

# Legislative Analysis



## UNCLAIMED PROPERTY AUDIT STANDARDS

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**House Bill 4289 as Enacted**  
**Public Act 148 of 2013**  
**Sponsor: Rep. Aric Nesbitt**  
**House Committee: Tax Policy**  
**Senate Committee: Finance**

### Second Analysis (7-22-14)

**BRIEF SUMMARY:** The bill amended the Unclaimed Property Act to impose certain standards regarding how unclaimed property audits are conducted.

**FISCAL IMPACT:** The bill would have an indeterminate fiscal impact on the Department of Treasury. The department would realize certain increased costs associated with administration of the new provisions under the bill. The bill would require the department to promulgate administrative rules on audit standards within one year of the bill's effective date. Moreover, the bill would require the department to provide those who are subject to an audit under the act with a complete audit report and findings. Any potential administrative cost increases would be covered under current appropriation levels. The Department of Treasury has indicated that they anticipate no impact on potential revenues because the bill would only define the procedural aspects of the program.

### THE APPARENT PROBLEM:

The Uniform Unclaimed Property Act provides for the reversion to state custody of any unclaimed property, including money orders, travelers checks, personal checks, gift certificates, wages, bank accounts, and the contents of safe deposit boxes. Generally speaking, property that remains unclaimed or dormant for a certain number of years, as provided in the act, will be transferred to the state (that is, "escheated"). Once property is escheated, the value of the property reverts to the state's General Fund, less a portion set aside to meet expected claims and related administrative expenses. Unclaimed property (or its equivalent value) is maintained by the state for property owners in perpetuity. There is no time limit in which a claim for abandoned or unclaimed property must be made; a person or his or her heirs always has the right to claim the property.

The act requires that individuals, businesses, and other commercial entities ("holders") of presumably abandoned and unclaimed property file an annual unclaimed property report with the Department of Treasury (Unclaimed Property Division) by July 1, and also requires them to pay or deliver the abandoned property to the department.

To ensure compliance with the act, the department (or its authorized agents) may examine (audit) the records of persons and holders of property, including those who believe that they do not hold any reportable property. The act permits the department to

contract with third parties to conduct unclaimed property audits on its behalf, and explicitly states that in instances where the a holder maintains incomplete records or maintains records that do not sufficiently allow the holder to file an accurate unclaimed property report, the department may require the holder to report and pay "an amount as may reasonably be estimated from any available records."

Given the revenue implications of the escheating of unclaimed property, there has been a renewed focus throughout the country – with Michigan being no exception – on state unclaimed property laws and how they are administered.<sup>1</sup> These efforts have included longer look-back periods, shorter dormancy periods (requiring properties to escheat more quickly), and aggressive audit techniques.<sup>2</sup>

The Department of Treasury uses third-party auditors to conduct unclaimed property audits on its behalf.<sup>3</sup> While that fact alone is problematic for many businesses, others have concerns with the manner in which the audits themselves are conducted. These concerns apply equally to tax audits and unclaimed property audits.

For instance, a recent *Michigan Bar Journal* article notes, "Aggressive legal positions, audit by sampling, and demands for documentation not likely kept in the ordinary course of business can inflate the size of [state escheats revenues]. Some of these techniques 'uncover' unclaimed property that cannot even be traced to an actual owner."<sup>4</sup> It has been suggested that the Department of Treasury establish, and comply with, certain audit standards. Other bills introduced this session focus on tax audits, while House Bill 4289 concerns unclaimed property audits.<sup>5</sup>

### ***THE CONTENT OF THE BILL:***

The bill amended the Uniform Unclaimed Property Tax (1995 PA 29) to impose certain standards in how unclaimed property examinations (audits) are conducted.

#### **Audit Standards**

The act permits the Department of Treasury (or its authorized agents) to conduct an examination (audit) of the records holders of unclaimed property and other persons, including those believing that they do not hold any reportable property. House Bill 4289 requires than any examination (audit) be done in accordance with generally accepted

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<sup>1</sup> See, for example, 2010 PA 197, which shortened the dormancy period of most types of property.

<sup>2</sup> See, for example, Walter Nagel, Donald Griswold, Jeremy Abrams, and Derek Young, "Are States (Es)Cheating You?", *State Tax Notes*, April 29, 2013.

<sup>3</sup> <http://www.michigan.gov/micontractconnect/0,4541,7-225-48680---,00.html>

<sup>4</sup> Carolee Kvorciak Cameron and Jackie J. Cook, "How the Gold Gets in the Pot at the Rainbow's End: An Attorney's Guide to Unclaimed Property Compliance in Michigan", *Michigan Bar Journal*, October 2012.

<sup>5</sup> As a whole, see House Bills 4288-4292. In general, the package of bills restricts the use of "indirect methods" and sampling during the course of an audit by the Department of Treasury to determine a taxpayer's tax liability or the amount of unclaimed property reportable and payable to the department, and provides for greater transparency in the administration of the several tax laws of the state. Among other things, House Bill 4291 would require the Department of Treasury to promulgate administrative rules establishing audit standards.

auditing standards (GAAS) to the extent applicable.<sup>6</sup> The bill would also require the department to begin promulgating administrative rules on audit standards by submitting a request for rulemaking as provided under the Administrative Procedures Act (MCL 24.239) with the LARA Office of Regulatory Reinvention within six months of the bill's effective date (March 14, 2014).<sup>7</sup>

### **Audit Report and Findings**

The bill also requires that persons subject to an audit under the act be provided with a complete audit report, including details on the work performed, the types of property reviewed, any estimation techniques, calculations on the amount of potential property due, a statement of findings, and other correspondence and documentation that support the report of findings.

### **Estimation**

The act permits the Department of Treasury to require holders of unclaimed property to report and pay an amount as may reasonably be estimated from any available records, in cases where the holder did not maintain sufficient records to file an accurate unclaimed property report or where the holder did not maintain records identifying the last known address of the property owner.<sup>8</sup>

The bill provides that when a person subject to an examination does not have "substantially complete records," the department (or its agents) may determine the amount of any abandoned or unclaimed property due based upon a reasonable method of estimation that is consistent with the audit standards established in rules promulgated by the department (as required in the bill). If the person has filed all required reports and maintained "substantially complete records," the examination would have to include a review of the person's books and records, not be based on an estimate, and consider all evidence presented by the property holder to remediate any findings.

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<sup>6</sup> See, generally, <http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00150.pdf>. A similar statutory requirement that unclaimed property audits be performed in accordance with generally accepted auditing standards is included in the unclaimed property law of Illinois, 765 ILCS 1025/11.5. Similarly, Ohio Administrative Code 1301:10-3-04(C) requires state and contract auditors to observe rule 202 of the AICPA's code of professional ethics, which requires adherence to generally accepted auditing standards, and the statements on auditing standards issued by the auditing standards board, as both relate to the identification and collection of unclaimed funds from holders. These standards include, but are not limited to, general standards for field work, and standards for reporting. The unclaimed property audit contracts that the Department of Technology, Management, and Budget has with several auditing firms already includes a requirement that the audits be performed in accordance with generally accepted auditing standards. See, for example, [http://www.michigan.gov/documents/micontractconnect/2200207\\_387396\\_7.pdf](http://www.michigan.gov/documents/micontractconnect/2200207_387396_7.pdf).

<sup>7</sup> Section 40 of the act (MCL 567.260) authorizes the department to promulgate administrative rules under the Administrative Procedures Act necessary to carry out the act. The department has not promulgated any rules carrying out the act. See the ORR website for pending Treasury administrative rule changes, <http://www7.dleg.state.mi.us/orr/Rules.aspx?type=dept&id=TY>.

<sup>8</sup> This provision was first added to the 1981 version of the Uniform Unclaimed Property Act and retained in the 1995 version, which provides the basis of the Michigan statute. In practice, when records for an audit year are not available and the unclaimed properties cannot be determined, auditors use an estimation process to determine the value of property that should have been reported. The estimation formula considers the years where records existed and value of properties due during those years and applies the value to the years where records don't exist.

The bill defines "substantially complete records" to mean that the property holder must maintain at least 90% of the records necessary for unclaimed property examination purposes as defined under the principles of internal controls. A determination of whether records are "substantially complete" would not be made based solely on the percentage of the total overall individual records to be examined, but also on the "materiality level of value" of the records.<sup>9</sup> The bill provides that a lack of more than 10% of the records for a particular property class would not result in the extrapolation of error in those areas in which a person had filed all of the required reports and maintained at least 90% of the overall records for that property class. Further, the bill notes, substantially complete records would not be meant to be an absolute measurement of all available records.

## **BACKGROUND INFORMATION:**

The bill requires the Department of Treasury to develop unclaimed audit property standards. Ohio appears to be one of the few states that have established such standards. Ohio Administrative Code (OAC) 1301:10-3-04 specifies the factors to be considered by the state in determining whether reasonable cause exists to believe that a holder of unclaimed property has failed to comply may be subject to an involuntary examination (audit).<sup>10</sup> These standards include a rules concerning the use of estimation techniques to determine the amount of reportable property, stating:

*The calculation of the holder's total unclaimed funds reporting liability may include the utilization of estimation techniques. Estimation techniques may be necessary if the examination of the records review period fails to identify dormant accounts reported or due in each year of the examination period and a review of the reporting history of the holder maintained by the state and the holder shows that the holder failed to report, or underreported, the type(s) of account(s) in question during the examination period. The selection of the estimation technique to be utilized shall be made prior to the closing review. The division auditor or contract auditor shall use one of the following methods to calculate the holder's estimated unclaimed funds reporting liability for those years requiring estimation:*

*(a) The asset method which utilizes the average of actual annual reportable unclaimed funds with Ohio addresses as a percentage of the total end of year assets of the company. The average of actual annual reportable unclaimed funds with Ohio addresses as a percentage of total end of year assets shall be calculated by adding the actual annual reportable unclaimed funds with Ohio addresses as a percentage of the total end of year assets for each year and dividing by the number of years for which actual reportable unclaimed funds were*

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<sup>9</sup> The Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* defines "materiality" as "[t]he magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." See, also, the Accounting Standards Board standard, *Materiality in Planning and Performing an Audit*, <http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-C-00320.pdf>.

<sup>10</sup> <http://codes.ohio.gov/oac/1301:10-3-04>

*identified. The total assets at the end of the year(s) corresponding to the reporting cycle(s) subject to estimation techniques, are then multiplied by the average of actual annual reportable unclaimed funds with Ohio addresses as a percentage of the total end of year assets. The sum of the calculated amounts is the estimated unclaimed funds reporting liability for the examination period;*

*(b) The sales method which utilizes the average of actual annual reportable unclaimed funds with Ohio addresses as a percentage of the gross end of year sales of the company. The average of actual annual reportable unclaimed funds with Ohio addresses as a percentage of gross end of year sales shall be calculated by adding the actual annual reportable unclaimed funds with Ohio addresses as a percentage of gross end of year sales for each year and dividing by the number of years for which actual reportable unclaimed funds were identified. The gross sales at the end of the year(s) corresponding to the reporting cycle(s) subject to estimation techniques, are then multiplied by the average of actual annual reportable unclaimed funds with Ohio addresses as a percentage of gross end of year sales. The sum of the calculated amounts is the estimated unclaimed funds reporting liability for the examination period;*

*(c) Other estimation technique that is mutually agreeable to the holder, the state, and the contract auditor.*

## **ARGUMENTS:**

### **For:**

The bill provides some direction and standards regarding how Department of Treasury unclaimed property audits are to be conducted. Given the significant revenue implications of various methods of administering unclaimed property laws, there are concerns that unclaimed property laws are becoming more focused on their revenue raising potential than with their true purpose of returning abandoned or unclaimed properties to their rightful owners.

Indeed, one observer noted, "[a]lthough states do not take title to the property they recover, most state laws provide that at least some portion of funds received as unclaimed property is deposited in a state's general fund, or go so far as to direct the proceeds from unclaimed property to fund specific state programs. The benefits of a state's use of unclaimed property are compounded by the fact that underlying owners, to whom the property rightfully belongs, rarely claim escheated property from the state. Thus states have begun to transform their unclaimed-property laws and regulations into revenue-raising mechanisms that undermine their original, consumer-protection-oriented goal of reuniting missing owners with their property."<sup>11</sup>

There are many concerns over the administration of unclaimed property laws. Among those, is the use of estimation and sampling to determine the amount that should be

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<sup>11</sup> See William S. King, "A Bridge Too Far: Due Process Considerations in State Unclaimed-Property Law Enforcement", 45 Suffolk U. L. Rev. 1249, <http://suffolklawreview.org/king-unclaimed-property/>.

escheated if the property holder fails to maintain sufficient records. A recent article appearing in *State Tax Notes* observed that in estimating the amount of unclaimed property held for periods where records are insufficient "the state will typically calculate the holder's actual unclaimed property liability for the more recent periods for which the holder does not have adequate records; compute an 'error rate' equal to the unclaimed property liability as a percentage of the holders revenues (or other financial metric, as appropriate) for those periods; and use the 'error rate' to extrapolate unclaimed property liability for the prior periods based on the revenues (or other financial metric) of the holder for those periods. Any 'estimated' unclaimed property, of course, has no real or identifiable owner..."<sup>12</sup>

The need for the articulation of some baseline unclaimed property audit standards is vitally important, as a recent article appearing in *The Tax Executive* observed, "most [unclaimed property] laws...have provisions that allow a state to estimate a holder's liability for [unclaimed property] that the holder failed to report if the holder has not complied with recordkeeping requirements. No state has issued guidance, however, on how to formulate a liability estimate. Moreover, no federal court has ever ruled on acceptable estimate techniques for determining [unclaimed] property liability. In fact, no federal court has concluded that estimating a liability is even permissible."<sup>13</sup>

While continuing to authorize the Department of Treasury to use "reasonable" estimation techniques in the absence of sufficient records, the bill provides for some basic standards by explicitly requiring that unclaimed property audits be conducted in accordance with generally accepted auditing standards and by permitting the use of estimation only in instances where the holder did not maintain "sufficiently complete" records. The Department of Treasury has not promulgated any administrative rules implementing the unclaimed property act or published any other unclaimed property audit guidance materials, with the only real guidance on the conduct of unclaimed property audits occurring through DMTB's individual contracts with the third-party auditors. (Among the requirements set forth in the contracts is a requirement that audits be conducted in accordance with generally accepted auditing standards.)

The bill's definition of "sufficiently complete" aids in providing some direction in determining the sufficiency of records and, more importantly, specifying when estimation can and cannot be used in an unclaimed property audit. This is an important limit on the use of estimation, especially given potential due process concerns on how estimations are used. One observer notes, "When escheating funds, a state merely acts as a 'conservator' of the property, rather than a primary party with a claim to the property. When money and property is escheated through an estimation, the state does not stand in the shoes of any owner because the escheated funds and property are not attributable to any; the local

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<sup>12</sup> Ethan D. Millar and Kendall L. Houghton, "Unclaimed Property: The Solution to State Budget Woes?", *State Tax Notes*, September 12, 2011.

<sup>13</sup> Chris Hopkins, "Estimating Unclaimed Property Liability: The Wild West of Accounting," *The Tax Executive* Nov/Dec 2012, [http://www.tei.org/news/articles/Documents/TTE\\_ND12\\_Hopkins\\_EstUnclaimedProperty.pdf](http://www.tei.org/news/articles/Documents/TTE_ND12_Hopkins_EstUnclaimedProperty.pdf). See, however, Ohio Administrative Code 1301:10-3-04, reprinted in the section on Background Information.

conclusion, therefore, is that the calculation of these amounts is driven by revenue-raising motivations, which alone produces further due process concerns."<sup>14</sup>

***Response:***

While establishing some standards on how unclaimed property audits is a step in the right direction, there are other concerns regarding the conduct of unclaimed property audits that still need to be addressed. These include the continued use of third-party contingent fee auditors by the Department of Treasury. A 2009 study of state unclaimed property laws by the Council for State Taxation (COST) notes, "[c]ontingent-fee arrangements encourage auditors to be overly aggressive, to interpret State laws to their own advantage rather than in society's best interest, to 'cherry pick' audit targets, and to ignore holder errors that would result in lower assessments. The risk of abuse creates a perception of unfairness that colors holders' relationships with administrators and creates an atmosphere of mistrust that hinders compliance."<sup>15</sup>

Moreover, one observer noted, "the current use of multijurisdictional audits adds to a predatory auditing environment by third-party auditors. When tasked with an audit for one state, private auditing companies then solicit states, seeking authority to act as their agent to audit an unclaimed-property holder as well. States have a bevy of reasons to accept the auditor's offer: their statutes may not require that any formal selection criteria be met before an audit takes place, the auditor is likely compensated by a percentage of the unclaimed property recovered so the state will not suffer any loss by engaging the auditor, and states are strapped for cash so the property recovered will likely be usable revenue because it is rarely claimed by owners.

The 1981 and 1995 Uniform Acts do not require that a 'reason to believe' standard must be met before allowing an unclaimed-property audit. Because states may easily authorize audits and auditors can pick potential targets by hawking their services from state to state, suspected holders are sometimes chosen for an audit based on no more than the scant possibility that unclaimed property will be recovered. Meanwhile, companies under audit expend significant amounts of time and money defending themselves in the audit process....As the unclaimed-property scheme exists now, auditors act as bounty hunters examining books and records with little or no incentive to investigate with fairness or impartiality because their fees are paid as a percentage of their findings."<sup>16</sup>

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.

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<sup>14</sup> "A Bridge Too Far: Due Process Considerations in State Unclaimed-Property Law Enforcement."

<sup>15</sup> Jana S. Leslie, "The Best and Worst of State Unclaimed Property Laws: Scorecard on State Unclaimed Property Statutes: The Holders' Perspective", Council on State Taxation, January 2009, at <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=71960>. The use of third-party auditors was explicitly permitted in the 1981 and 1995 versions of the Uniform Unclaimed Property Act, although neither version specifically addressed how third-party auditors were to be compensated.

<sup>16</sup> "A Bridge Too Far: Due Process Considerations in State Unclaimed-Property Law Enforcement."