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UNCLAIMED PROPERTY

Illinois Demands Retroactive Reporting of Previously Exempted Unclaimed Property

A troubling trend is a reduction in scope or a complete removal of B2B exemptions.

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During the mid- to late-1990s, around a dozen states adopted so-called business-to-business ("B2B") exemptions for unclaimed accounts payable checks and/or accounts receivable credit balances. The basic concept behind an unclaimed property B2B exemption is that transactions between companies that frequently do business with each other are different from other types of transactions that are more likely to result in unclaimed payments, such as transactions between companies and consumers. In other words, inadvertent overpayments and underpayments and other accounting errors that occur between companies are generally the types of issues that are thought to be best resolved between private parties with relatively equivalent bargaining power, rather than through the state unclaimed property process, in states that have enacted B2B exemptions.

Consequently, uncashed checks and unused credits that are owed between business associations in B2B states generally do not have to be reported as unclaimed property, while they may have to be reported and remitted as unclaimed property in states that do not have a statutory B2B exemption.

However, a more recent and troubling trend among B2B states is a reduction in scope or a complete removal of B2B exemptions. Some states, such as Illinois, have recently gone even further by referring to

the B2B exemption as a "loophole" and requiring retroactive reporting of previously exempted properties.[1] This article explores the recent B2B exemption removal in Illinois and compares this development to past B2B exemption removals and attempts by states to impose retroactive reporting provisions for properties that were previously not reportable under states' unclaimed property laws.

Illinois Removal of B2B Exemption and Demands for Retroactive Reporting

On March 23, 2000, Illinois enacted a B2B exemption by passing House Bill 1852, whereby amounts held for business entities (as opposed to being held for individuals) were exempted from being reported as unclaimed property. Specifically, House Bill 1852 amended the Illinois Unclaimed Property Act to read in part as follows: "any property due or owed by a business association to or for the benefit of another business association resulting from a transaction occurring in the normal and ordinary course of business shall be exempt from the provisions of this Act."

In a statement of legislative intent by the Illinois House of Representatives, the exemption was described as including, but not being limited to, "checks issued for the payment of goods and services or credits issued to business customers. It would also apply to refunds, overpayments, uncashed checks, credit memos, and write-offs."[2]

Since the enactment of the Illinois B2B exemption, companies operating in the state of Illinois have had a reduced unclaimed property compliance burden, and the exemption covered properties with last transaction dates occurring in 1995 and forward. The benefits to companies under the exemption included a reduced unclaimed property liability and the absence of long and onerous recordkeeping requirements in the event of an audit.

On July 6, 2017, Illinois enacted Senate Bill 9, which became effective on January 1, 2018. The legislation repealed Illinois' Uniform Disposition of Unclaimed Property Act and replaced it with a version of the Revised Uniform Unclaimed Property Act (RUUPA). The revised act removes the previous B2B exemption. Moreover, the new act contains a transitional provision calling for reporting of items that were previously exempt from reporting. The likely reason behind removing this exemption is budgetary constraints in Illinois amid the ongoing budget crisis.[3]

The retroactive provision requires that the initial report under the new law must contain previously exempted B2B items for the past eight years, including the preceding five years, but also factoring in the new dormancy period of three years. Therefore, the retroactive provision encompasses properties with last transaction dates going back to January 1, 2010.

The transitional provision reads as follows: "(a) An initial report filed under this Act for property that was not required to be reported before the effective date of this Act, but that is required to be reported under this Act, must include all items of property that would have been presumed abandoned during the 5-year period preceding the effective date of this Act as if this Act had been in effect during that period."

From the practical perspective of a company, reviewing detailed documentation to determine whether previously exempt properties are now reportable has the potential to be burdensome, time consuming, and resource intensive. Additionally, if the properties were previously identified as statutorily exempt, the liability (or a portion of it) may have been recognized as income by companies on the recommendation of their financial statement auditors. As a result, previously exempted properties would no longer be showing as open liabilities in the books and records of companies, making a re-creation of the records for the purpose of retroactive reporting a difficult to impossible undertaking.

For companies currently under audit, the state of Illinois (through third-party auditors) has, as of the time of writing this article, already begun to reflect the removal of the Illinois B2B exemption and the retroactive application of that removal. The introduction of legislation, which removes a previous exemption or adds a new reporting requirement, in conjunction with demands for retroactive reporting, has historically been associated with an increase in audit activity by the state in question.

Applying new unclaimed property legislation retroactively has previously been found to violate the substantive due process of companies under audit, as shown in the U.S. District Court for the District of Delaware case[4] which was decided on June 28, 2016. On February 14, 2018, Senate Bill 2901 was introduced in the Illinois Senate. This bill would reinstate the previous B2B exemption, but the bill currently appears to have a low chance of being enacted into law.[5]

As a result of the likely increases in unclaimed property liability and administrative burden to companies that are associated with retroactive reporting legislation, such legislation has historically been associated with legal challenges in other jurisdictions, such as in Massachusetts and the District of Columbia, which is the subject of the following discussion.

Massachusetts B2B Removal and Retroactive Audit Liability—The *Biogen* Case

In the late 1990s, a number of unclaimed property audits in which the Commonwealth of Massachusetts demanded reporting as unclaimed property of accounts receivable credits, often exceeding seven figures

in liability, prompted lobbying by the business community for a B2B exemption. This lobbying was ultimately successful and resulted in an amendment from November 6, 2000, to the Massachusetts unclaimed property statute, which added a B2B exemption. The legislation in question provides the following: "any outstanding credit balances to a vendor or commercial customer from a vendor resulting from a transaction occurring in the normal and ordinary course of business shall be exempt from the provisions of this chapter."

The legislation became effective November 6, 2000. In 2001, the Massachusetts State Treasurer created accompanying regulations, which defined how the exemption would be implemented. These regulations specified that the exemption would apply retroactively to "all prior and current reporting years." In other words, properties that were not exempt from reporting prior to the effective date of the exemption would nevertheless *not* have to be reported, according to the original regulations.

However, budget concerns in 2004 prompted a newly appointed State Treasurer, Timothy Cahill, to revise the regulations that governed the B2B exemption. These revised regulations had the effect of severely limiting the scope of the exemption, while demands for payments of accounts receivable credit balances under audit increased significantly.

These payment demands under audit prompted legal challenges with respect to the scope reduction of the B2B exemption and the retroactive nature of the legislation. The amended regulations stated that accounts payable checks were no longer exempt, and that accounts receivable credits had to be "outstanding" for the exemption to apply. The effect of the amended regulations with respect to retroactive reporting was that accounts payable checks and most accounts receivable credits, which were previously exempt from reporting, became reportable in 2004, which included properties with last transaction dates going back to the early 1980s.

A key court case, *(Biogen Idec MA, Inc. v. Treasurer and Receiver General)* was filed as a result of the 2004 regulations governing the B2B exemption in Massachusetts. In this case, the Massachusetts Supreme Judicial Court considered whether the State Treasurer's assessment of approximately $800,000 on audit for uncashed account payable checks from the period between the years 1984-2004 was proper. It concluded that this assessment was not proper because it determined that the regulations that Treasurer Cahill adopted in 2004 could not be applied retroactively.

The Court stated: "[T]here is no basis for applying the amended regulations retroactively. The uncashed accounts payable checks may fall within the outstanding credit balance exemption under the original

regulations, but indisputably do not qualify for the outstanding credit balance exemption under the amended regulations. As a result, if the original regulations govern, Biogen would not be required to surrender $781,251.34; but, if the amended regulations apply, it would be required to pay the Treasurer that amount. . . . In essence, because the credit balance exemption under the original regulations applied to uncashed accounts payable checks, the amended regulations impose a new liability on Biogen to surrender those funds to the Treasurer. In these circumstances, the amended regulations cannot be retroactively applied."[6]

The state high court specified that the original regulations from 2001 were reasonable and consistent with the intent of the 2000 amendment, which created the B2B exemption, and determined that the 2001 regulations would be applied in the *Biogen* case.

As in the case of the 2017 Illinois B2B removal legislation, the 2004 Massachusetts regulations attempted essentially to remove the B2B exemption and require checks and credits that were previously exempted to be reported under its audit program. Massachusetts did not prevail in its attempts to retroactively apply a removal of a previous B2B exemption because the attempt did not comport with the intent of the original law from 2000 and because the retroactive addition of a liability was considered improper.

District of Columbia Retroactive Reporting—The *Riggs National Bank* Case

In the late 1970s, a legislative effort was started in the District of Columbia to stop the then commonplace practice of banks in the District converting unclaimed deposits into income.[7] According to the District, this practice resulted in a "windfall" for these institutions and, as a result, legislation updating the District unclaimed property statute was enacted in 1981. This new legislation provided that unclaimed deposits, cashiers' checks and other properties held by the banks must be reported and remitted to the District as unclaimed property. The new legislation also included the following language: "This chapter shall apply retroactively to all items of property which would have been presumed abandoned if this chapter had been in effect as of January 1, 1980."

The new legislation was meant to be "remedial" in nature, meaning that it was meant to "right a wrong" from the past. As a result, the District initiated a number of unclaimed property audits against banks in the District after the legislation was enacted. In 1987, the District filed a lawsuit against Riggs National Bank ("Riggs") as the result of an audit that was started in 1985.[8] The audit identified approximately $2.6 million of dormant deposits, with last transaction dates going back to the early 1970s.

Riggs argued in the lawsuit that certain stale-dated checks and dormant deposits belonging to unknown owners that had been converted into income by the bank prior to the enactment of the new legislation were not reportable to the District as unclaimed property. The reason given was that it would not be possible to recreate old account balances because the property in question had been comingled with other funds. Riggs also claimed that if a long-lost owner of an unclaimed check or deposit came forward to claim his or her property, the bank routinely honored such requests.

With respect to the retroactivity issue, there was some confusion over the phrase "property which would have been presumed abandoned if this chapter had been in effect as of January 1, 1980." Riggs argued that if this phrase covered all property that would have been presumed abandoned as of this date, the cut-off date might as well have been January 1, 1880, which it argued was not the legislative intent.

The District of Columbia Court of Appeals nevertheless held that property which was showing as dormant as of January 1, 1980 in the bank's books and records was indeed reportable, and also held that old account balances did not need to be recreated, which Riggs had argued was impossible [9] The balance as of January 1, 1980, would be used to determine the amount of reportable property. The court added that if Riggs had the ability to honor requests for payment by previously lost customers as it had claimed, it would appear to have the ability to comply with the retroactive legislation.

The District did prevail in its attempts to retroactively collect unclaimed property from banks that arose before the legislation that allowed this collection was enacted. As previously mentioned, the original intent of the District legislation was to be remedial in nature and correct the issue of banks treating unclaimed property as income, which is likely a reason behind the court's sympathetic treatment of the District's retroactive collection attempts in the *Riggs* case.

Do B2B Exemptions Create Windfalls for Companies?

In the case of banks in the District of Columbia converting dormant account balances into income, an argument defining the amounts in question as a windfall for the banks can clearly be made. These balances most likely became dormant because their owners forgot about them, moved, or died. There would be few reasons to believe that some sort of accounting error occurred which created a dormant balance, especially because many of the balances were historically reduced by bank fees on a monthly or annual basis, and were often ultimately reduced to a zero balance.[10]

On the other hand, as mentioned previously, it is much more likely that transactions such as inadvertent overpayments and underpayments and other accounting errors occur between companies that frequently

do business with one another. For example, many companies have rebate programs that give their business customers price reductions based on purchasing volume, speed of payment, etc. In some cases, business customers may neglect to use a discount that they are entitled to under a rebate program when they make a payment, which could create a credit balance relating to the rebate program on the books of the company selling the product or service in question. In states that do not have B2B exemptions, such credits may be reportable as unclaimed property.

However, using the example of the rebate program, it is also common for business customers to use rebates that they are not entitled to, for example by taking advantage of a rebate even though they did not meet the purchase volume requirement. Consequently, as it relates to B2B exemptions, these overpayments and underpayments are basically thought to balance each other out over time, thus being a zero-sum game between the buyer and seller. This provides a rationale for B2B exemptions on a micro level and speaks against the idea that B2B exemptions create windfalls for companies.

Even if the transactions between two companies do not always balance out, there is a further rationale for B2B exemptions on the macro level by taking into account amounts that would have been reported as unclaimed property if a B2B exemption did not exist. For example, if Company A and Company B made erroneous overpayments at roughly the same frequency according to their sizes to various companies during a year, those overpayments will, in theory, eventually be reported as unclaimed property by these various companies. The amounts that were reported as unclaimed property to the state can be claimed back by the company that made the overpayment.

Implications for the Implementation of the Illinois Retroactive Reporting Requirement

The experience from Massachusetts has shown that budgetary concerns have driven attempts to remove B2B exemptions and collect previously exempted property on a retroactive basis. In the case of the District of Columbia, budgetary concerns were probably also a factor, but the main reason for enacting the new retroactive reporting requirements was to "right the wrong" of banks using dormant property as income.

In the case of Illinois, it is difficult to overlook the current state budget crisis as a factor in the new legislation. However, the Illinois State Treasurer's characterization of the previous B2B exemption as a "loophole" indicates that an element of "righting a wrong" is also present in the attempt to collect previously exempted property.

The fact that Illinois has already begun to reflect the B2B removal and its retroactive application under audit signals the likelihood that this issue will be litigated in the future, as it was in Massachusetts and the District of Columbia. If such litigation occurs in the future, Illinois is likely to characterize the previous B2B exemption as a "windfall" for businesses.

The experiences of Massachusetts and the District of Columbia have shown that legislative efforts like the Illinois B2B removal and retroactive reporting requirements tend to be followed by increased audit activity by the legislating jurisdiction. As a result, companies that have historically utilized the previous B2B exemption in Illinois would be well advised to retain records relating to the transactions in question as evidence in the event of an audit and to seek the advice of seasoned consultants and attorneys who understand the potential implications of the Illinois B2B removal, as well as how the retroactive provision may play out in conjunction with current reporting requirements, potential future proposed changes, and potential future litigation.

[1] Email to holders from Illinois Treasurer Michael Frerichs, *Changes to Reporting Unclaimed Property in 2018,* Jan. 3, 2018.

[2] http://ilga.gov/house/journals/hdailyjrnls91/hjd91079_r.html.

[3] https://www.bloomberg.com/news/articles/2017-05-31/illinois-budget-crisis-is-about-to-get-even-harder-to-resolve.

[4] *Temple-Inland, Inc. v. Cook*, No. 1:14-cv-00654 (D. Del. June 28, 2016).

[5] http://www.ilga.gov/legislation/BillStatus.asp?DocNum=2901&GAID=14&DocTypeID=SB&LegId=110138&SessionID=91&GA=100.

[6] *Biogen Idec MA, Inc. v. Treasurer & Receiver Gen.,*454 Mass. 174, 191 (2009).

[7] https://law.justia.com/cases/district-of-columbia/court-of-appeals/1990/88-1016-4.html.

[8] https://www.washingtonpost.com/archive/business/1987/05/15/riggs-sued-over-abandoned-accounts/2de72149-baf1-4488-867d-bcb4e4ab163c/?utm_term=.96b0c41f63ae.

[9] *Riggs Nat. Bank v. District of Columbia,*581 A.2d 1229 (1990).

[10] https://law.justia.com/cases/district-of-columbia/court-of-appeals/1990/88-1016-4.html.