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Tracking the dramatic changes in abandoned and unclaimed property

Dear clients and alumni,

Happy Spring! Several months have passed since the busiest quarter of sales for companies selling gift cards. Now is a great time to analyze potential issues related to unredeemed gift cards. The featured article focuses on key considerations for companies related to possible gift card restructuring and transfer pricing. In addition, we have included summaries of enacted legislation that we have been tracking.

We hope you enjoy reading this edition of our newsletter, and look forward to hearing from you. Your continued feedback is invaluable to us.

Regards,

Janet Gagliano
National Leader - Abandoned and Unclaimed Property

Managing AUP in the Retail Industry:

Key gift card restructuring and transfer pricing considerations

In brief

Research firm CEB TowerGroup Research estimates that gift card sales will top $110 billion in 2012[1] . With the explosion of retailers implementing gift card programs over the last two decades, two questions often arise: What are the benefits to establishing a gift card company? And, what are the best practices for setting one up?

Retailers that decide they want to form a gift card company in order to reduce their multi-state reporting responsibility associated with the escheatment of gift cards and/or merchandise credits (collectively referred to as 'gift cards'), have several things they need to consider. One of the main areas of focus by the states when they determine that a company is using a gift card company to manage its internal gift card program is whether there is a business purpose and substance to the gift card company. Although there are many requirements or elements that go into establishing business purpose for an entity, one highlighted item that we have seen state's unclaimed property administrators request is a transfer pricing study. This article focuses on the various unclaimed property and transfer pricing considerations needed to assist in the development of a transfer pricing study in the formation of a gift card company.

In detail

All states, including the District of Columbia, and the territories of Puerto Rico and the Virgin Islands, have abandoned and unclaimed property laws requiring companies with tangible or intangible personal property due and owing to a third party to turn the property or its value over to the state. Abandoned and unclaimed property has become an increasing source of revenue for the states and as a result, states are increasing their efforts in auditing and assessing liability in this area.

Companies in the retail industry have unique challenges around their gift card programs. Our experience has shown that between 5 percent and 15 percent of gift cards are never redeemed and most retailers complete thousands of gift card transactions each year. If a gift card goes unredeemed, then it will be escheatable to a state unless there is an exemption for this type of property. Generally, unredeemed gift cards are escheatable to various states depending on the last known address of the owners. However, if there are no records indicating the address of the gift card purchaser, then the unredeemed gift cards would be remitted to the state of incorporation. Consequently, a retailer must establish a method to track the gift card's purchase, use and outstanding balance. If a period of time elapses during which there has been no activity on the gift card, then the retailer must report and remit the gift card to the appropriate state's unclaimed property division.

It may be possible to reduce this administrative burden and reporting responsibility through the establishment of a gift card company or subsidiary ("GiftCo") in a state that does not require the escheatment or reporting of unredeemed gift cards. Many states provide escheat exemptions for gift cards, which may be for the full or partial value of the

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[1] CEB TowerGroup Research Press Release, December 17, 2012 "Gift card Sales To Top $110 Billion As Card Spillage Declines 20 Percent."

gift card and may depend on the contractual nature of the gift card program. By creating a GiftCo and incorporating it in a state which exempts unredeemed gift cards from its unclaimed property laws, a company can potentially reduce or eliminate its unclaimed property liability for unredeemed gift cards.

A GiftCo is a separate entity within a company's organizational structure whose main purpose is to oversee the company's internal gift card program, thus assisting companies with managing their gift card activity and streamlining their business operations. Setting up a GiftCo may yield several benefits relating to unclaimed property and business operations, such as:

- the ability to isolate and track the performance of the GiftCo and the unredeemed balances, without the need to track and report unclaimed property to multiple jurisdictions
- helping to determine if the GiftCo costs are contributing to the planned goals
- determining if the GiftCo should consider outsourcing certain operational or support responsibilities to a third party
- the ability to proactively manage the impact of GiftCo spillage or breakage.

There are several steps that must be taken to set up a GiftCo., but one that should be seriously considered for both income tax and unclaimed property purposes is the completion of a transfer pricing study. While often viewed as a document to support a taxpayer's intercompany transactions and assist in defending against an audit, recently a transfer pricing study is being requested by states' unclaimed property auditors when a company has a GiftCo in place to assist with its gift card program. This request is being made to determine what unclaimed property reporting responsibilities the GiftCo may or may not have. It is for this reason that we focus on this one very important component in this article.

Transfer Pricing Considerations

States have increasingly (in particular during the economic downturn) scrutinized intercompany transactions among related entities. There is a perceived notion that multi-jurisdictional companies set up separate entities primarily for tax planning objectives. In addition, states expect that companies have prepared formal transfer pricing studies to help them price related party transactions. Therefore, the absence of one can lead to longer audits, potential tax adjustments, and the possibility of penalties.

Transfer pricing studies help to address the following issues:

- whether the rationale for setting up the entity was motivated by a valid business purpose
- if the pricing among the related parties is arm's length according to transfer pricing methods prescribed by the IRC Section 482 regulations
- whether the economic substance of the entity is supported.

It is strongly recommended that a retailer arrange for the preparation of an independent transfer pricing study to document the intentions of the company and assist in setting pricing policies when it is first setting up the GiftCo. Updates are advisable on a periodic basis as the initial estimates for income and costs of the GiftCo can quickly change. Although the questions above are items that are often addressed for income tax audit purposes, the extension of its requirement for unclaimed property purposes is to support that the entity holding the liability associated with the gift cards has a valid and sustainable business purpose within the overall entity structure. For purposes of determining the proper sourcing of unclaimed property, states often look to the entity that is actually holding the liability on its books and records. In an effort to substantiate that the GiftCo is a valid entity within the overall corporate structure, and that it is the entity holding the liability, the use of a transfer pricing study is to assist with this substance becomes essential as well. The existence of a transfer pricing study supports the fact that the GiftCo really manages an important component of an organization's gift card program.

The following items detail key information that should be covered in a transfer pricing study:

- **Company and industry overview**. The company overview section should address the business purpose for setting up the separate legal entity and highlight the numerous reasons why the particular retailer chose to start its program. There is substantial industry data that identifies the numerous benefits of such a decision which should be summarized here. Finally, it is helpful for the study to reference that retailers have options for outsourcing certain or all gift card operations to third party companies.

- **Identification of the related party transactions**. The primary intercompany transaction is typically a program fee that the GiftCo receives from the retailer for managing the business operations. Next, it is common for the GiftCo to reimburse the retailer for certain marketing, selling, activation and redemption costs that are needed to sell the gift cards to the retail consumer. Finally, depending on how the GiftCo is structured, it may also need to procure certain corporate and support services from the retailer or third parties. All of the intercompany fee's in which the transfer pricing study addresses, should be incorporated into the various intercompany agreements that the GiftCo will have so that it is fairly compensated for the services it provides. Without the inclusion of such fees within a transfer pricing study to support the GiftCo transactions, states could question if the compensation that GiftCo is receiving and the expenses it is paying for services is fairly being administered.

- **Selection of transfer pricing method(s) for pricing the related party transactions**. Most states have adopted the federal IRC Section 482 regulations as the standard for setting prices among related parties for state-to-state transactions. This section of the study should summarize the IRC Section 482 regulations and help identify the best method for analyzing each of the identified intercompany transactions.

- **Economic analysis**. After the transfer pricing methods have been selected, the transfer pricing study should identify external benchmark companies or transactions. Application of the transfer pricing methods should result in a range of acceptable prices for each transaction.

- **Conclusions**. The conclusion section of the study generally summarizes the various categories of intercompany transactions as well as the ranges of arm's length prices calculated in the economic analysis. Because there are often multiple intercompany transactions, it is helpful for the conclusion section to include a pro forma estimate of the income statement for the gift card company.

A thorough transfer pricing study may be one of the primary tools for supporting the fact that a GiftCo is in place to address the key business operations and unclaimed property reporting requirements. Since transfer pricing studies involve extensive analysis that will address many of the auditor's inquiries regarding where the liability to remit properly resides. Accordingly, a transfer pricing study should be responsive to a request for the current facts and circumstances of the GiftCo.

The takeaway

Most retailers have gift card programs that require significant monitoring to facilitate proper reporting and remitting is being completed for unclaimed property purposes. To assist in streamlining this process and to better align its gift card program with its business objectives and reporting obligations, retailers should consider the significant benefits that a GiftCo could provide. While income tax auditors have previously requested a copy of a transfer pricing study, recently the unclaimed property auditors have been doing the same. Preparation of a transfer pricing study would assist retailers with planning for either type of scrutiny and audit in this area.

Multistate developments

While not fully inclusive of all developments in state AUP, the following provides highlights of some notable items.

Alabama

2013 AL H 112 , signed by the Governor April 18, 2013

This bill provides the following:

- allows banks to treat all deposit products equally regarding abandonment
- allows all payment instruments issued by the state to be remitted to unclaimed property for the benefit of the payee at expiration
- requires a holder to electronically report with certain exceptions
- protects the state when receiving property and the holder when remitting property
- clarifies property received by early reporting
- gives protection to consumers who claim their property through a third-party source.

Arkansas

2013 AR S 115, signed by the Governor February 14, 2013

This bill amends the Unclaimed Property Act to exclude funds distributable from a trust or custodial account established by a State of Arkansas supported retirement system to provide a defined benefit pension plan.

California

2013 Spring Newsletter, April 2013

The quarterly issue of the newsletter from the State Controller's Office contains information on submitting the holder remit report, the new universal holder face sheet (UFS-1), issues a reminder regarding unclaimed securities remittance and discusses due diligence letters for the 2013 report year.

Unclaimed Property Holder Handbook, March 2013

The State Controller's Office has updated the Unclaimed Property Holder Handbook in March 2013 to amend the Owner and Relationship Type Codes and the Universal Holder Face Sheet (UFS-1) instructions.

Colorado

2013 CO H 1102, signed by the Governor March 15, 2013

This bill defines gift cards as a "prefunded tangible or electronic record of a specific monetary value evidencing a business association's agreement to provide goods, services, credit, money, or anything of value". "Gift card" includes, but is not limited to, a tangible card, electronic card, stored-value card, or certificate or similar instrument, card or tangible record, all of which contain a microprocessor chip, magnetic chip, or other means for the storage of information and for which the value is decremented upon each use.

"Gift card" does not include a prefunded tangible or electronic record issued by, or on behalf of, any government agency, a gift certificate issued only on paper, a prepaid telecommunications or technology card, a card or certificate issued to a consumer pursuant to an awards, loyalty, or promotional program for which no money or other item of monetary value was exchanged, a card issued for wages or other payroll purposes, a card used for rebates or refunds, or a card donated or sold below face value at a volume discount to an employer or charitable organization for fundraising purposes.

The gift card provision does not apply to unclaimed gift cards where the holder or issuer is a business association with annual gross receipts from the sales or issuance of all gift cards totaling $200,000 or less.

Indiana

2013 IN S 222, signed by the Governor April 12, 2013

This bill provides that tangible property held in a safe deposit box or safekeeping depository in Indiana that is presumed abandoned is subject to Indiana custody, regardless of the last known address of the apparent owner. Tangible property held in a safe deposit box or safekeeping depository in another state that is presumed abandoned is subject to Indiana custody if the last known address of the owner is in Indiana and the property is located in a state that does not provide for the escheat or custodial taking of the property. The presumed abandonment period is reduced from five years to three years for property or sale proceeds of a safe deposit box of safekeeping depository that remains unclaimed.

Montana

2013 MT S 34, signed by the Governor March 29, 2013

Creates the "Unclaimed Life Insurance Benefits Act" to provide that unclaimed death benefits escheat to the state. The bill also requires an insurer to perform a comparison of life insurance policies, annuity contracts, and retained asset accounts that are in force for its insureds against a death master file on at least a semiannual basis to identify potential matches of its insureds.

Submitting an Unclaimed Property Report (April 22, 2013)

The Department of Revenue has posted information regarding reporting procedures, including electronic holder reporting, and holder report types.

New Mexico

2013 NM S 312, signed by the Governor April 1, 2013

Requires insurers to make good faith efforts to locate beneficiaries and provide claim materials, providing that unclaimed benefits escheat to the state; clarifies that certificates of property or casualty insurance are not insurance policies; specifies terms for certificates of property or casualty insurance.

New York

2013 NY A 1831 and S 2756, signed by the Governor March 15, 2013

Amends life insurance statute to clarify unclaimed life insurance policies and procedures including required data, procedures for the insurer's affiliates, the required time frame for searches, etc.

North Dakota

2013 ND H 1171, signed by the Governor April 26, 2013

This bill creates a new Act that relates to the unclaimed property life insurance contracts. Before November 1, 2014, an insurer must perform a comparison of the insurer's insureds' in-force life insurance policies and retained asset accounts against a death master file in order to identify potential matches of the insurer's insureds. Semiannually, an insurer must perform a comparison of the insurer's insureds' in-force life insurance policies and retained asset accounts against the revised death master file in order to identify the potential matches of the insurer's insureds. Additionally, the presumed abandonment date is reduced from three years to one year for unclaimed funds held or owing under any life or endowment insurance policy or annuity contract that has matured or terminated.

2013 ND H 1162, signed by the Governor April 1, 2013

Amends the unclaimed property definitions statute by adding a definition for money orders.

2013 ND S 2058, signed by the Governor March 14, 2013

North Dakota Section 47-30.1-30(2) currently states "...The administrator may not contract for an examination done within this state". This bill adds the following provision, "without reasonable cause to believe that a person has failed to comply with this chapter". Therefore, the amended language allows the state to contract for unclaimed property examinations with reasonable cause. In addition, the bill authorizes the commissioner to furnish to the unclaimed property division of the board of university and school lands, a taxpayer's name, address, and federal identification number for identifying the owner of an unclaimed voucher authorized by the commissioner or to locate the apparent owner of unclaimed property.

Let’s talk

For more information, please do not hesitate to contact:

Janet Gagliano

Partner, National Practice Leader-
Abandoned and Unclaimed Property

Atlanta

+1 (678) 419-1068

janet.c.gagliano@us.pwc.com

Heela Popal

Director, East Region Leader-

Abandoned and Unclaimed Property

Atlanta

+1 (678) 419-1462

heela.popal@us.pwc.com

Stephen Snyder

Director, Transfer Pricing-

Tax Controversy and Dispute Resolution
Atlanta

+1 (678) 419-1474

stephen.l.snyder@us.pwc.com

Loredana Pfannenbecker

Director, National Gift Card Specialist-
Abandoned and Unclaimed Property

Stamford

+1 (203) 539-5211

loredana.c.pfannenbecker@us.pwc.com

Keith Robinson, Ph.D.

Principal, National Transfer Pricing-

Tax Controversy and Dispute Resolution
Atlanta

+1 (678) 419-1188

keith.w.robinson@us.pwc.com