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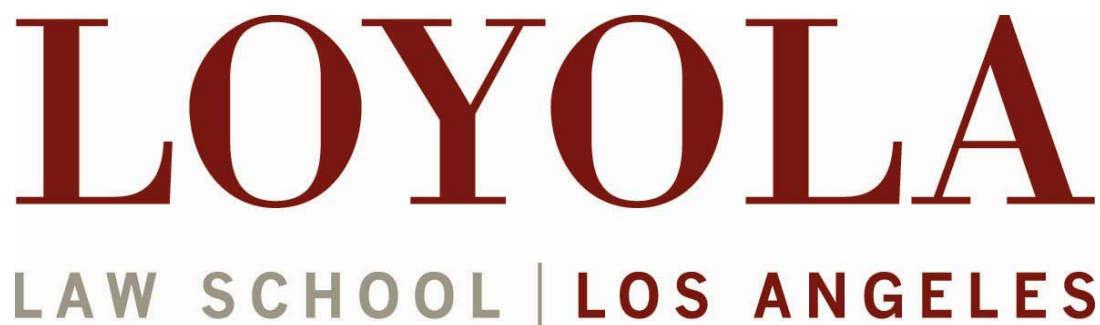
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**Inadvertence and the Internal Revenue Code:
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Property Laws**

Professor Ellen P. Aprill

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INADVERTENCE AND THE INTERNAL REVENUE CODE: FEDERAL TAX CONSEQUENCES OF STATE UNCLAIMED PROPERTY LAWS

*Ellen P. Aprill**

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Each year Americans lose track of personal property worth, in the aggregate, hundreds of millions of dollars. According to one estimate, 25%

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of us are owed money or other assets about which we do not know.¹ We fail to cash checks for stock dividends or salary payments. We neglect to claim security deposits, utility deposits, and insurance benefits. Checking and savings accounts remain untouched, gift certificates unused. We die without informing our heirs about all our assets. Author David Folsom believes that unclaimed property in this country may amount to some \$1 trillion.²

Laws in all fifty states require businesses that hold certain kinds of unclaimed property³ to transfer such property to the state after periods of inactivity that vary from less than one to seven years.⁴ As a result of these laws, states hold billions of dollars of unclaimed property.⁵ New York, for example, held \$416 billion as of 1998 and California currently has \$2.6 billion in unclaimed property funds.⁶

1. Deborah Mendenhall, *Strike It Rich; Here's How to Stake Your Claim to Treasures You Didn't Even Know Existed*, CHI. TRIB., Apr. 13, 1998, at C1. Another author puts the number at 1 in 10. DAVID W. FOLSOM, *ASSETS UNKNOWN: HOW TO FIND MONEY YOU DIDN'T KNOW YOU HAD* vi (1996). The author checked the list of California residents with unclaimed property against the names of all her colleagues and found a little under 10% of her faculty had unclaimed property, most often unclaimed insurance reimbursement checks. My colleagues in turn looked on the list and found money for many friends and family.

2. FOLSOM, *supra* note 1, at vi.

3. Thus, unclaimed property laws refer to these private businesses holding unclaimed funds as "holders." See text *infra* p. 11. See text *infra* p. 11 for a list of the kinds of property subject to these laws.

4. See generally ANTHONY L. ANDREOLI & J. BROOKE SPOTSWOOD, *GUIDE TO UNCLAIMED PROPERTY AND ESCHEAT LAWS* (2d ed. 1993). The period varies from asset to asset and state to state. "As a result of the states' awakening to the vast potential in unclaimed property revenues, they have viewed the holding periods with an eye toward increasing the dollar volume reported by holders of unclaimed property" and "have reduced time period on certain types of property to three years, and in some cases one year." *Id.* at 13-16. In particular, New York, California and Massachusetts have reduced the holding period below five years for most types of property. In these states, the holding period is generally three years. See *id.* at NY-2, MA-2, CA-2.

5. Folsom estimates that the states hold more than 30 billion dollars acquired from private parties, such as banks, insurance companies, and transfer agents. See FOLSOM, *supra* note 1, at 24-25. In 1997, *Money Magazine* estimated the number as closer to \$35 billion. See Joan Caplin, *Have You Claimed All the Money Belonging to You?*, MONEY, Dec. 1997, at 106. The federal government is the largest holder of unclaimed property in the form of federal pensions, savings bonds and tax refunds. See FOLSOM, *supra* note 1, at vi. See also GOVERNMENTAL ACCOUNTING OFFICE, *UNCLAIMED MONEY: PROPOSALS FOR TRANSFERRING UNCLAIMED PROPERTY TO STATES*, AFMD 89-44 (May 1989). The GAO found that federal agencies varied considerably in their efforts to establish procedures for finding and returning amounts owed. *Id.* at 25.

6. See Jayson Blair, *Reuniting New Yorkers With Forgotten Billions*, N.Y. TIMES, July 5, 1998, § 1, at 16; California State Controller's Office, *Unclaimed Property Program Description*, (11/8/00), available at <http://www.sco.ca.gov/col/ucp/bbs/desc/>; News Release, Office of the California State Controller, PR Newswire, May 21, 1998, available in LEXIS, News Library, current news File. New York last year returned \$60 million to 60,000 claimants; California disburses nearly \$100 million in claims each year, and its data base of missing owners has names of nearly 7 million people. See *id.* Since 1971, Delaware has taken in \$451.2 million of lost assets into its general fund as well as receiving a \$216.5

State governments do not themselves take title to this unclaimed property, but hold the property in perpetuity as custodian for the owner.⁷ After the state has acquired the property, state administrators, some more vigorously than others, seek to identify the owner and return the property. If the owner is found, the owner receives back the property and, in some states and for some kinds of property, interest on the property at a statutory rate, a rate generally less than the amount the state earns on these funds.⁸ If the owner is not found (and the vast majority are not), the state has the use of these funds in perpetuity.⁹

Most states acquire such lost property pursuant to statutes modeled, in whole or in part, on the Uniform Unclaimed Property Act ("UUPA").¹⁰ The National Conference of Commissioners on Uniform State Laws, the sponsor of the UUPA, has described the purposes of the model act: "[T]o protect the interests of owners, to relieve the holders from annoyance, expense, and liability, to preclude multiple liability, and to give the adopting state the use of some considerable sums of money that otherwise would, in effect, become a windfall to the holders thereof."¹¹ Thus, one express function of the UUPA is to supply states with a source of non-tax revenues. The American Tax Policy Institute, recognizing the growing importance of such laws, has recently commissioned a study of state audits of unclaimed property.¹² State Tax Reporters published by Commerce Clearing House now include detailed coverage of state unclaimed property laws.¹³

The amount of unclaimed property subject to these laws is expected to increase markedly in upcoming decades. An industry publication recently observed, "Given the shrinking resources available to state governments and

million settlement reached in 1995 after a dispute with New York as to which state was entitled to abandoned property related to corporate stock. See Dale Dallabrida, "Lost Money" Is Delaware's Gain, GANNETT NEWS SERVICE, June 5, 1998, available in LEXIS, News Library, current news File. Massachusetts collected more than \$90 million in unclaimed property in 1995. See Daniel Golden, *Finders Keepers*, BOSTON GLOBE, Apr. 30, 1996 (Metro/Region), at 1.

7. See UNIF. UNCLAIMED PROPERTY ACT, Prefatory Note (Amended 1985), 8B U.L.A. 104 (Supp. 2000).

8. See *infra* note 86.

9. It has been estimated that states have returned 4% of all unclaimed property they have collected. Currently, they are returning each year approximately 25% of the dollar amount of collections for that year. See Mendenhall, *supra* note 1, at C1; Golden, *supra* note 6, at 1.

10. See generally UNIF. UNCLAIMED PROPERTY ACT, 8B U.L.A. 103 (Supp. 2000); for history of amendment, see *id.*, Prefatory Note, 8B U.L.A. 104 (Supp. 2000).

11. 8B U.L.A. 567 (1994).

12. Michael I. Saltzman, *Providing Protection in State Unclaimed Property Audits*, 2000 TNT 243-85 (Dec. 18, 2000).

13. See generally ST. TAX REP. (CCH).

a widespread anti-tax climate, it is likely that non-tax revenue-generating programs such as abandoned property will not only be fully embraced by the states but expanded and strengthened."¹⁴ The director of Louisiana's unclaimed property program has commented, "Unclaimed property of the future will include IRAs . . . Can you imagine the number of people who will start accounts with \$2,000 now and forget about them 50 years later?"¹⁵

Like the number of people with claims, the dollar amount of funds reclaimed by owners is also expected to grow. The media have been drawing attention to the existence of these state funds and the ability of owners and their heirs to reclaim such property. Authors of books, private finding companies, and state administrators have been interviewed for *The New York Times*, *Money Magazine*, the *Oprah Winfrey* show, *CNN Today* and *NBC's Today* show.¹⁶ States reported an increase in claims after the Oprah Winfrey show.¹⁷ Many states now post on the Internet lists of those with unclaimed property.¹⁸

The loss and recovery of property raise a myriad of federal tax issues, issues involving taxation of the holder, the owner, and of the state itself. While most individual claims are small,¹⁹ they have important tax consequences in the aggregate. Moreover, some claims involve hundreds of thousands of dollars and thus could have an enormous impact on the particular claimant's tax liability.²⁰ At a theoretical level, the issues are among the thorniest involving the definition of ownership and income. Many of the

14. Todd R. Stimmel, *Unclaimed Property: A Credit Risk Liability*, 84 CREDIT WORLD 13 (1996).

15. Gary Heinlein, *Lucky 46,000 Can Lay Claim to \$17 Million: State Looks for Owners of Long-Forgotten Cash, Assets and Valuables*, DETROIT NEWS, May 18, 1997, at A1.

16. See Laura Pedersen-Pietersen, *Minding Your Business: Getting the Goods on Missing Goods*, N.Y. TIMES, July 6, 1997, § 3, at 5; *The Money Club* (CNBC News Transcript, July 10, 1997); *The Money Club* (CNBC Transcript, July 4, 1997); *CNN Today* (CNN television broadcast Mar. 12, 1997); Kelly D. Smith, *How to Find Your Share of \$30 Billion in Lost Money*, MONEY, Nov. 1996, at 22.

17. See Dallabrida, *supra* note 6.

18. See the National Association of Unclaimed Property Administrators, available at <http://www.unclaimed.org/> (last visited Dec. 31, 2000) (searchable database for 26 states and addresses for the respective unclaimed property offices in all 50 states).

19. See Dallabrida, *supra* note 6. A survey of unclaimed property administrators conducted by the author in 1997 [hereinafter *Survey*] found that in Massachusetts the average collection is \$100 with the majority between \$50-\$100; in New York, in 1996, the average collection was \$44 with 65% under \$100, and Illinois had an average claim of \$1,295. (*Survey* on file with author.)

20. Louisiana presented one widow with a check for \$1 million, representing the proceeds of a matured bond her late husband had purchased. See Heinlein, *supra* note 15. One long-deceased Boston candy maker had \$3,000,000 in unclaimed property. See Daniel Golden, *Finders Keepers*, BOSTON GLOBE, May 1, 1996 (National/Foreign), at 12. New York paid \$4.7 million to the Cambodian government in 1995. Massachusetts has 20-25 claims per year over \$100,000. Illinois has many claims annually between \$250,000 and \$500,000. See *Survey*, *supra* note 19.

issues raised by the UUPA are precisely those that plague students beginning their study of the federal income tax—windfalls, the tax benefit rule, the treatment of deposits, constructive receipt. Estate tax issues, such as the definition of the gross estate, arise as well. Up to now, the academic literature involving unclaimed property statutes paid scant attention to the tax issues.²¹ The few judicial and administrative tax authorities discussing these issues have considered the effect of these laws only on private companies holding unclaimed property.

This article addresses both the theoretical and practical tax considerations involved in UUPA and similar statutes. It discusses how the practical effects of these laws force us to reconsider some of the theoretical underpinnings of a variety of tax doctrines. In particular, it exposes how our substantive tax laws assume that taxpayers act intentionally, as rational actors knowledgeable about and aware of their actions. For the most part, our substantive tax laws, unlike the procedural rules with their specific penalties for negligence,²² are ill-equipped to deal with accident, inadvertence, or carelessness on the part of the taxpayer.

Issues involving accident and carelessness also arise in connection with personal deductions permitted for casualty loss and medical expenses. A sizeable body of scholarship has focused on whether such expenditures should be taxed, in particular whether they constitute consumption under the Haig-Simons definition of income.²³ Like earlier considerations of the casualty loss

21. See Suellen M. Wolfe, *Escheat and the Concept of Apportionment: A Bright Line Test to Slice a Shadow*, 27 ARIZ. ST. L.J. 173 (1995); Note, *Origins and Development of Modern Escheat*, 61 COLUM. L. REV. 1319 (1961); Jo Beth Prewitt, Note, *Unclaimed Property—A Potential Source of Non-Tax Revenue*, 45 MO. L. REV. 493 (1980); Ray H. Garrison, *Escheats, Abandoned Property Acts, and Their Revenue Aspects*, 35 KY. L.J. 302 (1947); Andrew W. McThenia, Jr. & David J. Epstein, *Issues of Sovereignty in Escheat and the Uniform Unclaimed Property Act*, 40 WASH. & LEE L. REV. 1429 (1983); R. Perry Sentell, Jr., *Escheat, Unclaimed Property and the Supreme Court*, 17 CASE W. RES. L. REV. 50 (1965); James J. Shestack, *Disposition of Unclaimed Property—A Proposed Model Act*, 46 NW. U. L. REV. 48 (1951); Comment, *A Survey of State Abandoned or Unclaimed Property Statutes*, 9 ST. LOUIS U. L.J. 85 (1964); Susan T. Kelly, *Unclaimed Billions: Federal Encroachment on States' Right in Abandoned Property*, 33 B.C. L. REV. 1037 (1992); K. Reed Mayo, *Virginia's Acquisition of Unclaimed and Abandoned Personal Property*, 27 WM. & MARY L. REV. 409 (1986); Billy F. Hicks, *Escheat in Texas: A Current Look at the Intangible Issue*, 29 SW. L.J. 575 (1975); Note, *Modern Rationales of Escheat*, 112 U. PA. L. REV. 95 (1963); Note, *Escheat of Corporate Dividends*, 65 HARV. L. REV. 1408 (1952).

22. See, e.g., I.R.C. §§ 6013, 6161, 6652, 6662, 6709.

23. See, e.g., Daniel Halperin, *Valuing Personal Consumption: Cost versus Value and the Impact of Insurance*, 1 FLA. TAX REV. 1 (1992); Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Deductions and the Exclusion of Medical Insurance Premiums*, 79 CAL. L. REV. 1485 (1991); Thomas Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343 (1989); Stanley A. Koppelman, *Personal Deductions under an Ideal Income Tax*, 43 TAX L. REV. 679 (1988); Joel S. Newman, *Of Taxes and Other Casualties*, 34 HASTINGS L.J. 941 (1983); Mark G. Kelman, *Personal*

and medical expense deduction, examining the tax issues implicated by unclaimed property laws forces us to refine and rethink a range of basic tax concepts, including the very nature of the tax base. The case of unclaimed property also reminds us that our tax laws apply to human behavior and that our tax base needs to allow for human frailty. It enables us to identify those tax doctrines that accommodate carelessness and those that do not. Indeed, it asks us to develop, categorize, and, at least in part, judge tax doctrines on the basis of their ability to make this accommodation.

Part I considers the work of other scholars on the tax treatment of carelessness. Part II describes the operation of statutes such as the UUPA. Part III, IV, V and VI consider, respectively, the consequences of the UUPA when the owner fails to claim the property, while the holder keeps the unclaimed property, after state acquisition and use of the unclaimed property, and upon recovery by the original owner or the owner's heirs or devisees. The article concludes by suggesting that various tax doctrines, including the notion of debt, be limited to knowing actions by the taxpayer.

I. CARELESSNESS IN TAX THEORY

Notions of accident or carelessness, either by the taxpayer or by those, such as transfer agents, brokers, and banks with whom the taxpayer deals, do not fit neatly into traditional tax policy concerns, whether they involve the definition of income, concern with efficiency and incentives, or the proper role of a wealth transfer tax.²⁴

Tax scholars have most often broached the tax treatment of carelessness when evaluating the personal deduction for medical expenses under § 213 or casualty losses under § 165(c) against the Haig-Simons definition of income. This influential and classic attempt to achieve an ideal or comprehensive tax base defines income as consumption plus net accretions to wealth.²⁵ This formulation, however, does not tell us whether to consider abandonment of property or loss through carelessness as a form of consumption or change in market value.

Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World, 31 STAN. L. REV. 831 (1979); William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972).

24. Note that not all tax policy issues—in particular not equity, distributional issues, but these are the issues that bear on this problem—need to decide what to do with administrative questions.

25. See HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 206 (1938).

Focusing on the meaning of consumption under the Haig-Simons definition, William Andrews argued that we should look to the actual enjoyment of goods and services: “[I]f his [a taxpayer’s] consumption . . . of real goods and services (or claims thereto) is less than his money income, for whatever reason, in any substantial and ascertainable way, then under Simons’ definition that discrepancy should be adjusted for by a deduction from money income.”²⁶ Applying this understanding, Andrews reasoned that neither medical expenses nor charitable contributions should be included in the income tax base. In his view, neither use should constitute consumption because neither is a private preclusive appropriation that improves a taxpayer’s position beyond a base line of tax-free good health.²⁷

Under the Andrews view of the Haig-Simons definition, then, unclaimed property that has been presumed abandoned should be deducted as a loss, no matter whether the taxpayer or someone else was the careless one. The taxpayer has not enjoyed private, preclusive use. If such property is properly deductible, then its recovery would represent income. Of course, those who have lost track of their property will not be in a position to claim the loss, unless they can do so on an amended return before the statute of limitations runs. Only those who recover property would be aware of its earlier loss, and thus the practical impact of Andrew’s theoretical view is to increase taxation of those who recover unclaimed property. Recovery would permit private preclusive use for the taxpayer’s consumption.

Professor Kelman took sharp issue with Professor Andrews’ approach. In Professor Kelman’s view, income, the amount available for consumption, not consumption itself, is what should matter for an income tax.²⁸ He states, “While the tax system should not force a taxpayer to take dominion over as many resources as she is able, once she voluntarily takes control of resources, her particular subsequent uses of those resources are irrelevant to tax law.”²⁹ Under this criterion, Kelman, nonetheless, felt no discomfort with a casualty deduction for a stolen paycheck because “the taxpayer has never effectively received or appropriated income; that earnings capacity over a lifetime includes the risk of being unable to appropriate one’s earnings and that it is

26. Andrews, *supra* note 23, at 309, 325. Haig has explained, “Modern economic analysis recognizes that fundamentally income is a flow of satisfactions, of intangible psychological experiences.” Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, in READINGS IN THE ECONOMICS OF TAXATION 54, 55 (R. Muguave & C. Shoup eds., 1959), *quoted in* Halperin, *supra* note 23, at 1, 6.

27. Andrews, *supra* note 23.

28. Kelman, *supra* note 23, at 834.

29. *Id.* at 835.

administratively feasible to measure differential risks among taxpayers only when losses actually occur."³⁰

For Kelman, as for others, voluntariness is a key touchstone. At the time he was writing, section 104 protected a taxpayer from taxation of proceeds of a tort judgment for invasion of privacy. Kelman approved the result: "Ultimately, it is the *involuntariness* of the conversion that bars taxability."³¹ Because Professor Kelman believes that "the trigger to taxability ought to be a person's voluntary entrance into the market,"³² and because he would wish to avoid forced marketing, he would not tax imputed income from leisure or services provided within the household.

Similarly, Professor Koppelman would allow deductions for involuntary expenditures because "the involuntary nature of an item may suggest that the taxpayer does not receive personal value equal to the amount of the expenditure."³³ Professor Halperin, too, would generally measure consumption on an ex ante basis by the amount expended precisely because he believes that "most significant losses are a result of voluntary behavior or could be avoided through insurance."³⁴ Like Kelman, Halperin is ambivalent about how to treat a stolen paycheck or misplaced cash. On one hand, as he explains, a taxpayer whose paycheck is stolen gets no benefit from the transaction and perhaps should be entitled to a deduction. On the other, "it could be that the loss of a paycheck or theft of cash is a result of a life-style choice For example, the taxpayer may lose his paycheck when he stops in a bar on the way home from work."³⁵

All these commentators are willing to consider excluding involuntary expenditures from the tax base.³⁶ All except Andrews would include in the

30. *Id.* at 859-60 n.87. He continues, "But the deductions for losses of previously appropriated property are more bothersome; they come more and more to resemble other disappointments with purchased commodities." *Id.*

31. *Id.* at 843 (emphasis in original).

32. *Id.* at 838.

33. Koppelman, *supra* note 23, at 709. For a discussion of tax issues somewhat the inverse of inadvertence—whether the compulsive nature of a taxpayer's behavior prevents compulsive gambler Zarin from realizing cancellation of indebtedness income, see Daniel Shaviro, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 TAX L. REV. 215 (1990).

34. Halperin, *supra* note 23, at 6.

35. *Id.* at 23.

36. Professor Halperin, for example, has written in defense of the deduction for casualty losses: In a statistical sense, of course, destruction by fire is one of the hazards of home ownership "voluntarily" assumed when the taxpayer chooses to buy a personal residence. But if a dog can distinguish between being kicked and being stumbled over, as Holmes asserted, we can properly distinguish between the minor frustrations of life—a cigarette burn in a rug, a dented fender, a quarter lost when fumbling for change to put in a parking meter—and major casualties ("sudden,

income tax base voluntary personal expenditures, at least those that result from conscious choice, as a taxable element of consumption. Yet carelessness, negligence and inadvertence are difficult to categorize as either voluntary or involuntary. Professor Newman, writing about the casualty loss deduction has observed:

If casualty losses caused by voluntary acts are nondeductible, is a negligent act a voluntary act? Unfortunately, on a continuum from voluntary to involuntary, negligence falls in between "had to" and "did not have to," closer to the fuzzier "could have prevented." The location of negligence on the voluntary/involuntary continuum is not helpful.³⁷

Even if we reject voluntariness as a criterion, categorizing carelessness under the traditional Haig-Simons definition is difficult. We could say that to tax carelessness is to tax leisure; the property most often goes unclaimed because the owner failed to exercise care. Equally plausibly, we could say that unclaimed property must be considered in the tax base under either arm of Haig-Simons: either failure to keep track of the property is a form of consumption or unclaimed property involves the consequences of market transactions, whether earning a salary check or buying dividend-paying stock or filing an insurance claim, and thus loss of control of the property does represent a net decrease in wealth.

The Haig-Simons approach purports to offer an economic definition of income. By positing a comprehensive tax base, this definition in particular emphasizes questions of horizontal equity, of taxing in the same way those who are similarly situated.³⁸ Questions of economic efficiency have always attracted tax theorists as well. At its simplest, economic efficiency seeks the aggregate maximization of wealth and income in society and as a criterion for tax law asks that taxes be designed to minimize the misallocation of resources.

unexpected and unusual") events that do not "commonly occur in the ordinary course of day-to-day living.

Halperin, *supra* note 23, at 14.

37. Newman, *supra* note 23, at 951. Professor Newman continues, "Our tax system generally espouses the notion that negligence is not material." *Id.* at 952. He bases this conclusion on the absence of a requirement in either the casualty loss or the medical expense deduction sections that the deductible personal expenses be reasonable. Therefore, he reasons, such expenses may be unreasonable and could be deducted even if they resulted from negligence. *See id.* at 952 n.36. Believing both that "no expenditure which is the result of conscious choice should be deductible" and that negligent losses should be deductible as casualties, he would characterize negligent acts as involuntary and deductible as a casualty loss. *Id.* at 949-50.

38. *See* Michael A. Livingston, *Reinventing Tax Scholarship: Lawyers, Economists, and the Role of the Legal Academy*, 83 CORNELL L. REV. 365, 378 n.35 (1998).

"This means, for one thing, that we should try to be sure that we have not produced unintended perverse incentives."³⁹

In tort law, for example, efficiency analysis assumes that increasing the costs of carelessness or negligence will give individuals an incentive to be careful. Taxing unclaimed property, however, seems unlikely to have such incentive effects, at least for careless owners.⁴⁰ Loss of the property is itself a detriment that should encourage diligence. Additional tax consequences are unlikely to encourage a greater level of care.

Tax efficiency, however, is concerned with the difference between consumers' actual after-tax behavior and the behavior they would engage in merely because they have less revenue.⁴¹ Of late, several tax scholars have argued that efficiency analysis in the form of optimal taxation offers a more sophisticated approach than Haig-Simons.⁴² "This theory begins by observing that tax preferences and penalties disturb the free market . . . only to the extent that behavior is, in fact, subject to modification" and that thus, taxes should be heavier on items that are "inelastic," that is, have a low "response rate" to tax.⁴³

Under such a view, unclaimed property is ripe for income taxation. Since loss of property is its own punishment, taxation in addition will not modify economic behavior. Although not articulated in this way, the inelasticity of careless loss may in fact be one of the motivations for states' adopting unclaimed property laws. The state taking possession of unclaimed property represents a relatively painless method of raising revenue.

Unclaimed property, moreover, involves estate taxation as well as income taxation, and economic efficiency is a classic justification for the estate tax. "Since death is an uncertain future event and since it removes from the scene of action the person chiefly interested, death taxation probably has less effect on the individual's activities than do other more immediately pressing taxes."⁴⁴ Indeed, one scholar has characterized bequests as "largely 'accidental'" and explained that, as a result, "an estate tax has *no* behavioral impacts. It represents a nondistortionary source of revenue that permits the

39. WILLIAM A. KLEIN & JOSEPH BANKMAN, *FEDERAL INCOME TAXATION* 23 (10th ed. 1994).

40. As discussed, however, the situation might be different with holders of the property. See *infra* p. 22.

41. See David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1650-51 (1999).

42. See *id.*; Livingston, *supra* note 38, at 365, 381 n.54.

43. DODGE ET AL., *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY* 27 (2d ed. 1999).

44. Roy Blough & Carl Shoup, *A Report on the Federal Revenue System Submitted to the Undersecretary of the Treasury Roswell Magill*, reprinted in 70 TAX NOTES 1071, 1151 (1996).

government to lower the use of other, distorting taxes.”⁴⁵ That is, under such an efficiency approach, accident calls for taxation.

With the estate tax as with the income tax, other considerations, in particular the proper base for the tax, may call for a different answer. In the case of the estate tax, many scholars have deemed an accessions tax, a tax on the recipient’s cumulative lifetime gifts and inheritances, preferable to an estate tax, which is a tax on the transfer of property by gift or on death. Scholars promoting an accessions tax argue both that it “would be more consistent with the purpose of federal transfer taxes to promote dispersion of wealth” and “that rate graduation in accordance with the circumstances of the recipient is fairer, or at least more rational, than graduation according to the wealth of transferors, simply because the recipient probably bears the burden of the tax in any event.”⁴⁶ As discussed in more detail below, since the executors, heirs or devisees are often the ones who learn about the unclaimed property and seek its return, unclaimed property poses a particularly stark choice between an estate tax and an accessions tax.

Loss and recovery of unclaimed property raises all of these theoretical issues. Moreover, it raises an even broader question, the extent to which our tax models accept the economic model that taxpayers act as rational, utility maximizers. The model of economic efficiency, after all, assumes that two willing parties are entering into voluntary transactions. In contrast, the case of unclaimed property demonstrates how frequently people err. It suggests that both in general and in the development of discrete tax doctrines, we need to supplement our economic models with psychological ones, whether in grand tax theories or individual tax doctrines.

II. OPERATION OF UNCLAIMED PROPERTY LAWS

In the vast majority of states, unclaimed property laws now establish a detailed and elaborate statutory scheme for dealing with property involuntarily lost through neglect, carelessness, or inadvertence. Common law directed that property without a known owner would escheat to the sovereign,⁴⁷ whether the sovereign was feudal lord or the state. As society became more complicated and the types of intangible personal property increased, statutes began to replace common law. For example, California in 1915 adopted a statute for

45. Douglas Holtz-Eakin, *The Uneasy Empirical Case for Abolishing the Estate Tax*, 51 TAX L. REV. 495, 508 (1996) (emphasis in original).

46. William D. Andrews, *The Accessions Tax Proposal*, 22 TAX L. REV. 589, 590 (1967).

47. See ANDREOLI & SPOTSWOOD, *supra* note 4, at 3-3.

the escheat of bank deposits.⁴⁸ It required a judicial proceeding for the particular deposits to be declared abandoned and thus eligible for escheat to the state.⁴⁹

In 1954, the National Conference on Commissioners on Uniform State Laws and the American Bar Association approved for the first time a Uniform Disposition of Unclaimed Property Act.⁵⁰ This Act was revised in 1966,⁵¹ and in 1981 the Commissioners proposed the Uniform Unclaimed Property Act.⁵² As of July 1995, the vast majority of the states had adopted most of the provisions of 1981's Uniform Unclaimed Property Act.⁵³ In 1995, the Commissioners approved yet another revision of these model laws, the Uniform Unclaimed Property Act (UUPA).⁵⁴ These model laws cover such intangible personal property as dormant checking and savings accounts, uncashed payroll or cashiers checks, money orders and travelers checks, certificates of deposit, customer deposits or overpayments, paid-up life insurance policies, health and accident insurance payments, uncashed death benefit checks, gift certificates, stock and dividends, utility deposits and mineral royalty payments.⁵⁵

The UUPA applies when property is "presumed abandoned."⁵⁶ Property is presumed abandoned when the apparent owner has not indicated some interest in the property, such as claiming a dividend or making a deposit to a bank account.⁵⁷ The UUPA defines an apparent owner as "a person whose name appears on the records of a holder as the person entitled to property held, issued, or owing by the holder."⁵⁸ The holder, who is "a person obligated to hold for the account of, or deliver, or pay to, the owner property that is subject to this [Act],"⁵⁹ then must file a report regarding the property with the appropriate state administrator.⁶⁰

Section 2 of the UUPA lists the presumptions of abandonment. For example, wages and other compensation for personal services are presumed

48. See *State of California v. Savings Union Bank and Trust Co.*, 199 P. 26, 27 (Cal. 1921).

49. See *id.*

50. See UNIF. DISPOSITION OF UNCLAIMED PROPERTY ACT, 8A U.L.A. 267 (1993).

51. See *id.* at 207.

52. See UNIF. UNCLAIMED PROPERTY ACT, 8B U.L.A. 567 (1993).

53. See ANDREOLI & SPOTSWOOD, *supra* note 4, at 4-4.

54. See UNIF. UNCLAIMED PROPERTY ACT (amended 1995), 8B U.L.A. 103 (Supp. 2000).

55. See *id.*

56. See *id.* § 2(a) at 110.

57. See *id.*

58. *Id.* § 1(2) at 106.

59. *Id.* § 1(6) at 106.

60. See *id.* § 7(a) at 119.

abandoned one year after the compensation becomes payable.⁶¹ Stock or other equity interest in a business or financial association is presumed abandoned five years after the date of the most recent dividend or “the date of the second mailing of a statement of account or other notification or communication that was returned as undeliverable or after the holder discontinued mailings, notifications, or communications to the apparent owner.”⁶²

The 1995 amendments reduced the period of time after which abandonment will be presumed in several instances.⁶³ Under the UUPA, the presumption of abandonment period for corporate stock is now five years instead of the seven years specified in the 1981 version of the uniform act, while that for gift certificates is now three years instead of five years.⁶⁴ Some states have gone further. For most properties, California, Massachusetts and New York have a three-year period for presumption of abandonment.⁶⁵

A corporation or a business entity that holds property presumed abandoned is required to make a report to the state administrator and to pay or deliver the property to the administrator.⁶⁶ In general, the report must contain the nature of the property, the name, if known, and last known address, if any, and the social security number or taxpayer identification number, if readily ascertainable, of the apparent owner of property with a value of \$50 or more, except with respect to traveler’s checks or money orders.⁶⁷ The Comment to the UUPA notes that before filing this report, the holder “must send written notice to the apparent owner, if the owner’s claim is not barred by the statute of limitations, the property has a value of \$50 or more, and the holder’s records do not disclose the address to be inaccurate.”⁶⁸ Besides this requirement, the holder does not have to take on any other efforts to notify the apparent owner. Furthermore, a holder who “pays or delivers property to the administrator in good faith is relieved of all liability arising thereafter with respect to the property.”⁶⁹ The state and its administrator will then assume custody and responsibility over the property.⁷⁰

61. See *id.* § 2(a)(12) at 111.

62. *Id.* § 2(a)(3) at 111.

63. *Id.* § 2, cmt. at 112.

64. See *id.* § 2, at 110; ANDREOLI & SPOTSWOOD, *supra* note 4, at NEW DEV-7.

65. See ANDREOLI & SPOTSWOOD, *supra* note 4, at CA-2, MA-2, NY-2.

66. See UNIF. UNCLAIMED PROPERTY ACT §§ 7, 8 (amended 1999), 8B U.L.A. 119 (Supp. 2000).

67. See *id.* § 7(b)(1)(2) at 119.

68. *Id.* § 7 cmt., 8B U.L.A. 119-120 (Supp. 2000).

69. *Id.* § 10(b) at 122.

70. See *id.*

Next, the state administrator publishes a notice in a newspaper of general circulation in the county of the state in which is located the last known address of any person named in the notice.⁷¹ The advertisement must contain the name of each apparent owner, their last known address, an explanation that the property of the owner is presumed to be abandoned and has been taken into protective custody by the state, and a statement that the information on the property and its return to the owner is available.⁷² In many jurisdictions, the state administrator must also send a notice to the apparent owner's last known address.⁷³

For non-cash property, other than securities, the state administrator sells the property to the highest bidder at a public sale or auction.⁷⁴ Securities must be sold at the prevailing price on the exchange.⁷⁵ Under the UUPA, the state will sell such non-cash property within three years of its receipt.⁷⁶ Some states sell the property sooner. In California, the state controller sells securities listed on an established stock exchange within one year following receipt.⁷⁷ Nevada also sells within one year.⁷⁸ New York waits fifteen months before selling.⁷⁹

Generally, the administrator deposits in the general fund or some other state fund all proceeds received under the UUPA, including proceeds from the public sale of the abandoned property.⁸⁰ Thus, the state benefits from the monies themselves or from earnings on these monies. Before making this deposit, the state administrator of the abandoned property may retain some money in a trust account for payment and administration of claims.⁸¹ The Comment to the UUPA recommends the state to retain at least \$100,000.⁸²

71. *See id.* § 9(a) at 121.

72. *See id.*

73. *See, e.g.,* CAL. CIV. PROC. CODE § 1531(e) (West 1997).

74. *See* UNIF. UNCLAIMED PROPERTY ACT § 12(a) (amended 1995), 8B U.L.A. 124 (Supp. 2000). The Comment suggests that this section is not applicable to money, except for money that is considered a "collector's specie having value greater than the face value of the money as cash." *Id.* at 125.

75. *See id.* § 12(b) at 124.

76. *See id.*

77. *See* CAL. CIV. PROC. CODE § 1563 (West 1997).

78. *See* ANDREOLI & SPOTSWOOD, *supra* note 4, at NV-23.

79. *See id.* at NY-88.

80. *See* UNIF. UNCLAIMED PROPERTY ACT § 13(a), 8B U.L.A. 126 (Supp. 2000). Illinois transfers the funds to the state pension plan; Florida uses the money for education. *See* ILL. COMP. STAT. § 1025/18 (West 1998); FLA. STAT. ch. 717.123 (1998).

81. *See* UNIF. UNCLAIMED PROPERTY ACT § 13(a) (amended 1995), 8B U.L.A. 588 (Supp. 2000).

82. *See id.* California every month transfers the excess over \$50,000 into the general fund. This can be done more often if deemed necessary. Massachusetts keeps up to \$500,000 in an unclaimed property fund but not at a constant rate; at the end of the year all funds are transferred to the general fund.

Owners of the property may file claims for the funds at any time.⁸³ There is no time restriction. Moreover, an owner is defined to include “a person who has a legal or equitable interest in the property subject to this [Act] or the person’s legal representative.”⁸⁴ Thus, owner includes heirs and devisees of the person who owned the property at the time of the presumed abandonment. In addition, since owners can file claims many years after presumed abandonment, the UUPA is not a true escheat statute, although people often refer to the UUPA and similar state statutes as escheat statutes.

Under the UUPA, the owner is entitled to “any income or gain realized or accruing on the property at or before liquidation or conversion of the property into money.”⁸⁵ In addition, the owner of an interest-bearing demand, savings or time deposit will generally receive interest at a specified statutory rate or at any lesser rate the property earned while in possession of the holder.⁸⁶ Section 11 of the UUPA states, “Interest begins to accrue when the property is delivered to the administrator and ceases on the earlier of the expiration of 10 years after delivery or the date on which payment is made to the owner.”⁸⁷ For property that is not interest-bearing, such as an unclaimed salary check, the UUPA imposes no obligation upon the state to pay interest, even though the state itself can either use or earn money on the funds.⁸⁸ Some states, such as Nebraska, are less generous than the UUPA and pay no interest on claims.⁸⁹ Other states are more generous than the UUPA.⁹⁰

In sum, assets that are subject to unclaimed property statutes go through a series of steps. First, property will be subject to these laws only if the owner fails to indicate some interest in the property, such as claiming a dividend or using a gift certificate, for a period of time. Second, the holder will retain this property until it is presumed abandoned under the unclaimed property statutes. Third, at the time of presumed abandonment, the state will take possession of the property. Fourth, in a small percentage of cases, the owner, defined by the

Arizona keeps a minimum of \$100,000 in a separate unclaimed property fund. *See Survey, supra* note 19.

83. *See id.*

84. UNIF. UNCLAIMED PROPERTY ACT § 1(11) (amended 1995), 8B U.L.A. 107 (Supp. 2000).

85. *Id.* § 11, at 123.

86. *See id.*

87. *Id.*

88. *Id.*

89. *See* NEB. REV. STAT. § 44-4845(1) (1998).

90. For example, in California, owners whose claims are allowed receive the amount of the claim plus interest “at the rate of 5 percent compounded annually or the current interest rate received upon deposit held in the Pooled Money Investment Account, whichever is lower . . . for the period the property was on deposit in the Unclaimed Property Fund.” *See* CAL. CIV. PROC. CODE § 1540(c) (West 1997). For other state examples, *see infra* note 205.

unclaimed property statutes to include heirs and devisees as well as the initial owner at the time of presumed abandonment, may file a claim and obtain a recovery. All of these steps raise tax issues, as described below. At each step, resolution of the tax issues is complicated by the fact that the applicable tax doctrines are not designed for the kind of inadvertence or failure to act that creates unclaimed property.

III. FAILURE OF OWNERS TO ACT REGARDING THE PROPERTY

Most owners deal with intangible property regularly and claim intangible personal property promptly. Dividends, for example, are generally claimed within three to six months following payment date.⁹¹ Such property will be claimed rather than unclaimed. Only property ignored by its owner runs the risk of being subject to unclaimed property statutes. Chronologically, then, the first tax question for unclaimed property is the income tax consequences for owners who fail to collect the funds when made available by the holders or who otherwise ignore their property.

A. *Constructive Receipt*

Many of the items subject to the unclaimed property statutes, including interest, dividends, and salary checks, would have been income if the apparent owner had in fact collected the amounts.⁹² If we assume that the owners are individuals (which should be the case in the vast majority of instances), failure to collect these monies may not prevent them from being taxable to the owners. They may well be in constructive receipt of these amounts. Applying constructive receipt doctrine to these funds, however, points up contradictions in the doctrine itself.

Individuals are generally under the cash method of accounting. Under the cash method of accounting, "all items which constitute gross income (whether in the form of cash, property, or services) [are] included [in income] for the taxable year in which actually or constructively received," while expenditures "are to be deducted for the taxable year in which actually made."⁹³ The cash

91. See Wolfe, *supra* note 21, at 249 n.89 (quoting Delaware Special Master in *Delaware v. New York*, 113 S. Ct. 1550 (1993)).

92. Other items, such as gift certificates, utility deposits, or life insurance proceeds, would not. Yet other items, such as annuity payments, would be part income and part recovery of basis. See I.R.C. § 72 (2000).

93. Treas. Reg. § 1.446-1(c)(1)(i) (2000).

method does not ask when claims or obligations actually arose. It is “formal, mechanical, and easier for non-accountants to understand and implement.”⁹⁴ The tax code permits cash basis accounting, because of its simplicity, even though “[t]ax theorists regard cash basis accounting as less accurate than accrual accounting, which takes into account the taxpayer’s rights and liabilities.”⁹⁵ Cash basis accounting is an issue of administrative simplicity. It is not, for example, consistent with the Haig-Simons definition of income.

At the same time, the cash method is subject to manipulation. The doctrine of constructive receipt operates as an anti-abuse measure to guard against cash method taxpayers playing fast and loose with the progressive rate structure and the concept of annual accounting. The regulations state:

[I]ncome although not actually reduced to a taxpayer’s possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.⁹⁶

“The most obvious candidates for constructive receipt treatment are uncashed dividend and salary checks . . . and similar items that could be turned into cash with a stroke of the pen but that the taxpayer deliberately or *inadvertently* fails to present for payment or otherwise process in the normal fashion.”⁹⁷ The regulations state clearly, “Dividends on corporate stock are constructively received when unqualifiedly made subject to the demand of the shareholder.”⁹⁸

Some cases suggest that owners are in constructive receipt whatever the reason for their failure to receive the cash to which they were entitled.⁹⁹ Language from *Loose v. United States*¹⁰⁰ is particularly unyielding. There, the taxpayer was unable to clip and cash interest coupons because of a stroke that disabled him physically and mentally.¹⁰¹ The Court nonetheless determined him to be in constructive receipt of the income.¹⁰² It rejected the argument

94. Theodore P. Seto, *Drafting a Federal Balanced Budget Amendment That Does What It Is Supposed to Do (And No More)*, 106 YALE L.J. 1449, 1480 (1997).

95. BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 105.3.1 (2d ed. 1992).

96. Treas. Reg. § 1.451-2(a) (2000).

97. BITTKER & LOKKEN, *supra* note 95, at ¶ 105.3.3, at 105.52 (emphasis added).

98. Treas. Reg. § 1.451-2(b) (2000).

99. *Loose v. United States*, 74 F.2d 147, 150 (8th Cir. 1948).

100. *Id.*

101. *Id.* at 148.

102. *Id.* at 150.

that the taxpayer's handicap prevented application of the constructive receipt doctrine:

[T]he strongest reason for holding constructive receipt of income to be within the statute is that for taxation purposes income is received or realized when it is made subject to the will and control of the taxpayer and can be, except for his own action or inaction, reduced to actual possession. So viewed, it makes no difference why the taxpayer did not reduce to actual possession. The matter is in no wise dependent upon what he does or upon what he fails to do. It depends solely upon the existence of a situation where the income is fully available to him.¹⁰³

As applied in *Loose*, the constructive receipt rule worked to the taxpayer's disadvantage. The *Loose* understanding of constructive receipt, however, is likely to benefit owners of unclaimed property. The constructive receipt doctrine "can be invoked by taxpayers to assign items to years before actual receipt, even if the statute of limitations has run on the year of constructive receipt."¹⁰⁴ Unclaimed property is unlikely to have been reported at the time it was constructively received. If owners could not be located to receive the monies in question, it is extremely improbable that they would have received a W-4 or Form 1099 and included the amounts in their income tax return. Thus, under this version of the constructive receipt doctrine, if owners eventually reclaim property that should have been reported under the doctrine of constructive receipt, they will owe no income tax on these amounts for past years if the statute of limitations has run.¹⁰⁵

Other cases, however, seem to suggest that a taxpayer is not in constructive receipt of lost property without actual notice.¹⁰⁶ As a famous quotation regarding constructive receipt has it, "[a] taxpayer may not deliberately turn his back upon income and thus select the year for which he will report it."¹⁰⁷ In the case of unclaimed property, however, the taxpayer does not deliberately turn his back. The Tax Court explained in *Furstenberg v. Commissioner* that funds are considered available for taxpayer to draw on only if taxpayer has "notice . . . that the funds are subject to his will and

103. *Id.* at 150.

104. BITTKER & LOKKEN, *supra* note 95, at ¶ 105.3.3.

105. See text, *infra* pp. 160-63. Of course, in some cases the statute will not have run, particularly if the six-year limit applies. See *id.* In such cases, owners recovering property will owe tax and should file amended returns to avoid deficiency assessments. Here and throughout the article, I assume that the conditions for application of the statutory mitigation provisions, particularly a determination, have not been satisfied. See I.R.C. §§ 1311-1314 (2000).

106. *Furstenberg v. Commissioner*, 83 T.C. 755, 792 (1984).

107. *Hamilton Nat'l Bank of Chattanooga v. Comm'r*, 29 B.T.A. 63, 67 (1933).

control.”¹⁰⁸ In *Furstenberg*, however, there was no attempt to give the taxpayer notice that a distribution from a trust fund was available to her prior to the date of her expatriation.¹⁰⁹ Holders of unclaimed property, in contrast, must attempt to give notice to owners.¹¹⁰

Even an attempt to give notice, according to some authorities, is not sufficient to invoke constructive receipt. In *Davis v. Commissioner*, the post office attempted to deliver to the taxpayer a check containing severance pay by certified mail on December 31, 1974.¹¹¹ The taxpayer was not at home.¹¹² She arrived home after the post office had closed, saw the notice of attempted delivery, and thought it would be a notice of increase in her rent.¹¹³ She picked up the letter containing the severance pay on January 2, 1975.¹¹⁴ The court held that she was not in constructive receipt of the severance pay in 1974.¹¹⁵ It explained that a taxpayer has constructively received amounts only if the taxpayer has notice that the funds are subject to his will and control.¹¹⁶ Where the failure to receive notice does not result from a conscious choice to postpone receipt of the funds until the following year, the court concluded, the doctrine of constructive receipt is inappropriate.¹¹⁷ The court explained that the taxpayer had no actual knowledge or expectation that the income would be available to her in the earlier year.¹¹⁸

In many cases involving unclaimed property, owners also have no actual notice of their rights to such payments. Sometimes owners fail to receive notice through no fault of their own—negligence by holders or transfer agents produced the failure of notice.¹¹⁹ Often, however, owners’ own carelessness is responsible for this lack of notice. They fail to inform holders of new addresses, to open mail, to keep track of mail received. They simply forget

108. *Furstenberg*, 83 T.C. at 792. The court also commented, “This is clearly not a case in which petitioner ‘turned her back’ on the income by taking any affirmative steps to delay receipt of the check.” *Id.* Property becomes unclaimed property only if the taxpayer fails to take any affirmative steps.

109. *Id.*

110. See UNIF. UNCLAIMED PROPERTY ACT § 7(e) (amended 1995), 8B U.L.A. 612 (Supp. 2000).

111. 37 T.C.M. (CCH) 42 (1978).

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.* at 45.

116. 32 T.C.M. (CCH) at 44.

117. *Id.* at 44-45.

118. *Id.*

119. See Michael G. Wagner, *Big Windfalls Lose Gusto in Unclaimed Property Case*, L.A. TIMES, May 4, 1997, at A1 (describing a suit by former shareholders of Blue Chip Stamp for failure of transfer agent to give them notice of merger with Berkshire Hathaway with subsequent transfer and sale of shares by state of California under unclaimed property law for far less than value of shares at time owners located).

about funds in banks, retirement accounts, etc. Owners whose property is eventually presumed abandoned may have ignored the notices sent by the holders. The owner lacks actual notice, not through conscious choice, but nonetheless because of the taxpayer's own failure.

If application of the doctrine of constructive receipt turns on actual notice of availability, whether or not owners had constructively received the unclaimed funds, may depend on the particular reason in each case why the owner did not receive the funds. If so, the results are perverse. Owners whose property is presumed abandoned because they ignored notices would have been in constructive receipt and, as a result of the statute of limitations running, likely not to be taxed upon any recovery. In contrast, an owner who failed to receive notice because of negligence of the holder, would not be in constructive receipt and taxable at the time of recovery.¹²⁰ Moreover, owners who fail to receive actual notice because of their own carelessness—their own unconscious action—as, for example, in notifying holders of changes in address are difficult to categorize under the authorities regarding notice as prerequisite to constructive receipt. Thus, the example of unclaimed property undermines “notice” as the touchstone for constructive receipt.

Even under the stricter standards of the *Loose* case, however, it is difficult to see how these funds are “fully available” to a taxpayer when, as in one typical situation, the transfer agent or corporation paying the dividend errs in giving notice and the owner does not know the funds exist. To say that the taxpayer who is a victim of such error is in constructive receipt—which in this case is likely to allow the taxpayer to avoid taxation upon later recovery—would force us to impose on taxpayers an affirmative obligation to maintain communication with those holders from whom the taxpayer might expect income. That is, considering accident in the context of constructive receipt raises the specter that this doctrine in fact implicitly places affirmative duties on taxpayers.

The example of unclaimed property also forces us to ask whether, if the purpose of the constructive receipt doctrine is to avoid taxpayer manipulation, we should put limits on its use when taxpayers invoke it to their advantage. Further, it exposes how the doctrine of constructive receipt may assume intentional action, intentional failure to act, or even inability to act, but not inadvertence on the part of taxpayers. When this assumption proves false, as it does with unclaimed property, the doctrine becomes unreliable. It may be that, when looking at the particular doctrine of constructive receipt in

120. See *infra* Part V.

isolation, the benefits of an easy categorical rule that treats inadvertence the same way as intention outweigh any costs. Constructive receipt is only one doctrine. The example of unclaimed property asks us to examine the treatment of carelessness in a variety of tax settings. Such a broader view may lead to a different conclusion.

B. Abandonment

Other property potentially subject to the unclaimed property statutes does not represent items of income, but assets of the owners. This latter class would include stocks, bonds, insurance reimbursements, security deposits, even bank accounts. By ignoring this property, the owners would seem to be abandoning it.¹²¹

In some situations under the Internal Revenue Code, abandonment of property gives rise to a loss deduction.¹²² Should, in theory, such a loss deduction apply here? Of course, such a deduction is unlikely to be actually taken on the owner's return. To take the deduction, the owner must be aware of the property and if the owner is aware of it, the property would not be abandoned. Unclaimed property laws apply only to owners who have lost track of their property; if they do not realize they own it, they will not know to take a loss deduction either. Such characterization of the presumed abandonment, however, is important for tax consequences under the tax benefit rule should the owner eventually recover the property, whether before or after the statute of limitations has run, as discussed further below.

Loss deductions for abandoned property are available only if certain requirements are met. First, the property must be held for use in a trade or business or in a transaction undertaken for profit.¹²³ Some categories subject to the unclaimed property statutes, such as utility deposits or gift certificates or travelers' checks, clearly would fail this requirement. Others, such as stock certificates, bonds, or interest-bearing bank accounts, might. Even for this second class of property, however, no loss would be allowed under current tax rules.¹²⁴ An abandonment loss is permitted only if the owner established an

121. Indeed, under the unclaimed property laws, a state takes possession of unclaimed funds when they are "presumed abandoned." UNIF. UNCLAIMED PROPERTY ACT § 4 (amended 1995) at 72. Thus, the question of whether an abandonment loss is allowed might arise at the time the state takes possession, rather than when the owner begins inactivity. Even if such is the timing, the analysis and conclusions above would be the same.

122. See Treas. Reg. § 1.165-1 (2000).

123. See *id.* at §§ 1.165-2(a), 1.167(a)-8(a).

124. *Id.* at § 1.167(a)-8(a).

intent not to use the abandoned property again or to retrieve it for sale or other disposition.¹²⁵ Non-use is not sufficient.¹²⁶ Thus, such unclaimed property is not abandoned property for federal tax purposes.

Yet again, the unclaimed property statutes reveal how ill-equipped are the substantive provisions of the tax code to deal with unintentional acts, with carelessness. Even if nowhere else, we would think that "loss" deductions would apply to "lost" property. Property, however, is lost for tax purposes only if we know it to be lost.

IV. UNCLAIMED PROPERTY IN THE HANDS OF HOLDERS

If owners do not claim their property, it will remain in the hands of the holders—the transfer agent for the dividends, the insurance company for the insurance claim, etc.—for at least the period of time, usually several years, until "presumed abandonment."¹²⁷ Chronologically, the next question is the tax treatment of unclaimed property while it is in the hands of the holders.

During that period of time, the property is subject to the claims of the owner. If property remains unclaimed at the time of presumed abandonment, all holders, whether large companies or small, are obligated to transfer these unclaimed funds to the state. Therefore, legally, all unclaimed funds in the holder's possession are subject to an offsetting claim by either the owner or the state on behalf of the owners. In practice, moreover, many businesses are unaware of the obligation to transfer these assets to the state. States, at least until very recently, have not devoted resources to enforcing the unclaimed property statutes vigorously. Audit efforts vary. For many holders, unclaimed property is a relatively permanent and unrestricted source of interest-free capital.

The tension between the law and practice under unclaimed property statutes complicates tax treatment. Tax treatment of holders is the one area where there are existing authorities. While some of these authorities emphasize the actual practice, others stress the content of the law, whatever the practice. The more recent authorities adopt the latter view.

Some early cases suggest that holders of unclaimed property must include the property in income unless they have been complying with unclaimed

125. *Id.*

126. See *Golden Gate Disposal Co. v. CIR*, 38 T.C.M (CCH) 835, 837 (1979), *aff'd*, 642 F.2d 455 (9th Cir. 1981).

127. UNIF. UNCLAIMED PROPERTY ACT § 2(a) (amended 1995).

property laws.¹²⁸ These authorities, although directly on point, predate modern unclaimed property statutes, recent enforcement efforts, and an important Supreme Court decision regarding the tax consequences of offsetting obligations.¹²⁹ Under a later case, a General Counsel Memorandum, and the Supreme Court case, the legal obligation to turn over unclaimed property to the state appears to protect holders from having to include the property as income, however long they make use of it. Yet such treatment raises a host of practical and theoretical problems. Once again, the carelessness that underlies loss of property forces reconsideration of tax doctrines.

A. Existing Authorities

1. Unclaimed Property as Income

The earliest authority involving unclaimed property, *Fidelity-Philadelphia Trust Co. v. Commissioner*,¹³⁰ required the holder to include the unclaimed property in income. The case involved a bank, which, after fruitless attempts to locate the owners of inactive accounts, made funds from unclaimed deposit accounts available for general use by transferring the funds from a deposit liability account to surplus. The bank argued that its liability to the state under the escheat laws prevented the unclaimed deposits from being income to it. The Tax Court rejected this claim on the grounds that the taxpayer had never made reports under the escheat laws and that the Commonwealth of Pennsylvania had never enforced its escheat provisions against the bank. "The mere fact that it may, at some later time, be required to turn over such deposits to the Commonwealth does not prevent them from being income to the bank in 1948," wrote the Tax Court.¹³¹ "If escheat proceedings should be initiated in some later year, petitioner may then be in a position to claim a deduction for funds surrendered."¹³²

Similarly, in *Colonial Wholesale Beverage Corp. v. Commissioner*,¹³³ the Tax Court required bottle deposits taken by the petitioner in accordance with

128. See *infra* notes 130, 133 & 135.

129. See *infra* note 144.

130. 23 T.C. 527, 532 (1954).

131. *Id.* at 532.

132. *Id.* The court's discussion echoes strongly the "claim of right" doctrine. See *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932).

133. 55 T.C.M. (CCH) 1736 (1988).

Massachusetts laws to be included in income when received. The taxpayer had argued against including the amounts in income in part on the grounds that the Massachusetts' abandoned property laws might require it ultimately to turn over the unclaimed deposits to the state. The Tax Court there denied exclusion because of the possibility the petitioner might at some future time be called upon to pay over unclaimed deposits to Massachusetts. It rested this decision on there being "no indication that petitioner has acknowledged the application of the escheat law to such deposits."¹³⁴

In both these cases, the laws applicable to unclaimed property were not enforced and thus did not represent any practical limitation on the holder's right to or use of the funds. Later authorities involving holders in compliance with unclaimed property laws reach a different conclusion.

2. *Unclaimed Property as Debt*

Authorities in which holders have complied with unclaimed property laws conclude that unclaimed property does not give rise to income for the holder. Moreover, these authorities suggest that the very existence of unclaimed property laws produces this result, whether or not the holder has been complying with the unclaimed property laws.

In *Bituminous Casualty Corp. v. Commissioner*,¹³⁵ the Tax Court held that reserves for outstanding drafts and checks were not income to an insurance company when the insurance company regularly filed escheat reports and paid to appropriate states amounts with respect to this unclaimed property. The Court concluded that the company "has a clear liability to pay . . . either to the payee or to a State under the appropriate escheat laws."¹³⁶ It distinguished *Fidelity-Philadelphia Trust* on the grounds that the escheat laws had been ignored and thus the holder had no liability to repay.¹³⁷

Similarly, in General Counsel Memorandum 36,076,¹³⁸ the IRS looked not at the degree of the taxpayer's compliance with state unclaimed property laws but simply at the substance of the state unclaimed property law.¹³⁹ It concluded that a stock brokerage firm, which had been aware of and

134. *Id.* at 1742.

135. 57 T.C. 58, 89 (1971).

136. *Id.* at 89.

137. *See id.* at 90.

138. Gen. Couns. Mem. 36,076 (Nov. 11, 1974).

139. *See id.*

complying with the law, was not required to accrue into income unclaimed dividends and interest.¹⁴⁰ The Memorandum explained that

with respect to potential windfalls involving unclaimed bank deposits, unclaimed dividends held by brokers, and unclaimed premium refunds, both the courts and the Service have effectively recognized that such amounts are not includable in the taxpayer's gross income until the time when it is reasonable to assume that such amounts have ceased to be a true liability or to be regarded as such by the taxpayer.¹⁴¹

Under state law, unclaimed dividends and interest escheated to the state if still unclaimed after five years, and the IRS characterized these laws as self-executing.¹⁴² Since, "by operation of law all such dividends and interest constitute a liability . . . owed to the State," the amounts remained a true liability and were not income to the brokerage house.¹⁴³

The existing authorities, then, are clear that holders complying with state unclaimed property laws do not have to include unclaimed funds as income. Treatment of holders who have not been complying with these laws is less clear. Under *Colonial Wholesale Beverage* and *Fidelity-Philadelphia Trust*, such holders would have income. Under the authority of *Bituminous Casualty* and General Counsel Memorandum 36,076, the legal obligation to the state may protect the holders from including unclaimed funds as income.

Basing taxation on the holder's knowledge of the unclaimed property laws and thus on the degree of state publicity and enforcement of the law, as does the first set of authorities, makes for difficulties in administering the tax system—unclaimed property might be income for holders in one state, but not another; income for some kinds of businesses but not for others; tax treatment might differ from year to year. If, as under the later authorities, state law is treated as self-executing, holders will be able to use unclaimed property as their own for decades without having to pay interest or to treat the funds as income.

140. *See id.*

141. The General Counsel Memorandum explains, [a]n unclaimed amount will cease to be a true liability or be regarded as such when (1) the taxpayer asserts dominion over it as its own or (2) a reasonable period of time passes as determined by experience during which the amount remains unclaimed or during which the taxpayer is unable to locate the true owner.

Id.

142. *See id.*

143. *Id.*

A relatively recent Supreme Court case, *Commissioner v. Indianapolis Power & Light Co.*,¹⁴⁴ reinforces the implication of *Bituminous Casualty* that the holder's liability to pay the state, whether or not enforced, protects unclaimed funds from being included as income. The case involved the proper tax treatment by an accrual-basis utility of deposits it required from some of its customers.¹⁴⁵ For years after 1976, the utility, using a fixed formula to judge the customer's creditworthiness, required some five percent of its customers to deposit twice the customer's estimated monthly bill.¹⁴⁶ The utility commingled these deposits with other receipts and had full use and control over the funds.¹⁴⁷ For deposits held nine months or more, the utility paid the customers interest at a rate of 6%.¹⁴⁸ Customers who made timely payments for nine months or who satisfied the credit test could obtain a refund.¹⁴⁹ The refund would be made in cash or by check or, at the customer's option, be applied against future bills.¹⁵⁰ After seven years any unclaimed deposits escheated to the state.¹⁵¹

The Commissioner argued for treating the deposits as taxable advanced payments for electricity, because they secured the payment of future income.¹⁵² The Supreme Court disagreed.¹⁵³ It emphasized the similarities between loans, which are excluded from income without question, and the deposits at issue in the case.¹⁵⁴ The Court explained that "these deposits were acquired subject to an express 'obligation to repay,' either at the time service was terminated or at the time a customer established good credit . . . both the timing and method of that refund are largely within the control of the customer."¹⁵⁵ The Court emphasized that the touchstone for inclusion in income was not unconstrained use but "whether the taxpayer has some guarantee that he will be allowed to keep the money."¹⁵⁶ The utility's right to retain the money was "contingent upon events outside its control," and the Court held "that such dominion as IPL has over these customer deposits is

144. 493 U.S. 203, 214 (1990).

145. *See id.* at 204.

146. *See id.* at 204-05.

147. *See id.*

148. *See id.*

149. *See Indianapolis Power & Light Co.*, 493 U.S. at 204-05.

150. *See id.* at 205.

151. *See* IND. CODE § 32-9-1-6(a) (1988). From 1974-77 only about \$9,000 escheated to the state.

152. 493 U.S. at 206.

153. *See id.* at 210.

154. *See id.* at 207-08.

155. *Id.* at 209.

156. *Id.* at 210.

insufficient for the deposits to qualify as taxable income at the time they are made.”¹⁵⁷

Actual experience with such deposits did not enter into the Court’s conclusion. The Tax Court had explained that over the years at issue, between fifty-seven percent and sixty-nine percent of refunds were made by a credit to the bill,¹⁵⁸ but the Supreme Court did not even cite such statistics.¹⁵⁹

The Supreme Court in *Indianapolis Power* made the obligation to repay key to excluding deposits from income.¹⁶⁰ When such reasoning is applied to unclaimed property laws, the potential state claim will prevent unclaimed property from being included in the holder’s income, no matter how long the period between the holder identifying the funds as unclaimed and the state’s possession of them. That is, all unclaimed funds become deposits awaiting payment to the owner or the state, since the holders have a legal obligation to turn over the funds. The unclaimed property in the hands of the holder is treated as if the holder had borrowed the money.

B. Critique

The position taken in *Indianapolis Power* that an obligation to repay qualifies receipts for treatment as debt has been sharply criticized. Although he wrote well before the Supreme Court decision, Professor William Popkin has offered an analysis that serves to question the Supreme Court’s reasoning: “Tax is not always deferred on funds which the taxpayer is obligated to repay. An embezzler, for example, must pay tax in the year the money is embezzled.”¹⁶¹ As the Supreme Court has observed, “a taxpayer [who] acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction to their disposition,” is taxable on the income whether or not under an unqualified duty and obligation to repay.¹⁶² Neither the person who is the victim of embezzlement nor the person who has suffered unclaimed property has chosen to make a loan to another. Somewhat analogously, then, an owner who gives

157. *Indianapolis Power & Light Co.*, 493 U.S. at 214.

158. See 88 T.C. at 969.

159. See generally *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990).

160. See *id.* at 207-14.

161. William D. Popkin, *The Taxation of Borrowing*, 56 IND. L.J. 43, 46 (1980). For Professor Popkin the “critical distinction between embezzlement and borrowing is that the embezzler usually has much greater control over whether and when to repay the funds.” *Id.* He also notes the “undesirability of the embezzler’s activity.” *Id.* at 47.

162. *James v. United States*, 366 U.S. 213, 219 (1961).

a holder use of unclaimed property only inadvertently rather than intentionally seems to undermine characterization of the relationship as debt.

Most of the criticism of *Indianapolis Power*, however, goes to the issue of interest on such so-called debt, and these criticisms are important for proper analysis of unclaimed property in the hands of holders. Professor Coven has argued that treatment of receipts as debt should be defined "by the extent to which obligations to incur future costs are recognized as offsetting the value of a receipt," and that therefore exclusion from taxation "should be limited to receipts that are offset by repayment obligations that bear stated interest at a market rate."¹⁶³ He would ignore the taxpayer's control over the repayment of principal, the factor emphasized by *Indianapolis Power*. He takes the position that only amounts subject to a market rate of interest should be excluded from income; to the extent that no such interest is paid, the cash receipt would be taxable.¹⁶⁴

Other critics of *Indianapolis Power* believe that Professor Coven himself ignored unstated or implicit interest. For Professor Yin, the "first premise" of the time value of money rules is "that all deferred payment transactions include interest, either explicitly or implicitly."¹⁶⁵ Similarly, Professor Klein explains that payment of interest does not distinguish the categories of loan, advance payment, and deposit:

In an arm's-length transaction, the value of a nominally interest-free (or below-market-rate) loan, deposit, or advance payment will be reflected in a price of some related part of the entire transaction. Thus, there can be no fundamental economic differentiation among loans, deposits, and advance payments according to whether there is an obligation to pay interest.¹⁶⁶

163. Glenn E. Coven, *Redefining Debt: Of Indianapolis Power and Fictitious Interest*, 10 VA. TAX REV. 587, 589, 618 (1990).

164. *Id.* at 644. He explains:

When a receipt is offset by a repayment obligation that bears a below-market stated rate of interest, the amount of the receipt that should be treated as a loan, and excluded from income, is the amount for which the present value of the actual interest established by the parties would represent a market rate of interest.

Id. at 643-44. If \$10,000 is 'loaned' at 6% when market is 10%, \$6,000 would be treated as debt and excluded and \$4,000 included in income. See *id.* at 644, example 2.

165. George K. Yin, *Of Indianapolis Power and Lights and the Definition of Debt: Another View*, 11 VA. TAX REV. 467, 474 (1991).

166. William A. Klein, *The UCLA Tax Policy Conference: Tailor to the Emperor with No Clothes: The Supreme Court's Tax Rules for Deposits and Advance Payments*, 41 UCLA L. REV. 1685, 1710 (1994). For Professor Klein the best, albeit weak, defense of the judicially developed rules distinguishing loans from advanced payments is that for the typical loan there is little uncertainty as to the future obligation and that the present value of the future obligations differs little from the amount of loan proceeds, while the offsetting obligation with respect to advanced payments is less certain. See *id.* at 1712-13.

These criticisms have implications as to how holders of unclaimed property should be taxed. Under Professor Coven's test, because the holders do not pay interest on the use of unclaimed funds during the period they use the funds as such, they would have to include the amounts in income and then take a deduction when they are paid to the state. The treatment under Professors Yin's and Klein's tests is less clear because amounts of unclaimed property do not represent arms-length transactions, but the opposite—the failure of some bargain, whether it be for banking services, payment for services rendered, payment of dividends on investment, etc. That is, in the case of unclaimed property, implicit or explicit interest was paid by the holder to the owner of the funds according to a relationship that has ceased to exist.

The failure of the arms-length bargain for either explicit or implicit interest makes treatment of the unclaimed property as a loan particularly problematic. As a practical, although not a legal matter, the holder is freed from obligation to the owner regarding these funds. The holder, in many cases, has and makes use of unclaimed funds. When the holder does so, current law does not require the holder to hold any part of any income earned for payment to the missing owner or to the state on behalf of the owner.¹⁶⁷ In General Counsel Memorandum 36,076, the Service observed that the state unclaimed property law did not require the brokerage to pay the state "a fair charge for the use of unclaimed dividends or interest."¹⁶⁸ The General Counsel Memorandum did not take a stand on the issue:

It should be noted that the public position of the Service of the tax consequences resulting from the free use of funds belonging to another is unclear. To our knowledge, in analogous situations involving unclaimed items of various types, the Service has never contended and no court has ever held that the possessor is liable for imputed interest on the free use of unclaimed items.¹⁶⁹

Since this General Counsel Memorandum, Congress has amended the Internal Revenue Code by adding § 7872 to require imputation of interest at the applicable federal rate (AFR) for certain kinds of interest-free and low-interest loans.¹⁷⁰ Section 7872, however, applies only to gift loans,

167. Gen. Couns. Mem. 36,076, *supra* note 138.

168. *Id.*

169. *Id.*

170. See I.R.C. § 7872(c) (2000). Loan is defined broadly for purposes of this section. Under the proposed regulations, it includes "any transaction under which the owner of money permits another person to use the money for a period of time after which the money is to be transferred to the owner or applied according to an express or implied agreement with the owner." Below-Market Loans, 50 Fed. Reg.

shareholder-corporation loans, employer-employee loans, and tax-avoidance loans, and thus does not in its current form apply to use of unclaimed property by holders.¹⁷¹

Although § 7872 does not apply to unclaimed property, the General Counsel Memorandum properly recognizes that, in theory, interest should be paid for the holder's use of such funds.¹⁷² Holders of unclaimed property receive the tax advantage of exclusion from income accorded to debt; yet, for the period they use the unclaimed property as such, they do not have an obligation to pay interest in any form—implicit or explicit. Thus, if the use of unclaimed property is to be treated as a loan to the holders, the holders should owe interest on use of the funds to the owners of the property. Such imputed interest would itself become part of the unclaimed property reported to and then transferred to the state. That is, in theory, some of the holder's earnings should be deductible by them as interest paid and taxable at some point to the owners as interest received.

In most cases, holders do not pay interest to owners' accounts. Instead, holders themselves earn income on these amounts and pay income tax on the earnings. Holders become surrogate taxpayers for the owners. While depending on surrogates is less than theoretically pure, the federal tax code often makes use of surrogate or substitute taxation, particularly when administrative difficulties stand in the way of taxing the proper taxpayer.¹⁷³

33553-01 (1985) (to be codified at 26 C.F.R. pt. 1.7872-2(a)(1)). "Loan" also includes an amount that "is treated for Federal tax purposes as a deposit rather than as a prepayment." Below-Market Loans, 50 Fed. Reg. 33553-01 (1985) (to be codified at 26 C.F.R. pt. 1.7872-2(b)(1)(i)). Under § 7872, the borrower is deemed to have received the imputed interest as a nonloan payment from the lender and to have paid the lender the imputed interest. See I.R.C. § 7872(a)(1) (2000). Characterization of this nonloan payment to the borrower will depend on the relationship between the borrower and the lender. See I.R.C. § 7872(c) (2000). For example, if an employer makes an interest-free demand loan of \$1,000 to an employee when the AFR is 9%, foregone interest will be \$90. On the last day of each calendar year, the employer will be deemed to pay \$90 to the employee as compensation and the employee is deemed to pay the employer \$90 as interest. For term loans, somewhat different rules, rules that recharacterize some of the original principal as a nonloan payment: the provision separates out unstated interest on such loans by bifurcating a cash payment that purports to be the receipt of a loan into two parts. The first portion, which is treated as the principal amount of a loan, is calculated by discounting all payments to present value, using the applicable federal rate. The remainder is treated as an outright nonloan payment. The nonloan payment will represent imputed interest; the borrower will be deemed to have paid this amount to the lender as interest under the original issue discount rules.

171. See I.R.C. § 7872(c) (2000). The tests for tax avoidance loans requires that a "principal purpose" of the interest arrangements be "the avoidance of any Federal tax." I.R.C. § 7872(c)(3)(B) (2000). These loans do not satisfy that test. Such a test, like so much in the tax code, requires an intention, not carelessness, on the part of the taxpayer.

172. Gen. Couns. Mem. 36,076, *supra* note 138.

173. KLEIN & BANKMAN, *supra* note 39, at 1711 offers the following:

Unclaimed property poses precisely such administrative difficulties—the proper taxpayer is lost—and thus is a prime candidate for surrogate taxation. Surrogate taxation is one tax doctrine that helps to deal with inadvertence and carelessness by shifting the tax burden to an identifiable taxpayer acting intentionally. Surrogacy is thus not simply a matter of administrative ease, but also acceptance of human frailty. Our tax system, whatever its economic or market-based rationale, must deal with flawed human beings. Surrogate taxation helps it to do so, and we should thus view surrogate taxation as more than a matter of administrative convenience.

Current law has evolved into a compromise. Holders do not have to include unclaimed funds in income at any time, but because of the obligation to pay the funds either to the owner or to the state, they are able to treat these funds as borrowed. At the same time, they are free in most instances to do this borrowing free of explicit or implicit interest. Moreover, although compliance is improving as states step up enforcement efforts, many holders, especially small businesses, do not know about, much less comply with, unclaimed property laws. This low level of compliance and holders' ability to use unclaimed funds interest-free raise questions about the appropriateness of the current tax treatment of unclaimed funds in the hands of the holder as a loan not subject to taxation. That is, the court in *Bituminous Casualty Corp.* may have been correct to say that a holder had no offsetting liability when the escheat laws imposing the liability had been ignored.¹⁷⁴

Moreover, holders have at best an inadvertent loan. Owners give holders use of this unclaimed property unintentionally. As the Supreme Court suggested in *James*, perhaps some kind of intentional action on the part of the owner to give use of the funds to another should be a prerequisite to characterization of any amount as a loan.¹⁷⁵ Examination of the unclaimed property laws thus helps us to refine our very notion of debt.

It sometimes happens that a tax detriment for one participant in a transaction is offset by a tax benefit to another participant. The person who suffers the detriment may in effect pay a tax as a surrogate for the person who should have been taxed on the benefit. For example, under current tax rules the auto club that receives and must report as income an advance payment of membership dues suffers a tax detriment because its income is overstated, but the member making the advance payment enjoys benefit by escaping tax on the implicit interest earned on the advance payment. It is unreasonable to assume, however, that the detriment and the benefit will always, or even generally, be equal in amount.

See generally Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986).

174. See *Bituminous Casualty Corp.*, 57 T.C. 58 (1971).

175. See *James*, 366 U.S. 213 (1961).

The accidental quality suggests that characterization of these amounts as a taxable windfall to the holder after some period of inactivity may be more accurate. The Uniform Unclaimed Property Act, after all, describes unclaimed property as a "windfall to the holders."¹⁷⁶ Windfalls are clearly taxable as income.¹⁷⁷ In the case of holders, moreover, considerations of economic efficiency may come into play. Property sometimes is unclaimed because holders failed to send notices to the correct addresses or otherwise keep track of owners. Being subject to taxation on unclaimed property, rather than treating the funds like a loan, should give holders an incentive to exercise care in keeping track of owners.

In sum, although the current law regarding tax treatment of unclaimed property in the hands of the holder seems clear, there are significant questions as to whether it achieves the proper result. Even more significantly, the issues raised by unclaimed property suggest that we rethink our notions of debt to require some intention on the part of the taxpayer to make a loan. Again, this analysis demonstrates that the tax code is ill-equipped to deal with inadvertence.

V. UNCLAIMED PROPERTY IN THE HANDS OF THE STATE

Holders must turn over to the state property presumed abandoned. When the state acquires unclaimed stock or bonds under unclaimed property statutes, for example, dividends on that stock or interest on the bond continue to accumulate until the state sells the asset. Both the receipt of earnings and the act of sale raise tax questions. In addition, states generally deposit the proceeds of such sales, along with unclaimed cash, in the general fund, reserving only a small amount for potential claims by owners. The next set of tax issues, then, involves the treatment of the unclaimed property once the state takes possession of it.

176. See *supra* note 7 and accompanying text (establishing UUPA in part to avoid "windfalls" to holders).

177. See Treas. Reg. § 1.61-14; *Cesarini v. United States*, 296 F. Supp. 3, 6 (N.D. Ohio 1969), *aff'd per curiam*, 428 F.2d 812 (6th Cir. 1970). A holder that included these amounts in income would be able to take a later deduction for any property paid to the owner or the state at a later date. Cf. Lawrence A. Zelenak & Martin J. McMahon, Jr., *Taxing Baseballs and Other Found Property*, 84 TAX NOTES 1299 (1999) and Joseph M. Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the 'Claim of Right Doctrine' to Found Objects, Including Record-Setting Baseballs*, 5 FLA. TAX REV. 685 (2000). This article does not discuss the claim of right doctrine because neither holders nor the state invoke a claim of right as to the presumed abandoned property.

Under the UUPA, “the State does not take title to unclaimed property, but takes custody only, and holds the property in perpetuity for the owner.”¹⁷⁸ That is, the states see themselves as acquiring an obligation and not the property itself.¹⁷⁹ They not only return the property to owners who claim it, but also undertake efforts to find the owners and reunite them with their property.¹⁸⁰ In *Connecticut Mutual Life Ins. Co. v. Moore*,¹⁸¹ the Supreme Court described the state as “a conservator” when claiming property under a custodial unclaimed property law. Similarly, the 1995 draft of the Preface to the Uniform Unclaimed Property Act explained, “the State acts as a conservator of the lost owner’s property and the Act is akin to a succession statute.”¹⁸² One of the two leading treatises explains, “The state succeeds to whatever rights the owner of the property may have.”¹⁸³ At the same time, the unclaimed property laws have as one of their purposes giving the states use of these funds.¹⁸⁴

The various goals and purposes of state unclaimed property laws make a variety of characterizations possible. In the case of unclaimed property, the uncertainty as to the proper tax characterization arises not only because of the multiple purposes of the Uniform Act, but also because inadvertence does not fit neatly into our substantive tax rules. Moreover, operation of the state unclaimed property laws raises questions about fiscal federalism, how the federal government should treat state programs when the state claims to be acting on behalf of its individual citizens. The state might be seen as having borrowed the money from the owner, as a custodian of the money so that all earnings on it properly belong and should be taxed to the owners, as a fiduciary required to treat the unclaimed property as held in trust and subject to the income tax rules applicable to trusts—rules that do accommodate human frailty—or as itself the owner of the funds.

178. UNIF. UNCLAIMED PROPERTY ACT, Prefatory Note, 8B U.L.A. 104 (Supp. 2000).

179. See 1 DAVID J. EPSTEIN ET AL., UNCLAIMED PROPERTY LAW AND REPORTING FORMS § 1.05 (1990).

180. UUPA requires publication of owner’s name in the county of last known address by November 30 of the year following the year in which the property was acquired by the state, if the amount is over \$50. UUPA, § 9, 8B U.L.A. 121-22 (Supp. 2000).

181. 333 U.S. 541, 546-47 (1948).

182. ANDREOLI & SPOTSWOOD, *supra* note 4, at 1995 Supplement, New Dev-5. This language did not appear in the Preface as adopted. See UUPA, Prefatory Note, 8B U.L.A. 104 (Supp. 2000).

183. *Id.* at 3-6.

184. See *supra* note 7.

A. *The State as Representative for the Owner*

Under the UUPA, the state "takes custody only, and holds the property in perpetuity for the owner."¹⁸⁵ Insofar as the state holds on behalf of the owner, it would act as the representative of the owner and might be taxed as such rather than as the sovereign. If the state acts simply as custodian of the unclaimed funds, it could be seen as an agent of the owner. As an agent, the state would treat all income from the property as belonging to the principal and as properly reported on the principal's tax return. If the state is a custodian for the owner, all income earned on the property belongs to the owner, and would currently be taxable to the owner each year. Yet, as explained above, not all states pay interest on all unclaimed property that is eventually claimed and no state pays over all the income earned on the property. Principals, moreover, control agents, and here the unknown owners have no control.¹⁸⁶

The state assigns to itself a responsibility greater than that of an agent. When the states acquire the unclaimed property, they, instead of the holders, benefit from the property. States assert extensive powers over unclaimed property. They transfer the vast majority of unclaimed funds to general revenue or other uses, retaining only a few hundred thousand dollars for potential claims by owners.¹⁸⁷ In only some instances do the states credit the account of owners with any earnings, and those earnings will generally be less than the state's earning on the funds.¹⁸⁸ If states acquire unclaimed property other than money, particularly stock, they sell it.¹⁸⁹

The Supreme Court has characterized the state in this role as "conservator" of the property.¹⁹⁰ Under the tax code, caretakers such as "custodians, escrow agents, receivers administering property subject to litigation" often "have a large measure of discretionary authority in managing

185. See *supra* note 127.

186. "It is the element of continuous subjection to the will of the principal which distinguishes the agent from other fiduciaries and the agency agreement from other agreements." RESTATEMENT (SECOND) OF AGENCY § 1 cmt. b (1958). Under the tax regulations, an agent is not a "fiduciary" for tax purposes. See Treas. Reg. § 301.7701-6(b)(2) (2000).

187. See *Survey*, *supra* note 19. Texas transfers everything to the unclaimed property fund. *Id.* Massachusetts retains about \$500,000. *Id.* California transfers the excess over \$50,000 into the general fund at the end of each month or sooner if deemed necessary. *Id.* New York retains no reserve in the unclaimed property fund. *Id.*

188. *Id.*

189. *Id.*

190. See *supra* note 132.

the assets entrusted to them and can be regarded as fiduciaries for the beneficial owners.”¹⁹¹ Tax regulations define a fiduciary as “a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.”¹⁹²

The definition of “trust” in the tax regulations seems to capture nicely state administration of unclaimed property laws:

Generally speaking, an arrangement will be treated as a trust . . . if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.¹⁹³

The notion of trustee, like the notion of surrogate taxpayer, permits the tax law to deal with inadvertence, unawareness, and carelessness.

Fiduciaries, however, have a variety of responsibilities under the common law. Trustees, for example, have a responsibility to earn income on principal.¹⁹⁴ If the state is in fact a conservator, its failure to pay market-rate interest at least on the funds that are eventually claimed is particularly troubling. Failure to earn income on funds is failure to preserve it. Trustees have a duty to keep trust property separate and not to commingle trustee funds with other funds. In most jurisdictions, a corporate trustee may commingle trustee funds, so long as all trust assets are in a common trust fund.¹⁹⁵ The UUPA, in contrast, recommends that state administrators reserve only a small amount—at least \$100,000—in a trust fund for any claims of owners.¹⁹⁶ The UUPA envisions that the vast majority of the unclaimed funds are transferred to the general revenue funds of the state and are not held in trust.¹⁹⁷

Moreover, the Internal Revenue Code itself assigns fiduciaries a variety of duties. They must give written notice of the fiduciary relationship to the IRS.¹⁹⁸ They must file a notice of termination of fiduciary relationship upon

191. BITTKER & LOKKEN, *supra* note 95, at ¶ 82.4.1.

192. Treas. Reg. § 301.6903-1(d) (2000).

193. *Id.* at § 301.7701-4(a).

194. See, e.g., RESTATEMENT (THIRD) OF TRUSTS § 227 (1992) (“The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would . . .”).

195. See AUSTIN W. SCOTT, SCOTT ON TRUSTS § 227.9 (4th ed. 1988). Under the tax law as well, a trust requires the existence of some separate entity. See generally BITTKER & LOKKEN, *supra* note 95, at ¶ 82.4.1.

196. UNIF. UNCLAIMED PROPERTY ACT § 13, 8B U.L.A. 126 (Supp. 2000).

197. *Id.* § 13, cmt. at 126.

198. See Treas. Reg. § 301.6903-1(a) (2000).

completion of their duties.¹⁹⁹ In some situations, custodians and conservators would have an additional obligation: to file an income tax return. Under § 6012(b)(2), “[i]f an individual is unable to make a return . . . , the return of such individual shall be made by a duly authorized agent, his committee, guardian, fiduciary or other person charged with the care of the person or property of such individual.”²⁰⁰ The owner of unclaimed property, although likely making a return regarding other income, is unable to make a return regarding this property. It is unclaimed property precisely because the owner is unaware of ownership. If it is the fiduciary of such property, perhaps the state should make a return.

Thus, while the unclaimed property laws describe the state as acting on behalf of the owner, the state’s behavior is not consistent with such a characterization. Nor would such behavior be practical, given the small percentage of owners who seek return of unclaimed property. Estimates put the total amount of property returned by the states at only four percent of total collections,²⁰¹ and the percentage of property currently returned as a percentage of property currently collected as approaching twenty-five percent.²⁰² Requiring the states to segregate these funds, invest them, and credit all earnings to them would be cumbersome and wasteful.

Furthermore, the usual rules for fiduciaries under the common law or the Internal Revenue Code, much less state statutory obligations, do not apply to states in their sovereign capacity. For the federal government (either the Internal Revenue Service or Congress) to require states to pay interest, file returns, and carry out other duties required by characterization of the state’s role as a fiduciary would raise a host of difficult questions of federalism and comity. To a considerable extent, the role of sovereign overlaps with the concept of trust. Governments are, at least in some loose sense, fiduciaries for their citizens. The fit is less perfect, however, when governments say they are acting on behalf of citizens in their individual capacity, the very claims states make under their unclaimed property laws.

199. *Id.* at § 301.6903-1(b).

200. I.R.C. § 6012(b)(2) (2000). *See also* Treas. Reg. § 1.6012-1(a)(5) (2000). Under current law, agents may file a return only with a power of attorney from the taxpayer, and “a receiver appointed by authority of law in possession of only a part of the property of an individual” has no responsibility to file a tax return. I.R.C. § 6012(b)(2).

201. *See supra* notes 1 and 7 and accompanying text.

202. *See supra* notes 1 and 6 and accompanying text. New York estimates the percentage of returned property at 22.4% as of March 31, 1997; Texas at 68.09% in 1997, and Arizona at 48%. *See Survey, supra* note 19.

B. The State as Borrower or as Owner

The tests articulated in *Indianapolis Power* may make the state a borrower of these funds from the owner rather than a fiduciary of the owner. Like the utility deposits in that case, the unclaimed funds are “acquired subject to an express ‘obligation to repay’” to the owner (which includes heirs or devisees of the original owner) at any time.²⁰³ The state has no guarantee that it will be able to keep the money. Upon demand of the owner, it must be returned. Until such a demand is made, the state has free use of the unclaimed funds. As borrower, the state would be free to use the funds as it sees fit, whether for state projects or to earn income.

Nonetheless, several considerations caution against characterizing unclaimed property in the custody of the state as borrowed from the owners. The first concern, discussed earlier,²⁰⁴ is whether characterization as a loan is appropriate when the lender had no intention to make a loan. The second is the failure of the state to pay a market rate of interest for use of this property to owners who do eventually reclaim it.²⁰⁵ Although, as discussed above, Supreme Court case law does not require payment of interest in order to characterize a relationship as a debt, this aspect of the Supreme Court case has troubled many commentators. The failure of the state to pay interest underscores the concerns raised earlier about the relationship between debt and payment of interest.²⁰⁶

Practical considerations underscore this concern, just as they did for treatment of holders. Only a small percentage of owners seek return of unclaimed property. Although the Supreme Court in *Indianapolis Power* looked to legal obligation and not to actual use of funds at issue to categorize a relationship as debt, in the case of unclaimed property the small return percentage means the state’s legal obligation has limited substance. Again, questions about the Supreme Court’s decision raise questions about characterizing the state as having borrowed this unclaimed property.

203. See *Indianapolis Power & Light Co.*, 493 U.S. at 203 (1990).

204. See text, *supra* pp. 152-54.

205. UUPA requires payment of specified rate unless actual amount accrued is lower for a period no longer than 10 years. UNIF. UNCLAIMED PROPERTY ACT § 11, 8B U.L.A. 123-24 (Supp. 2000). California pays 5%, West Virginia pays 4%, Illinois and Texas pay no interest, while Massachusetts pays 5% on interest-bearing accounts and 1% on all others. See *Survey*, *supra* note 19.

206. Judge Posner has observed that, in effect, unclaimed property represents “an interest-free loan to the state—in perpetuity if the owner never shows up to claim it.” *Commonwealth Edison Co. v. Vega*, 174 F.3d 870, 872 (7th Cir. 1999).

For holders, the difference between borrowing unclaimed property and owning it is important for purposes of taxation. That difference determines whether or not the holder is liable for federal income tax on the unclaimed property. States, in contrast, are generally not liable for federal income tax.²⁰⁷ Although the example of unclaimed property may make us question the current framework for excluding the income of state and local governments when they claim to be acting on the behalf of individual citizens, under current law, the difference between the state owning unclaimed property and, as happens in most cases, the state's indefinitely borrowing the property may be very small indeed. For many purposes, the categories of state borrowing and state ownership collapse. As discussed below,²⁰⁸ however, even under current law, whether the state is characterized as borrowing or owning the property could have significant consequences for the income and estate tax liabilities of owners who ultimately make successful claims from unclaimed property funds.

Nonetheless, although the state does not take title to unclaimed property but holds it for the benefit of the missing owner, characterizing the state as owner of the unclaimed funds for federal tax purposes avoids many difficulties. If the state is acting on behalf of the missing owner, all earnings on the unclaimed assets should belong to the missing owner and the state should report such earnings. If the state is borrowing the property from the owner, the owner would expect at least some interest on the loan.²⁰⁹ Characterizing the state as owner recognizes the extensive powers the state asserts over the unclaimed property and validates the power of the state to sell unclaimed assets and to transfer such property to general revenue funds. The state as the owner avoids questions about the state's responsibility to fulfill a fiduciary's duties under the tax code and recognizes the fact that only a small percentage of unclaimed assets are returned to their owners.

Treating the state as owner of the unclaimed property in its hands makes the state the surrogate taxpayer for the missing owner. As discussed earlier, surrogate taxation offers an approach for dealing with inadvertence and

207. See Gen. Couns. Mem. 14,407 (Jan. 28, 1935); Rev. Rul. 71-131, 1971-1 C.B. 29; Rev. Rul. 71-132, 1971-1 C.B. 30; Ellen P. Aprill, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates*, 23 J. CORP. L. 803, 803 (1998); Ellen P. Aprill, *Excluding the Income of State and Local Governments: The Need for Congressional Action*, 26 GA. L. REV. 421, 430-32, 450-65 (1992).

208. See *infra* note 246.

209. Perhaps, in the case of unclaimed property, the state's preservation of the property may be a form of implicit interest. Perhaps, because of the failure of the state to pay adequate interest, owners who recover property would have to recharacterize some of the recovered principal as original issue discount.

missing taxpayers and thus may be appropriate here. In this case, however, the surrogate is not subject to federal income tax and is taxed at a zero percent rate. Thus, from the point of view of federal revenue, the state as surrogate is not a neat substitute for a taxpaying citizen.

The historical development of unclaimed property laws supports treating the state as owner. Before the advent of modern unclaimed property laws, unclaimed property escheated to the state absolutely. Missing owners had no opportunity to file claims. Under a true escheat statute, there would be no question about treating the state as an owner. Considerations of comity and federalism argue against changing this federal tax result because the states have extended additional rights to their citizens.

Unclaimed property laws have a variety of purposes. The state is to act on behalf of the owner and also to use the unclaimed property for itself. These differing purposes make several different characterizations plausible for tax purposes—the state could be a borrower, a fiduciary for the apparent owner, or the state could be the owner of the property of which it has taken custody. One newspaper article has described whether the apparent owner or the state owns unclaimed property while the state takes care of it as a “key question.”²¹⁰ No one characterization adequately addresses the various roles the states play in connection with this property. For example, while characterizing the state as owner or borrower of the property seems to be the most consistent with the way the state treats the property, and also avoids troublesome questions about taxation of any earnings on the unclaimed property, such characterization is nonetheless inconsistent with statutory language specifying that the state holds the property as custodian on behalf of the missing owner. Such characterization requires ignoring other aspects of unclaimed property law, such as the state’s duties to the owners and legal title, upon which ownership for tax purposes so often turns.²¹¹ These difficulties arise because the owner is missing through carelessness on the part of either the owner or the holder. When the owner is missing, the tax law finds itself in a quandary.

210. Gene Meyer, *Abandoned Stocks Sold*, KAN. CITY STAR, Jan. 15, 1997, at F4, available in LEXIS, News Library, current news File. An IRS agent quoted in the article noted that “there’s not much precedent in IRS records to help decide that.” *Id.*

211. See, e.g., *Cottage Sav. Ass’n v. Comm’r*, 499 U.S. 554, 566-67 (1991) (tax characterization turning on legal entitlements); Lee A. Sheppard, *NYSBA Tax Section Meeting: The Six Unanswered Questions Facing Policymakers*, 65 TAX NOTES 158, 158-159 (1994) (reporting Deputy Assistant Secretary Cynthia Beerbower as criticizing tax law for relying on old wisdom and explaining that legal ownership has become irrelevant; economic ownership is what matters).

VI. RECOVERY OF UNCLAIMED PROPERTY

Owners, who are defined for purposes of the unclaimed property statutes to include heirs and devisees,²¹² do sometimes recover unclaimed property. To make a recovery, owners must learn that the state holds the property as abandoned and follow the necessary procedures to prove their right to it. Owners must affirm under penalty of perjury that they own the property claimed, produce the stock certificate if found or certify that they have not transferred the instruments if not found.²¹³ Recovery of such property raises its own set of federal tax issues.

At one time, such tax issues had little if any practical impact, however intriguing the proper treatment may be as a matter of theory. States did not enforce their unclaimed property statutes vigorously. Under earlier versions of most unclaimed property statutes, property was presumed abandoned only after seven years of inactivity.²¹⁴ In general, the Internal Revenue Service has only three years to assert a "deficiency,"²¹⁵ which is generally defined as additional taxes owed because of an error on the return.²¹⁶ Thus, even in the unlikely situation in which the original or a subsequent owner did recover property, the statute of limitations on any tax liability would have run. Although the period is extended to six years if the taxpayer omits from gross income more than "25 percent of the amount of gross income stated in the return,"²¹⁷ most claims are small. The chief of Delaware's unclaimed property office has stated, "You might be looking at \$10 here and \$15 there."²¹⁸ Other states have larger average claims. California reports its average claim amount is \$1,200 and Illinois reports \$1295.²¹⁹ In any case, the consequences for the tax system as a whole are significant. Moreover, some claims are large.²²⁰ For those individuals with large recoveries, individual tax consequences will also be significant.

212. Owner is defined under the UUPA as "a person who has a legal or equitable interest in property . . . or the person's legal representative." UUPA § 1(11), 8B U.L.A. 107 (Supp. 2000).

213. Illinois represents itself as having had very stringent requirements for making a claim. Texas turns down 41% and Arizona 21% of claims made. See *Survey*, *supra* note 19.

214. See ANDREOLI & SPOTTSWOOD, *supra* note 4.

215. I.R.C. § 6501(a) (2000).

216. *Id.* at § 6211(a).

217. I.R.C. § 6501(e)(1)(A) (2000).

218. Dallabrida, *supra* note 6.

219. See *Survey*, *supra* note 19.

220. See *supra* note 20 and accompanying text.

Newer versions of unclaimed property laws shorten the period for presumed abandonment,²²¹ and states have increased efforts both to take possession of unclaimed property and to identify the owners of the property.²²² States now regularly publish lists in newspapers, hire professional search firms, post names on the Internet, and conduct outreach programs, “especially when the amounts are large.”²²³ For example, since the spring of 1998, New York’s unclaimed property office has operated booths at “high pedestrian traffic areas like train stations and racetracks,”²²⁴ and New Hampshire publishes names of people owed unclaimed property in *The Union Leader* and has a booth at the Hopkinton Fair.²²⁵ As a result, it is becoming more likely for unclaimed property to be claimed by an owner before the expiration of the period for asserting a deficiency. For example, an owner may learn that the state has taken possession of dividends unclaimed for three or five years. Even if the statute of limitations has run for those dividends, the owner may well realize that there are also dividends to be claimed for the last two years, including the immediately preceding year. Occasionally, the dividends or other assets recovered may be so large as to trigger the six-year statute of limitations.²²⁶ Heirs going through a decedent’s papers may discover unclaimed property shortly after the original owner’s death and thus long before the assessment period has expired for the estate tax return. The practical impact of the proper tax treatment of these amounts has grown and will continue to grow.

Money claimed from the state may represent recovery of principal, interest or dividends paid on the lost property, gain upon sale by the state, or

221. See ANDREOLI & SPOTTSWOOD, *supra* note 4.

222. See *supra* notes 4, 5 and accompanying text. California Governor Gray Davis’ 2000-2001 budget included more than \$1 million “to boost staffing for Controller Kathleen Connell to help her return” unclaimed property to the 5.2 million Californians whose property the state was holding. Julie Tamaki, *Small Items Add Up in Big-Money State Budget*, L.A. TIMES, Jan. 18, 2000, at A3, available in LEXIS, News Library, current news File. The 1999-2000 budget had just \$15,000 for such efforts. *Id.*

223. Wagner, *supra* note 119 (interviewing Jundt, Executive Director of the National Association of Unclaimed Property Administrators).

224. Blair, *supra* note 6. New York’s Website “has logged 2.7 million searches since its introduction last July.” *Id.*

225. See Cissy Taylor, *State Treasury to Audit Property Accounts*, UNION LEADER, Feb. 23, 1999, at A1, available in LEXIS, News Library, current news File.

226. See *supra* note 20 and accompanying text. New York has one \$700,000 unclaimed account. See Blair, *supra* note 6. Illinois awarded \$500,000 to one man, while another single disbursement worth \$900,000 goes unclaimed. See Bob Kurson, *Check the List of Lost Loot in Sunday’s Sun-Times*, CHI. SUN-TIMES, Feb. 19, 1999, at 16. Louisiana paid out \$1.2 million to one person in a single claim. See Mark Hanson, *Program Features Local Woman: NBC Program was in Bismarck for Story on Unclaimed Property*, BISMARCK TRIB., Jan. 31, 1999, at 2A.

interest paid by the state. The claimant may be the original owner, that is, the person who lost the asset, or that owner's personal representative, heirs or devisees. Interest paid by the state may have accrued both before and after the apparent owner's death. Thus, recoveries themselves involve not only income tax, but also estate tax considerations.

A. Recovery by the Initial Owner

1. Recovery of Principal

The portion of a successful claim representing either the original owner's investment or amounts that should have been taxed under the doctrine of constructive receipt would be recovery of capital. As recovery of capital, these amounts are not subject to income tax. General principles regarding recovery of capital would seem to call for this conclusion, but, as with the case of constructive receipt, the involuntary and inadvertent nature of the loss of property raises questions about the tax doctrine.

Clark v. Commissioner is the classic case for the proposition that recovery of capital does not result in taxable income.²²⁷ There, a taxpayer received money from his tax counsel to compensate him for a loss in the form of greater tax liability suffered on account of erroneous advice given by the tax counsel.²²⁸ The Board of Tax Appeals held that the money received was not taxable:

So long as petitioner neither could nor did take a deduction in a prior year of this loss in such a way as to offset income for the prior year, the amount received by him in the taxable year, by way of recompense, is not then includable in his gross income

because the lawyer's action caused "a loss which impaired petitioner's capital."²²⁹

Revenue Ruling 81-277,²³⁰ which treats recovery from a contractor for failure to perform under a contract as return of capital rather than gross income, expands on this reasoning. It states, "Inherent in section 61 of the Code is the concept of economic gain. For a taxpayer to have income under section 61, there must be an economic gain that benefits the taxpayer

227. 40 B.T.A.M. 333 (1939), *acq.* 1957-1 C.B. 4.

228. *See id.* at 333-34.

229. *Id.* at 335.

230. Rev. Rul. 81-277, 1981-2 C.B. 15.

personally.”²³¹ Citing *Clark*, it continues, “Payments by the one causing a loss that do no more than restore a taxpayer to the position he or she was in before the loss was incurred are not includible in gross income because there is no economic gain.”²³²

According to Bittker and Lokken, *Clark*’s rationale is plausible “only where the loss is nondeductible,” as, for example, “because the loss is not within any category of deductions.”²³³ *Clark* thus can be seen as a variation of the tax benefit rule. Under § 111(a), the statutory codification of the judge-made tax benefit rule, “Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter.”²³⁴ In other words, recovery of an item must be included only to the extent its loss produced a tax benefit. In one classic example of the tax benefit rule, if a lender recovers payment on a debt it had deducted as a bad debt, the repayment must be included in income. Under the statutory tax benefit rule, even if there is a deduction for a loss, recovery is not included if the deduction did not produce a tax benefit.²³⁵ As discussed earlier, recovered unclaimed property was never abandoned for federal tax purposes. No deduction was available or taken for its loss; thus, there need not be an inclusion of the recovery.

As Professor Zelenak has written, *Clark* treats identically a person who receives an excludable amount and a person who does not, even though the person who receives the amount is in a better economic position than the person who does not and even though it puts the person who recovers in the same position as he would have been if the loss had been deductible.²³⁶ Professor Zelenak, following Professors Bankman and Klein, contrasts someone who recovers, as did *Clark*, \$20,000 from the tax preparer with someone who finds \$20,000 on the street.²³⁷ Professor Zelenak explains that *Clark* applies when there is a “nexus between loss and recovery.”²³⁸

231. *Id.*

232. *Id.*

233. BITTKER & LOKKEN, *supra* note 95, ¶ 5.8.1.

234. I.R.C. § 111(a) (2000).

235. *Id.*

236. See Lawrence Zelenak, *The Taxation of Tax Indemnity Payments: Recovery of Capital and the Contours of Gross Income*, 46 TAX L. REV. 381, 388-89 (1991).

237. *Id.* at 388-89.

238. *Id.* at 388 n.42 (1991) (citing WILLIAM KLEIN ET AL., *FEDERAL INCOME TAXATION* 190 (8th ed. 1990)).

Under this test, *Clark* would clearly apply to unclaimed property, since the nexus is particularly strong. Both statutory language of unclaimed property laws and cases interpreting these laws treat these funds as recovery by the owner of the owner's property. A key purpose of unclaimed property statutes, according to one court, is "to reunite owners with unclaimed funds or property" because the "State, through the Controller, acts as the protector of the rights of the true owner."²³⁹ The owner must prove ownership of the property.

But again, such a conclusion based on application of existing tax doctrine may be too facile. Applying the tax benefit doctrine to unclaimed property forces reconsideration and refinement of this tax doctrine. Recovery of capital under the principles of *Clark* or the tax benefit rule frequently involves a mistake of judgment on the part of the taxpayer. The taxpayer errs in concluding that his tax preparer is knowledgeable or that a particular borrower is a good risk, or that a party to a contract will perform. Such errors in judgment, however, nonetheless involve voluntary and intentional acts. The taxpayer hires the tax preparer, decides to make the loan, hires the contractor and depends on their expertise. In contrast, recovered property is property that the owner has unknowingly lost through neglect, carelessness or inadvertence. As a treatise explains, "It is property which the owner has unwittingly suffered to pass out of his possession and of whose whereabouts he has no knowledge."²⁴⁰ The owner, having had no idea he or she owns the property, can have no expectation of recovering the property. In fact, the property is "presumed abandoned" and the state has asserted control over the property, so much so that the state could be considered the owner of the property.²⁴¹ Using the comparison from *Bankman and Klein*, it is more as if the owner had found property someone else had lost than recover his money from his tax preparer. If so, the statutory rights of recovery given the owner should be characterized as a windfall and taxable as such.

Once again, the example of unclaimed property suggests that because standard tax doctrines assume that taxpayers make intentional voluntary acts, applying such tax doctrines to situations involving inadvertence may distort the purpose of the doctrines. Unclaimed property does not conform to the assumption underlying the tax doctrine and thus application of the tax doctrine may not be appropriate. If such is the case, the assumption that the taxpayer

239. *Bank of Am. Nat'l Trust and Sav. Ass'n v. Cory*, 210 Cal. Rptr. 351, 355 (1985).

240. ANDREOLI & SPOTSWOOD, *supra* note 4, at 1-6 (Supp. 1995).

241. See *supra* Part IV.B.

has acted intentionally in order to apply the tax benefit doctrine of intentional acts needs to be made an explicit part of our understanding of the doctrine.

2. *Dividends, Interest and Gain or Loss*

Reclaimed property includes not only recovery of principal but also of dividends or interest on unclaimed financial assets that accrued prior to sale by the state. In addition to interest or dividends paid by private businesses on unclaimed assets, successful claimants in some states will receive interest on at least certain kinds of claims for the period the state held the property.²⁴² These amounts again raise the questions of constructive receipt. If owners had been in constructive receipt of such earnings (and the statute of limitations had run), there would be no additional tax upon recovery. If they had not been in constructive receipt, they would owe tax at the time of recovery.

The constructive receipt issue involved in recovery differs from the constructive receipt issue discussed earlier. The aspect of constructive receipt important in Part I involved the relationship between taxpayer knowledge and failure to act to claim property. The issue involved in recovery of unclaimed property is the kind of action required of the owner in order to prove the claim. Under the regulations, "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations."²⁴³ In contrast, an insubstantial condition, such as submitting a document for cancellation or even a requirement that a routine fiduciary bond be filed,²⁴⁴ does not prevent constructive receipt.

Filing a claim under the UUPA may not be more onerous than many a ministerial act required in connection with many transactions involving assets. Owners must affirm under penalty of perjury that they own the property claimed, to produce the stock certificate if found or to certify that they have not transferred the instruments if not found.²⁴⁵ It is less onerous than, for example, having to obtain and file a fiduciary bond.

Nonetheless, the requirement here that a claim be filed seems to be more than a ministerial act. The filing of the claim does not guarantee receipt of the

242. See *supra* note 5 and accompanying text.

243. Treas. Reg. § 1.451-2(a).

244. See *Estate of Shelton v. Commissioner*, 612 F.2d 1276, 1280 (10th Cir. 1980).

245. But claims are not always accepted. See *infra* note 246. Moreover, when claims are made by heirs of a deceased owner, the state may require considerable additional information. A colleague of mine attempting to make a claim as the devisee of her late mother was asked not only for her mother's will, but also her father's will and, when she supplied his will, for several years of tax returns for a trust established in her mother's will.

funds. Under the UUPA, the state administrator must consider the claim and can deny it.²⁴⁶ The administrator can hold a hearing and hear evidence.²⁴⁷ Discretion and judgment are involved. The statutory procedures include a panoply of due process protections. For example, owners whose claims are denied can file a suit against the state administrator.²⁴⁸

If the requirement that a claim be filed and allowed by the state administrator is characterized as a substantial limitation, interest paid by the state would not have been constructively received earlier and would be subject to income tax in the year it is actually paid. Taxing owners who recover property on all the interest they receive when it is paid to them, however, is a mixed blessing. If the interest were deemed constructively received and if the state had held the property for a period beyond the statute of limitations, owners who reclaimed their property would be better off than characterizing the amounts as not having been constructively received. If the statute has not run, constructive receipt would involve interest on underpayment and possibly penalties for the owner recovering the property.²⁴⁹

Again the doctrine of constructive receipt plays out very oddly when applied to unclaimed property. Most taxpayers will not make claims until the three-year statute of limitations has run and thus would prefer that the amounts be deemed to have been constructively received. That is, a doctrine that is intended primarily to protect against taxpayer abuse would in this case shield taxpayers from taxation.²⁵⁰

Even if constructive receipt did not shield them, owners who make successful claims would be shielded from federal income taxation if such interest were deemed tax-exempt as interest on a state bond under § 103. Section 103 specifies that "gross income does not include interest on any State or local bond."²⁵¹ Section 150(a)(1) defines "bond" to include "any obligation."²⁵² The legislative history specifies that sale agreements, installment purchase agreements, finance leases, and other evidences of debt issued pursuant to a governmental unit's borrowing power are to be treated as bonds.²⁵³ While most bonds must be registered to be tax-exempt,

246. See UNIF. UNCLAIMED PROPERTY ACT § 15(b), 8B U.L.A. 128 (Supp. 2000).

247. See *id.* at § 15 at 128.

248. See *id.* § 16 at 129.

249. See *supra* note 90.

250. But see *supra* section II.A, noting that taxpayers in other contexts also use the doctrine of constructive receipt as a protection.

251. I.R.C. § 103(a) (2000).

252. *Id.* at § 150(a)(1).

253. See H.R. CONF. REP. NO. 99-841, at II-686 (1986). See also *Comm'r v. Meyer*, 104 F.2d 155,

§ 149(a)(2)(A) exempts from the registration requirement a bond that “is not of a type offered to the public.”²⁵⁴ If the state is deemed to have borrowed such funds pursuant to its borrowing authority, then any interest paid by the state could be tax-exempt.

Is this payment of interest pursuant to state unclaimed property statutes pursuant to the state’s borrowing power? While payment of interest is clearly authorized under various state unclaimed property statutes, these statutes, at least in their current form, do not characterize the state as issuing any kind of obligation under its borrowing power. There is no agreement between the owner and the state.²⁵⁵ Thus, it is far from clear whether such interest can be excluded under § 103. State administrators, by issuing 1099’s,²⁵⁶ seem to assume that it is not.²⁵⁷

Moreover, the lack of any agreement between the state and the owner raises the more general question discussed earlier—whether we characterize an inadvertent loan, a loan that the lender does not intentionally make, as a loan for tax purposes at all.²⁵⁸ The tax questions raised at the end of the unclaimed property chronology, recovery of property by the owner, rehearse

157 (2d Cir. 1939) (notes for the purchase of land); *Kings County Dev. Co. v. Comm’r*, 93 F.2d 33, 35 (9th Cir. 1937) (deferred payment contract for the purchase of real estate); *Newlin Mach. Corp. v. Comm’r*, 28 T.C. 837, 842 (1957) (installment obligations given to a vendor of equipment).

254. I.R.C. § 149(a)(2)(A) (2000).

255. *But cf.* *Power Equip. Co. v. United States*, 748 F.2d 1130, 1137 (6th Cir. 1984) (finding that interest on deferred sale of equipment was not properly authorized under state law); *Thompson v. Comm’r*, 52 T.C.M. (P-H) 245, 265 (1983), *aff’d in part*, 761 F.2d 259 (1985) (stating that the IRS failed to meet its burden of proving that contracts was not authorized by the state); Rev. Rul. 78-140, 1978-1 C.B. 27 (holding that interest on lottery winnings are not excludable under § 103).

256. California, for example, issues a Form 1099 when it pays interest on successful claims. *See Survey, supra* note 19.

257. Whether or not owners are in constructive receipt of any interest paid by the state and whether or not the interest can be excluded under § 103, there is also the question of whether the original issue discount (“OID”) rules of §§ 1271-75 might apply to require economic accrual of interest. If OID rules apply, owners would be treated as receiving interest from the state each year. OID rules apply when debt instruments are publicly offered or issued for money or publicly traded property. The state’s obligations under unclaimed property laws do not seem to fall into these categories, but the issue is not free of doubt.

258. Difficult tax issues arise not only in connection with interest paid by the state but also in connection with sales of unclaimed stock by the state. If the state had sold stock at a gain, for example, the amount recovered by the claimant for this unclaimed property will exceed the claimant’s basis in the property. If such sale is treated as having been made by the state either as owner or borrower, this excess should be taxed to the claimant upon recovery. Moreover, in such a case, any gain would be treated as ordinary income because the recovery is not a sale or exchange on this recovery. Claimants, however, are unlikely to realize that they might have gain. California, for example, gives claimants 1099’s only for interest paid. It does not report the amount realized from its sale of any unclaimed stock or notify the claimant that the sale may have generated gain or loss. *See Survey, supra* note 19.

the questions raised at the beginning, the owner's failure to take action regarding the property.

B. By Personal Representative, Heirs or Devisees of Initial Owner

Owners for purposes of unclaimed property statutes include those with legal or equitable interest in the property as well as legal representatives. It is easy to imagine relatives cleaning up the house after the demise of an elderly relative and discovering long-forgotten bank books or stock certificates. When unclaimed property is claimed by personal representatives, heirs or devisees, additional tax issues arise. If the state is considered the owner of the unclaimed property, for example, recovery by heirs of the owner could be characterized as a windfall subject to income taxation. In the case of heirs, however, estate tax issues become particularly salient.

One important question is the inclusion of these amounts in the decedent owner's gross estate. The regulations, for example, state:

The Federal estate tax is neither a property tax nor an inheritance tax. It is a tax imposed upon the transfer of the entire taxable estate. . . . Escheat of a decedent's property to the State for lack of heirs is a transfer which causes the property to be included in the decedent's gross estate.²⁵⁹

Moreover, transfer is defined broadly for purposes of the estate tax. Intestate transfers, which, like unclaimed property laws, involve failure to act rather than any intentional act on the part of the decedent, are subject to estate tax.

The tax regulations also explain that the gross estate includes "the value of all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his death."²⁶⁰ Furthermore, "property is includible in the gross estate of the principal, even if an agent or nominee is the owner of record."²⁶¹ Thus, whether the decedent's gross estate includes these amounts may depend on whether the state itself is to be treated as the owner of the property, borrower of the property, or as a fiduciary for the original owner. That is, is the decedent or the state the transferor of this property?

As explained above, the state considers itself to be holding the unclaimed property transferred to it as custodian for the benefit of the owner. If the state is holding the property for the benefit of the deceased owner, such assets

259. Treas. Reg. § 20.0-2(a).

260. Treas. Reg. § 20.2033-1(a) (2000).

261. BITTKER & LOKKEN, *supra* note 95, at ¶ 125.2.

should be included in the decedent's gross estate, even if the claims have not yet been filed and the state has not yet paid the claims. Similarly, if the state is treated as having borrowed the property, it owes a debt to the decedent that can be valued and included in the gross estate.

If the state rather than the apparent owner is deemed to be the owner of this property, heirs or devisees of a decedent might argue that the property was not owned by the decedent at the date of death and need not be included in the gross estate. They would further argue that they made the claim as owner and that such ownership was established only after the state accepted the claim.

At the same time, other aspects of unclaimed property laws undercut such a characterization. In particular, unclaimed property statutes define owner as "a person who has a legal or equitable interest in property subject to this [Act] or the person's legal representative."²⁶² Any heirs or devisees own the property only because of their relationship to the decedent, and the decedent did have a claim to the unclaimed property, a claim that now can be valued. Moreover, it is a truism of the federal estate tax that its reach turns largely on issues of state property law.²⁶³ Thus, the quoted statement may in and of itself call for including recovered unclaimed property in the decedent's gross estate.

Other considerations, however, lead to the opposite conclusion. Section 2033, the main provision of the estate tax,²⁶⁴ includes, but is not limited to, property that the decedent owns outright at death. In two recent Technical Advice Memoranda,²⁶⁵ the IRS concluded that the gross estate of each decedent included the value of illegal property in their possession. Both memoranda justified this inclusion on the grounds that even if the decedents lacked legal title, they possessed the economic equivalence of ownership—they enjoyed the use and economic benefits of the property.²⁶⁶ Technical Advice Memorandum 92-07-004, for example, quotes the Supreme Court, "Taxation is . . . concerned with . . . the *actual command* over the property taxed—the actual benefit for which the tax is paid."²⁶⁷ The Tax Court has observed that "we do not believe a taxable event can occur for gift

262. UNIF. UNCLAIMED PROPERTY ACT § 1(11) at 107, 8B U.L.A. 107 (Supp. 2000).

263. See *Morgan v. Comm'r*, 309 U.S. 78, 80 (1940); see generally RICHARD B. STEPHENS ET AL., *FEDERAL ESTATE AND GIFT TAXATION* ¶ 4.05[2] (7th ed. 1997 & Supp. 1998).

264. I.R.C. § 2033 (2000) provides, "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

265. See Tech. Adv. Mem. 92-07-004 (Oct. 21, 1991) (illegal drugs); Tech. Adv. Mem. 91-52-005 (Aug. 30, 1991) (artwork stolen in Germany and France during World War II).

266. See Tech. Adv. Mem. 92-07-004; Tech. Adv. Mem. 91-52-005 (Aug. 30, 1991).

267. Tech. Adv. Mem. 92-07-004 (Oct. 21, 1991) (quoting *Burnet v. Wells*, 289 U.S. 670, 678 (1933)).

tax purposes unless there is first and in fact an act of transfer by the donor; and there can be no act of transfer unless the act is voluntary and the transferor has some awareness that he is in fact making a transfer of property, that is, he must intend to do so."²⁶⁸ Unclaimed property is the mirror image of illegal property. Individual owners may, technically, retain legal title. They have, however, no command over the property and enjoy no benefit from it. In such a case, the policies underlying the estate tax suggest that gross estate should not include unclaimed property, even if heirs recover the property before the statute of limitations has run for purposes of the estate tax.

Thus, the estate tax consequences are uncertain.²⁶⁹ As with the other tax issues raised by unclaimed property laws, considering the estate tax consequences of this property invites us to confront basic questions about our tax laws, questions so basic that we take the answers for granted and do not examine our assumptions. How far do the estate tax rules extend? Should they apply to property when decedents had no idea that they had rights to the property? In particular, the example of unclaimed property recovered by relatives of a decedent underscores basic questions about our transfer tax system. Characterizing a decedent as transferring property the decedent has lost is uncomfortable. Yet, relatives who recover such property do have an accession to wealth and allowing such property to escape the transfer tax is also unsatisfactory. The example of unclaimed property lends support to those

268. *Estate of DiMarco v. Commissioner*, 87 T.C. 653, 663 (1986).

269. A set of similar uncertainties is apparent for earnings on unclaimed property or interest accrued by the state to the date of the apparent owner's death and paid by the state after the death merits particular discussion. The original owner's interest in these amounts does not arise after or because of death. One leading treatise states, "Accrued interest, whether it be on savings in a bank account, on a bond or a note arising out of an installment sale, or some less formal credit extension or loan made by the decedent during his life, is a section 2033 gross estate inclusion." STEPHENS ET AL., *supra* note 263, at ¶ 4.05[4]. The treatise further notes that, although Schedule C of Form 706 is not clear, "it is appropriate practice to state as separate items the principal amount of the note and interest accrued to the date of death," and cites Treas. Reg. § 20.2032-1(d)(1) (2000) for comparison. *Id.* If the state is seen as the borrower of the unclaimed property, the decedent has made a loan to the state, albeit an unintentional loan, and interest would be included. Again, the current law is unclear, because of the uncertainty as to who is the owner of the property for tax purposes after the state takes possession. Interest paid also raises questions about income in respect of a decedent ("IRD"), which includes "those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent." Treas. Reg. § 1.691(a)-1(b) (1999). The regulations specify that IRD includes "[i]ncome to which the decedent had a contingent claim at the time of his death." *Id.* at § 1.691(a)-1(b)(3). The deceased apparent owner had a right to interest under the unclaimed property laws, but may not have known of that right. Should a contingent right extend so far? In addition, if approval of the claim by the state is a condition precedent to the state's obligation to pay interest and the claim is filed by the apparent owner's heirs or personal representative after the apparent owner's death, none of the interest paid would be IRD.

who argue in favor of an accessions tax instead of an estate tax. As with the income tax, the treatment of unclaimed property raises issues about the appropriate tax base.

VII. CONCLUSION

One response to this study would be a call to Congress or the IRS to establish specific and special rules for loss and recovery of unclaimed property.²⁷⁰ The more important implications of the study, however, are far broader. Looking at carelessness through the lens of such tax doctrines as what constitutes debt or constructive receipt exposes how many tax doctrines assume that actions are the result of voluntary and conscious choice when in fact such doctrines also must be applied to actions that are not necessarily so. The billions of dollars in unclaimed property underscore just how often inadvertence occurs.

Professor Kelman believes that "the trigger to taxability ought to be a person's voluntary entrance into the market,"²⁷¹ and thus, in order to avoid forced marketing, he would not tax imputed income from leisure or services provided within the household. This study of unclaimed property shows how frequently the tax system takes for granted that the taxpayer has voluntarily entered the market. Our tax system assumes taxpayers are rational rather than fallible with "severe restrictions on cognitive capacity, attention span, and time that preclude assessing all relevant considerations in a 'rational' manner."²⁷²

270. Thus, an unclaimed property statute or regulation might specify that interest and dividends are constructively received by owners when the holders made the funds available. It could make clear that any interest (and gain realized upon sale of unclaimed stock) earned on the unclaimed property would be tax-exempt to the state and would be taxable only when paid to the claimant. The statute could clarify that other amounts representing recovery of capital would be taxed as such and not as a windfall. It could determine whether both principal and interest would be included in the apparent owner's gross estate. Congress could also specify that interest paid by states under unclaimed property laws could be treated as interest on a state obligation and thus excluded under § 103. By requiring distributions of unclaimed property to be reported to the Secretary of Treasury, the Treasury Department would be able to ensure that amounts are included in the estate of a decedent. Reports of distributions from unclaimed property accounts would also aid the Internal Revenue Service to track amounts constructively received for which the statute of limitations has not run, and state treasuries could also benefit from being able to tax such amounts.

271. Kelman, *supra* note 23, at 838.

272. Howard Latin, "Good" Warnings, Bad Products, and Cognitive Limitations, 41 UCLAL. REV. 1193, 1199 (1994).

Considering the tax consequences of unclaimed property, however, has important tax lessons for the tax system as a whole. In a general way, it serves as a reminder that, while the tax system generally deals with market transactions, those conducting the transactions are human beings subject to limitations. It suggests that the Haig-Simons definition of income fails to address, much less answer, some crucial questions regarding a tax base and tax system. It helps us to highlight those tax doctrines, such as surrogate taxation or the tax rules applicable to fiduciaries, that allow for human carelessness. Doctrines that have been treated simply as compromises for reasons of administrative ease take on a new meaning and prominence as a reflection of taxpayers' psychological makeup.

This study demonstrates the need for more of our substantive tax laws to be designed with real people and their real limitations in mind.²⁷³ More specifically, it suggests that the contours of many tax doctrines be limited to voluntary, or at least conscious, actions. Of special significance would be rethinking our notion of debt to require some conscious intention on the part of the taxpayer to make a loan. The lesson of unclaimed property statutes teaches that scholars, judges, and policymakers establishing or interpreting any tax doctrine should voluntarily and consciously consider whether that doctrine appropriately applies to careless or inadvertent actions.

273. See generally Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLAL. REV. 1861 (1994).