification has historically been used in the context of a particular item of property remitted as abandoned. For example, when a specific item of property associated with an Illinois address is remitted to Delaware, state law requires Delaware to indemnify the holder against claims for that specific amount asserted by either Illinois or the owner.[16] But we have identified no reports of instances in which Delaware has refunded *estimated* amounts in response to another state's assertion of its own right to estimate such amounts under a different method. That is, when another state makes an estimate based on the same property, Delaware does not appear to be willing to reimburse holders for the difference. Indeed, Delaware continued to claim its right to the Texas estimated amounts in *Temple-Inland*.[17]

The *Temple-Inland* situation is not necessarily an outlier. Florida's audit manual expressly permits estimation for companies either incorporated within the state or when "100% of the holder's account represents Florida payees."[18] Accordingly, like Texas, when a Delaware-incorporated company employs all its personnel in Florida, Florida may estimate payroll exposure to Florida for years in which records are not fully available, based on amounts owed to Florida employees. Delaware, likewise, would estimate a liability, based on the same data, for such years.

Ohio also permits an estimation method inconsistent with Delaware's view.[19] The regulation articulates three alternative methods — the asset method, the sales method, or another method agreeable to the holder, the state, and the contract auditor.[20] Both the assets and sales methods are based on "the average of actual annual reportable unclaimed funds with Ohio addresses."[21] So like

[13] *See supra* note 9.

[14] *See Temple-Inland*, 192 F. Supp.3d at 550.

[15] *Id.* at 449-550.

[16] *See generally* Del. Admin. Code tit. 12 section 104 - 2.24.2. Notwithstanding, the closing agreement required in Delaware's VDA waives the holder's right to indemnity to another claimant state for such amounts.

[17] *See Temple-Inland*, 192 F. Supp.3d at 550.

[18] *See* Florida Form DFS-UP-220.

[19] Ohio Admin. Code 1301:10-3-04(J)(2).

[20] *Id.* at subsections (a) through (c).

[21] *Id.* at subsections (a) and (b).

Florida and Texas, the Ohio estimation method is based on amounts that Delaware would use to estimate liability to the state of incorporation, creating the imposition of multiple liabilities for the same item of property.

In 2018 the Illinois Department of Finance promulgated proposed regulations in support of S.B. 9, which revised the unclaimed property act.[22] Those regulations expressly contemplate "net" or "first priority estimation" inconsistent with Delaware's position. In particular, the regulations require estimation for non-Illinois-domiciled entities to "reasonably approximate the amount of unclaimed property that should have been reported to Illinois if all reports had been filed and records had been maintained as required by the Act."[23] The regulation clarifies that "estimation should attempt to determine the amount of unclaimed property that should have been reported to Illinois under Sections 15-301, 15-302, and 15-303 (addressed property) and 15-304 (unaddressed property when the holder is domiciled in Illinois)."[24] In other words, Illinois estimation should be based on Illinois-reportable amounts.

In summary, states like Florida, Illinois, Ohio, and Texas are poised to implement estimation techniques more similar to that of the net approach. This creates an uncertainty as to which method should prevail (gross or net) and how holders should avoid any double liability assessments.

Holders Take Note

Holders should approach unclaimed property by taking the following Top 10 steps to understand risk profile, mitigate risks appropriately, and comply with state escheat laws:

1. Determine if your 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) states of incorporation/formation, and (e) dates of incorporation/formation, and so forth.
2. Determine whether the company, at parent or subsidiary levels, has undergone an unclaimed property audit or VDA, and if so, for which states, property types, and years.
3. Determine if the company, at parent or subsidiary levels, has undergone a bankruptcy proceeding that may preempt state escheat laws.
4. Determine whether the company has written unclaimed property policies and procedures.
5. Evaluate whether the company's record retention policies for treasury, tax, and related information are consistent with average state reach-back periods of 13-15 years (for example, monthly bank statements, monthly void and outstanding listings, monthly reconciliations, check registers, void and check paid support, settlement documents, tax returns, and merger and acquisition documentation).
6. Determine if the company or its subsidiaries have system conversions or limitations to obtaining data and researching data in the record retention period identified in step 5, and if so, for which property types and years.
7. Identify where the company has significant customers, vendors, and employees using state income tax apportionment workpapers coupled with customer, vendor, and employee master maintenance files.
8. Identify any unclaimed property reserves on balance sheets.
9. Identify any write-off or reclassification accounts for accounts receivable credits.
10. Identify any dummy customer or unapplied cash accounts on the balance sheet.

Based on the steps above and corresponding answers, consider conducting a feasibility review with escheat consultants and attorneys to determine the scope/materiality of unclaimed property risk under various

[22] Illinois Proposed Rule 760.790(e) (Estimation), 42 *Illinois Register* 39 (Sept. 28, 2018) at 17209-17210.

[23] *Id.*

[24] *Id.*

extrapolation methods discussed in this article. As is often the case, it is not about what is actually owed, but rather an exercise in bookkeeping that can demonstrate what a holder does not owe. This can have an incredible impact on the numerator of either the gross or net method, whichever is used. Nevertheless, if the risk is determined to be material or shows little to no escheatment compliance, steps can be taken in state VDA or amnesty programs to relieve the risk, without penalty or interest in most cases.

Closing Comments

This leaves us with the question we opened with: Does it really matter which method is used, as long as the holder doesn't pay twice on the same period or property type? If it's the bright-line standard using the gross method of extrapolation, arguably compliance is easier because legacy exposures are paid to a single state. But does this make sense? Would the state of incorporation actually indemnify a holder for an estimate calculated in another state using the net method for the same period or property type? How about indemnifying against a penalty? Experience with audits and the like suggests the answer to this probably is no.

Would it not be better to apportion liability among all the states, even extrapolation based on activity in that state similar to state income tax apportionment schemes? Wouldn't this do a better job of reuniting the property with the rightful owner and achieving the public policy good that escheatment hangs on? Moreover, holders could avail themselves more appropriately of business-to-business exemptions in each state that offers them, not only for address property, but also for extrapolated balances in that state. Would this be subject to challenge by large "incorporation" states as violative of the priority rules in *Texas v. New Jersey*?

Regardless of which side of the debate you are on, gross or net, escheatment obligations can be in the multimillions of dollars for organizations under either method depending on facts and circumstances. While there appears to be some conflict in the rules on which method applies, especially with recently adopted provisions in Utah and Illinois making extrapolation a penalty for failure to keep records, the fight goes on. States will continue to conduct audits and demand compliance; the important piece is that holders comply with state laws without paying more than their fair share. ■