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TAX ISSUES RELATED TO PONZI SCHEMES AND AN UPDATE ON OFFSHORE TAX EVASION LEGISLATION

HEARING

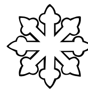
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

MARCH 17, 2009



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TAX ISSUES RELATED TO PONZI SCHEMES AND AN UPDATE ON OFFSHORE TAX EVASION LEGISLATION

TUESDAY, MARCH 17, 2009

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:02 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Kerry, Schumer, Stabenow, Cantwell, Nelson, Menendez, Carper, Grassley, Snowe, and Enzi.

Also present: Democratic Staff: Bill Dauster, Deputy Staff Director and General Counsel; John Angell, Senior Advisor; Cathy Koch, Chief Tax Counsel; Mary Baker, Detailee; Dan Gutschenritter, Intern; Vincent Mascia, Fellow; and Miki Hanada, Fellow. Republican Staff: Kolan Davis, Staff Director and Chief Counsel; Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; and Theresa Pattara, Tax Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

Sophocles wrote, "Things gained through unjust fraud are never secure."

Today we consider two kinds of unjust fraud. Today we look for ways to help honest taxpayers become just a little more secure. Today we examine the tax consequences of Bernard L. Madoff's scheme to defraud investors. And we consider ways to crack down on the efforts of offshore tax entities to defraud the U.S. Government of the taxes that they owe.

Last December, during one of our Nation's most severe financial crises, authorities uncovered perhaps the Nation's largest case of financial fraud. On December 11, Bernard L. Madoff was arrested after revealing that for 2 decades he had been running a Ponzi scheme that involved more than $60 billion. A court-appointed trustee found that, incredibly, Madoff's firm had conducted absolutely no trading for at least 13 years. Thirteen years of false earnings reportings, and 13 years of no trades.

Last week, Madoff pleaded guilty to 11 counts of fraud, money laundering, perjury, and theft. Those charges carry with them maximum sentences that add up to 150 years.

Senators Schumer, Cantwell, and Menendez requested that we hold a hearing on the tax consequences for these victims, and today IRS Commissioner Doug Shulman will explain how these victims can process their losses on their tax returns. We expect the Commissioner to discuss issues like theft loss, phantom income, and fraudulent conveyance.

Today we will also discuss the effort to combat another type of fraud. We will discuss outlines of potential legislation designed to stem overseas tax evasion. In the last Congress, the Finance Committee held two hearings on overseas tax evasion. In a May 2007 Finance Committee hearing, GAO testified about the Qualified Intermediary program and offshore tax evasion.

Qualified intermediaries are a key element of the government's overseas tax enforcement system. Qualified intermediaries are financial institutions that serve as our Nation's eyes and ears on the movement of U.S. funds overseas, but they do not work very well.

GAO determined that foreign corporations set up by an American individual, perhaps in the Cayman Islands, may enable that individual to hide income tax behind the corporate veil. A July 2008 Finance Committee hearing focused on the Cayman Islands, by the way, and offshore tax evasion. I asked the GAO to travel to the Caymans and look at the Ugland House. This is that famous 5-story building that the GAO testified has 18,587 tenants. Half of those tenants, about 9,000 of them, are reportedly Americans.

The GAO reported the following findings related to the Cayman Islands, just the Caymans: U.S. taxpayers have reported 1,400 controlled foreign corporations in the Cayman Islands; $2 trillion of bank assets are based there and 9,000 mutual funds, including hedge funds—a hedge fund for every 7 people on the island.

After the second hearing, I decided it was time to do something about this, to do what we could to close that overseas tax gap. Some have estimated the overseas tax gap to total $50 billion to $70 billion a year. I would remind all of us that the tax gap, again, is taxes legally owed but not timely paid.

Today we will discuss legislative proposals intended to enhance the transparency of offshore activity. We will consider how we can give the IRS better tools to deter, detect, and stop offshore noncompliance.

Among other proposals, here are three. The first would require entities transferring funds offshore, other than on behalf of publicly traded companies, to report to the IRS the amount and destination or account information of the funds transferred. This will give the IRS a trail of funds going offshore, and it will help the IRS to deter and detect offshore noncompliance.

The second proposal would extend the statute of limitations for tax returns with certain international transactions from 3 years to 6 years. This change would give the IRS more time to detect and examine often complicated offshore activity.

The third proposal would facilitate the IRS's ability to enforce compliance with the law's requirement for reports of foreign bank and financial accounts. The proposal would require entities to file these reports along with their tax returns.

As we look out at the deficits that we will be facing over the next few years, the importance of moving forward on the offshore tax

evasion problem becomes all the more clear. We need to reclaim every dollar of tax revenue that we can from these offshore tax evaders.

President Obama's fiscal year 2010 budget proposes a robust effort aimed at curbing offshore tax evasion. While we are waiting for the details of his plan, it makes sense for us to move forward nevertheless on proposals that we think could do the job.

While we are on the topic of scams, I am looking very closely at tax options that will reclaim these outrageous bonuses paid by AIG. The country is angry. Individual Americans are angry. I am angry. Four and a half million Americans have lost their jobs. At least 4.5 million Americans, in this recession, have lost their jobs. That these people are getting bonuses, getting multi-million dollar bonuses, while others are losing their jobs is just totally unfair. So we are looking at those ideas, and I will discuss them with committee members shortly.

So let us look for ways to address unjust fraud. Let us do what we can to help fraud's victims. And let us try to help honest taxpayers to become just a little more secure.

Senator Grassley?

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Mr. Chairman, I am going to just refer to one paragraph of my opening statement and put the rest in the record.

Some of the charities that invested in Bernie Madoff, including universities and those funded by Hollywood, would presumably have sophisticated advisors. This raises questions for me about whether the board members of these organizations were more interested in helping their friend than furthering charitable work.

Mr. Josephson, who is here to testify, will probably appreciate that as well, with his willingness to be here, again today—he has been before this committee before to discuss due diligence requirements for charities, trustees and boards of directors, as well as other tax implications for board misconduct under the Internal Revenue Service.

Then I would spend just a little bit of time thanking you for bringing up the AIG issue. We are here to talk about Ponzi schemes. I suppose every Ponzi scheme is different, and AIG may not fall into that category, but it surely brings into question a lot of tax issues that we have in TARP, and the fact that in some cases income limitations apply and in some cases they do not, and the extent to which bonuses are affected or not affected.

So I want to back you up on looking into that and doing what we can to make sure that these things do not happen in the future, because from the standpoint of not understanding Ponzi schemes, after about 7 or 8 months of reading about AIG and trying to determine what happens, I am not even sure we have a handle on exactly what happened. In the case of this economic recession caused by a lot of people taking chances and doing things that were not very transparent, we have to bring some transparency to this. So, I appreciate that very much.

The CHAIRMAN. Thank you, Senator, very, very much.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Now I welcome our witnesses. Our first is IRS Commissioner Doug Shulman. Thank you, Commissioner, for being here. Next, we have the Director of Tax Issues for the GAO, Michael Brostek. Finally, we have the former Assistant Attorney General for the New York State Law Department's Charities Bureau, William Josephson.

As is our normal practice, all of your statements will be included in the record, and I would ask each of you to speak for about 5 minutes.

We will start with you, Commissioner.

STATEMENT OF HON. DOUGLAS H. SHULMAN, COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Commissioner SHULMAN. Thank you, Mr. Chairman, Ranking Member Grassley, members of the committee. I appreciate the opportunity to testify today about Ponzi schemes in general, which also will provide some guidance around the Madoff situation, as well as talk to you about IRS's efforts to detect and stop unlawful offshore tax avoidance.

Beyond the toll of human suffering, the Madoff case raises numerous issues for the victims of losses from Ponzi-type investment schemes. To help provide clarity in this very complicated matter, today the IRS is issuing two guidance items that will assist victims of all Ponzi schemes.

Let me refer you to my written testimony, which has more details about our actions, and I will make a few points about the guidance. The first guidance is a revenue ruling, which is the Treasury Department and the IRS's best legal interpretation regarding the tax treatments of losses in Ponzi schemes.

Determining the amount and timing of tax deductions arising from Ponzi-type investment schemes is factually very difficult and depends on the taxpayer's prospect for recovering the lost money. Sometimes that can take years to determine.

The guidance we are issuing today clarifies that Ponzi losses are investment theft losses under the code, and that the taxpayer may deduct all of the purported earnings on which the investor paid taxes, as well as the cash invested in the Ponzi scheme. It also clarifies that the investment theft loss is not a normal casualty loss, and therefore is not subject to limitations that apply to non-investment type losses. This ruling should provide clarity and straightforward guidance to taxpayers.

In addition, we have issued a revenue procedure, with the goal of making it as easy as possible for taxpayers affected by these schemes to avail themselves of the proper tax deductions. Key to the revenue procedure is providing a safe-harbor method of computing and reporting losses. The procedure's goal, again, is to be helpful to taxpayers who are confronted with a very complex area of the law and difficult facts.

Mr. Chairman, I am also pleased to briefly describe the unprecedented focus that the IRS has brought to detecting and bringing to justice those who unlawfully hide assets overseas to avoid paying tax. In today's economic environment, where the Federal Govern-

ment is necessarily running large deficits to restore economic growth, it is more important than ever that American citizens feel confident that individuals and corporations are playing by the rules and paying the taxes that they owe.

When the American public is confronted with stories of financial institutions helping U.S. citizens to maintain secret overseas accounts involving sham trusts to improperly avoid U.S. tax, they should be outraged, as am I, and as I know you are. But they should also know that the U.S. Government is taking unprecedented measures, and there is much more to come.

I can assure you that the President and the Treasury Secretary are committed to taking aggressive action on offshore tax abuse. Over the next several months, the administration intends to propose a series of legislative and enforcement measures to reduce U.S. tax evasion and avoidance.

While I am proud of the progress we have made since I became Commissioner, we are only at the beginning. You should expect to see a multi-year effort of beefing up our resources and tools needed to address international tax abuse.

Since becoming Commissioner, I have made international issues a top priority. We actually discussed it at my confirmation hearing here a year ago at the Senate Finance Committee. I have increased the number of audits in this area and stepped up hiring of international investigators and experts. We have been steadily increasing pressure on offshore financial institutions that facilitate concealment of taxable income by U.S. citizens, and that pressure, I can assure you, will only increase.

The IRS's investigations are getting results. The Justice Department recently signed a deferred prosecution agreement with a major Swiss bank, which involved a payment of $780 million. They are also continuing to pursue a lawsuit for a civil summons to get more bank accounts from that institution.

Several so-called "tax haven countries" have pledged to reform bank secrecy laws, and just last week have agreed to comply with international standards for tax and data sharing. The IRS is also looking to improve information reporting and sharing.

Mr. Chairman, you referred to the Qualified Intermediary program, which gives us a line of sight to foreign financial institutions. We are looking to improve that program by increasing the type of information that those institutions must report about U.S. citizens, and also creating rules that insist on better due diligence on accounts opened or maintained by qualified intermediaries.

We are also exploring the increased use of, and potentially more, information reporting requirements around money being transferred in and out of the United States.

Mr. Chairman, I know that you are considering legislation designed to improve tax compliance with respect to offshore transactions. I appreciate all the support you have given to the IRS. I believe that the general direction of your legislation will help us combat offshore tax abuse. My staff and I are looking forward to working with you and other members of this committee on that legislation.

I want to thank you for the opportunity to testify, and I look forward to answering your questions.

The CHAIRMAN. Thank you very much, Commissioner.

[The prepared statement of Commissioner Shulman appears in the appendix.]

The CHAIRMAN. Mr. Brostek, you are next.

STATEMENT OF MICHAEL BROSTEK, DIRECTOR, TAX ISSUES, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Mr. BROSTEK. Mr. Chairman, Senator Grassley, and members of the committee, thank you for inviting me to discuss our work related to individuals' use of offshore locations to evade taxes.

My statement describes the characteristics of individuals found to have evaded tax and how they did so, describes factors that enable offshore noncompliance, and discusses challenges that offshore financial activities pose for the IRS.

Taxpayers whose noncompliance involved offshore locations are a diverse group. Some have owed relatively small amounts of taxes, interest and penalties, but some have evaded millions in taxes on hundreds of millions of dollars in assets. Some taxpayers appear to have been inadvertently failing to pay their taxes, such as when they inherited money overseas but failed to report income earned on that money. Others have used very elaborate structures that serve to hide their activities, and thus appear to have been quite deliberate in their evasion.

Regardless, taxpayers' offshore noncompliance can be enabled by the limited transparency that is the hallmark of many offshore jurisdictions. Some offshore jurisdictions share very limited information about U.S. taxpayers with IRS, and those wishing to evade taxes can devise elaborate, sometimes multinational, schemes to hide their activity.

Due to the limited transparency of offshore investments and transactions, compliance for those with offshore activity relies on self-reporting. Years of IRS research have shown that when compliance is so heavily voluntary, taxpayers tend to be non-compliant.

Financial advisors may also facilitate many offshore schemes. Advisors may cater to a retail market through conferences open to a very wide variety of individuals; alternatively, advisors may target just those with very substantial income or assets. Either way, advisors can use the relative ease and low cost of creating offshore accounts, companies, trusts, et cetera to help taxpayers hide their income.

These characteristics of offshore locations or activity make IRS enforcement challenging. The complexity of offshore cases results in examinations with an offshore component taking much longer than normal examinations—that is, audits. For the period we studied, the median time between a return being filed and the completion of an offshore examination was almost 500 days longer than for all other examinations.

Due to the 3-year civil statute of limitations, IRS sometimes prematurely ends offshore examinations even though declined cases may have more assessment potential than cases that are not near the statutory deadline. Congress has granted exceptions to the 3-year statute in some situations, for instance, when a taxpayer fails to report listed transactions. GAO suggests that Congress consider a statute extension for cases that do involve offshore activity.

To promote offshore compliance, IRS established the Qualified Intermediary program, QI program, in the year 2000. The program does help ensure that U.S.-source income paid to foreign persons is properly taxed. U.S.-source income includes, for example, interest on U.S. and corporate bonds, stock dividends, and rents. QIs are foreign financial institutions that contract with IRS to withhold U.S.-source income that they pay to their customers and to report certain information to IRS.

These QI program features should result in QIs being a better source of withholding decisions than U.S. withholding agents. That is, because QIs are overseas, they are more likely to have direct contact with the foreign customers than U.S. withholding agents would, and should be better able to judge whether customers are qualified for lower tax rates, such as under our treaties.

Second, QIs accept enhanced responsibilities for ensuring customers qualify for lower taxes, such as using IRS-approved documents to identify their customers. Finally, and importantly, QIs agree to have external parties review their accounts and procedures and report those results to IRS. However, the recent deferred prosecution agreement for UBS AG starkly shows that the program is an imperfect tool to thwart offshore compliance problems.

Earlier we made several recommendations to improve the QI program. Perhaps most pertinent to today's hearing is our recommendation that IRS require QIs' external auditors to report any indications of fraud or illegal acts that could significantly affect the results of their reviews of QI compliance. We cannot say that having this reporting requirement in place would have forestalled UBS's efforts to defraud the U.S. or led to earlier detection. However, the type of fraudulent activity engaged in by UBS is what our recommendation would cover.

That concludes my statement. I would be happy to answer questions.

The CHAIRMAN. Thank you very much, Mr. Brostek.

[The prepared statement of Mr. Brostek appears in the appendix.]

The CHAIRMAN. Mr. Josephson?

STATEMENT OF WILLIAM JOSEPHSON, FRIED, FRANK, HARRIS, SHRIVER, AND JACOBSON, LLP, NEW YORK, NY

Mr. JOSEPHSON. Thank you, Chairman Baucus, Senator Grassley, other Senators. I am very happy and honored to be able to appear before the committee again.

As the committee knows, I have prepared a very detailed statement that actually harks back to the committee staff recommendations in June of 2004 for charity reform; many of those recommendations have been enacted, too many have not.

I would like to submit my statement for the record. It contains a detailed list of proposed changes in the code, affecting both publicly supported charities and private foundations that I hope the committee will seriously consider.

The CHAIRMAN. Without objection, it will be included.

Mr. JOSEPHSON. Thank you.

[The prepared statement of Mr. Josephson appears in the appendix.]

Mr. JOSEPHSON. I would like to make a few general remarks about what I think the implications for charity the Madoff scandal has, and what I think the committee and the Congress need to do to try to ensure that charities do not get so involved again.

The Madoff scandal dramatizes the need for Congress to make a public policy decision that has needed to be made for a long time, but which it has deferred. We can go on as we have been, paying lip service to the Federal and State laws that affect fiduciary investment responsibilities.

In fact, the State laws are extremely difficult to enforce and have very little teeth. The jeopardy investment rules which are most pertinent to the Madoff scandal have, also, very little teeth, and the enforcement resources available to the IRS to do something about them are meager and inadequate to the task.

These facts send to charitable fiduciaries the wrong but unmistakable message that their fiduciary responsibilities somehow are less onerous and less important than those that they owe, for example, to trusts some of them may have for their children.

Alternatively, Congress can, and should, rewrite not just the private foundation jeopardy investment rules, though they certainly need to be rewritten, and apply them not just to private foundations but to all exempt organizations, including public charities, but Treasury also can rewrite the jeopardy investment regulations to make them as detailed and comprehensive as the excess compensation and benefit regulations are with respect to public charities that pay too much to their managers.

While Congress is doing this, hopefully it can clean up various anomalies in the code between the treatment of public charities and private foundations and the treatment within those categories that I discuss in detail in my statement.

Most important, Congress can at least give the Internal Revenue Service the resources that it should have had since 1969 to do the necessary public charity and private foundation enforcement that 40 of the 50 States do not do at all, and the other 10 do inadequately; otherwise the parade of charity scandals will continue endlessly.

Of course, the charities' trade associations will object. They will argue that "we will not be able to get people to serve as directors or trustees." But I know of no systematic, empirical evidence that that is true. From my own experience, I know that, if one truly cares about doing good, one serves, one takes one's service seriously, and one accepts those responsibilities and those liabilities.

The charities' arguments in this area remind me of those that were made when I was the head of the Charities Bureau, and Attorney General Elliott Spitzer reversed the longstanding precedent of his predecessors in order to give donors standing to enforce their restricted gifts. The charities argued that there will be a plethora of lawsuits the charities will have to spend charity money defending.

Well, unfortunately perhaps, that has not happened because, unlike for but one example, the Robertson family in the Princeton case where I was an expert witness for plaintiffs, too few donors have the motivation, the resources, and what Mayor LaGuardia used to call the intestinal fortitude to enforce their restricted gifts.

The committee staff recommended, in June of 2004, that the size of charity boards should be limited. Most of them are far too big, as compared, for example, to the for-profit boards of public companies. This is bad because responsibility of those fiduciaries is diffused and diluted, and those fiduciaries do not feel, and cannot be held, accountable for what they do.

Thank you, Mr. Chairman. I would be glad to answer any questions.

The CHAIRMAN. Thank you very much, Mr. Josephson. That was very persuasive.

I will start with you, Commissioner. Let us just do the math. Say an investor who lost $500,000 with Bernie Madoff, under these new guidelines—maybe not so new—what would the tax treatment be? What could the investor recoup?

Commissioner SHULMAN. Well, a couple of things. One, any investment made with—and I want to clarify, the ruling and procedure we put out today are trying to be applicable to all Ponzi schemes, not just the Madoff situation.

The CHAIRMAN. Right. Right.

Commissioner SHULMAN. I will use the example under Madoff. It is an investment theft loss. The $500,000—it can include both money put in, as well as earnings over time that were left in their account with Madoff.

The CHAIRMAN. Right.

Commissioner SHULMAN. And this is assuming they paid taxes on those earnings.

The CHAIRMAN. Correct.

Commissioner SHULMAN. It will be deductible in the year discovered, and we give some guidance in the revenue procedure about how to determine the year that it is discovered.

The CHAIRMAN. The full $500,000? I am sorry. What is deducted, what amount?

Commissioner SHULMAN. An amount. And then we have the procedure of safe harbor that says you can deduct up to 95 percent without us looking further. I mean, we will obviously make sure the documentation is correct, but there is a safe harbor of 95 percent immediately. Subtract from the 95 percent private insurance, including SIPC that you might get back, and you can deduct that 95 percent immediately. Then the remaining 5 percent, if you recover more in later years, is taxable if you have already taken a deduction. If you do not recover the 5 percent, you can then take that deduction later. So there is basically a safe harbor for 95 percent.

The CHAIRMAN. So about 95 percent is deductible then, basically?

Commissioner SHULMAN. More or less.

The CHAIRMAN. More or less. All right.

And these regulations. When are they in effect? When can taxpayers expect to be able to utilize them?

Commissioner SHULMAN. They can utilize them immediately. We plan to put them out on our website later today.

The CHAIRMAN. All right.

With respect to offshore problems, Mr. Brostek, last week the Finance Committee released a bipartisan draft of legislation intended to give IRS more tools, about eight proposals. One is information

reporting to the Service when funds are transferred to offshore accounts, and another requires the Foreign Bank Account Report, FBAR, to be attached to the tax return.

Just give me a sense of how effectively this will help us begin to solve this problem of evaded taxes.

Mr. BROSTEK. As I noted in my statement, when compliance is really dependent on the self-reporting of individuals, data indicates that taxpayers tend to take advantage of that lack of transparency.

The CHAIRMAN. Right.

Mr. BROSTEK. In general, the provisions in the bill appear to be trying to get more transparency over the transactions of individuals.

The CHAIRMAN. Right.

Mr. BROSTEK. Therefore, they ought to have something of a deterrent effect on the non-compliant behavior, reduce it just because the reporting is there. The provision should also give IRS some additional information to use in making more efficient use of its own resources to identify who is likely being non-compliant and, when they are doing audits, to be more efficient about conducting those audits and determining how much noncompliance there is.

The CHAIRMAN. How effective do you think it will be? I mean, is this enough? Do we need to do more? What is your sense? If we want to close this down, this overseas tax evasion, this tax gap, what do we have to do?

Mr. BROSTEK. Well, I hate to be pessimistic, but I do not think——

The CHAIRMAN. I want you to be realistic. But you are a good public servant.

Mr. BROSTEK. To be realistic, I do not think we are ever going to completely shut down tax evasion. Those who would like to evade tax are very inventive. They have people who are very inventive working for them, particularly those who have a lot of resources who can hire very good talent. So, I cannot say how much precisely your proposed legislation would reduce the gap. I do think it would be helpful. I do think it would reduce the amount of noncompliance.

The CHAIRMAN. So what more could we do?

Mr. BROSTEK. I do not have a set of proposals for you today.

The CHAIRMAN. Just some thoughts, some ideas.

Mr. BROSTEK. All right. Well, as I noted in the statement, I do think that one of the things you have in your legislation is to expand the period of time that IRS has to conduct audits, to extend the statute of limitations.

The CHAIRMAN. We do that, from 3 to 6.

Mr. BROSTEK. Yes. And I think that is desirable for a number of reasons, but in part because IRS agents are very careful not to extend over the statute of limitations. When we did our review of this situation, we found a number of individuals—I believe there were about 35 agents—who had been disciplined for taking more than the statutory amount of time in the 2-year period we studied. So extending the statute will make the IRS agents more able and willing to investigate complex cases that run beyond a 3-year period.

The CHAIRMAN. All right.

Americans are quite angry about these—I am going to ask this of you, Commissioner Shulman—AIG bonuses paid, and other bonuses paid. So my basic question to you, and it really outrages me, as it does, I think, most Americans. We want to do what we can to stop this nonsense. President Obama has made lots of statements about, he is trying to stop it. I think at one point the Treasury was in a position to stop the bonuses, but for some reason did not, I think in part they listened to the argument, we need those folks, they are experts, and all that. If they do not get their bonuses, they might leave. We do not know how to unwind all this stuff.

That has no effect on me. There are enough bright people in this country whom I think would go to work to try to unwind this. People there do not have to receive bonuses to stay. As I am told, they are really retention bonuses designed to encourage the folks in this product section to stay. But I do not think those bonuses should be paid. I do not know to what degree we can go back and get them. I do not know. But another option is to tax them. So the basic question is, what is the highest tax that we could impose on those bonuses that would be sustainable in court?

Commissioner SHULMAN. Let me say a couple of things, Mr. Chairman. As a citizen, I share your outrage. I cannot add a lot to what the President said yesterday, that he was outraged by these bonuses. I think we, obviously, operate within the contours of the tax law, and I have not looked at and do not know the specifics of this situation. But I will tell you, I heard you say earlier that this committee is going to look at this, and we stand ready, as you explore these issues, for the IRS to do what it can to assist in that exploration with both the committee, and obviously with the Department of Treasury. But I cannot answer the tax number.

The CHAIRMAN. I would like you to work with us, and we will work with others, too. But we have to find the answer to that question: what is the highest excise tax we can impose that is sustainable in court?

Senator Nelson, you are next.

Senator NELSON. Perhaps 90 percent, Mr. Chairman.

The CHAIRMAN. Let us find out what it is.

Senator NELSON. I want to congratulate the IRS and the Justice Department. When you exposed the massive fraud on the Swiss Bank, UBS, do you have any reason to believe that UBS is a one-time aberration, or are there other banks out there engaging in this fraudulent activity?

Commissioner SHULMAN. Yes. Thank you for your commendation. We have been trying to be very aggressive around offshore tax evasion.

I guess I cannot speak to other financial institutions. I think, as Mr. Brostek said, this is an issue that people are pushing the envelope on. What I will tell you is, we have a robust voluntary compliance initiative. We have a whistle-blower program. We know that taxpayers who were hiding assets overseas—we have their attention and they are very nervous because the IRS is applying more pressure and committees like this are talking about legislation.

I will also tell you that financial intermediaries that are facilitating this through a lot of formal and informal conversations have

paid attention and are making sure they have their ducks in a row and are abiding by the Qualified Intermediary program.

We are going to intensify and add to the tools in the Qualified Intermediary program and then hopefully work through some legislation. So I cannot talk to you about numbers and cannot talk to you about specific investigations, but I can tell you that we are heartened by the successes we have seen in this case. We plan to continue pursuing our summons around this case, and we are going to pursue anyone we find is facilitating offshore tax evasion.

Senator NELSON. All right. So the answer is, you do not know of any others?

Commissioner SHULMAN. I think the answer is, we have a whole bunch of things we are looking at. We have taxpayers coming in under the whistle-blower program. I am not in a position to speak publicly and authoritatively about others, but I can tell you this is an area we are looking at very closely.

Senator NELSON. All right. Well, thanks to the chairman, we are going to get into some legislation on this; the chairman has filed one version; I filed another version with Senator Levin.

There is a unique little wrinkle here, that an American citizen can go to a very exclusive tax shelter, the Virgin Islands' Economic Development Program. How many taxpayers participate in this Virgin Islands tax shelter, and what kind of oversight is the IRS exercising on them?

Commissioner SHULMAN. The first question, I do not have the number. As you know, the law allows the U.S. Virgin Islands to set up its own Economic Development Zone and have special tax rates. Any time we see special, significantly lower tax rates, it obviously presents potential opportunities for people to play games. We have some public lawsuits going on around this. We have a number of open cases where we are pursuing these issues.

The real issue hinges on the residency: is someone really a resident of the U.S. Virgin Islands, and what is their source of income? Is it a U.S. Virgin Islands source or a U.S. source? It is very fact-intensive. We have a number of open cases, some of which are docketed and you can see in the courts. But we are pretty focused on this, just like we are focused on a lot of places that have much lower tax rates where people are taking advantage of the system.

Senator NELSON. Will you share with the committee how many taxpayers participate in this Virgin Islands shelter?

Commissioner SHULMAN. Yes. I do not know. I will share with you what we have. I am not sure we have a clear definition of the Virgin Islands shelters, but I will get you as much information as we can.

Senator NELSON. All right. Thanks to the good work of the GAO, you found out that a number of financial institutions that have been receiving considerable Federal assistance from the TARP program have utilized the subsidiaries in countries or territories as tax havens. For example, AIG has five subsidiaries in Bermuda; Citigroup has 90 subsidiaries in the Caymans; Bank of America has 59 subsidiaries in the Caymans and even others in the Bahamas, Bermuda, and the Virgin Islands.

Now naturally, part of this outrage that the chairman has talked about is that the taxpayers want to know why, if they are receiving

all of these bailouts, are they also getting the shelter in these tax havens. Is it a valid business reason that they are creating these entities? Do you believe that tax avoidance underlies the decision or is it a legitimate decision by banks to create these subsidiaries in low- or no-tax jurisdictions?

Mr. BROSTEK. I think it is a mixture, sir. The work that we did for the chairman and ranking member on the Cayman Islands suggested that there are subsidiaries created in some of these low-tax jurisdictions for what I think we would all agree are fairly legitimate business purposes. For instance, we saw that the sale of U.S. manufactured aircraft was facilitated through the Export-Import Bank, a U.S. Government-affiliated entity that had worked with Boeing and other manufacturers, to sell airplanes through the Cayman Islands.

But I also think that a number of these facilities are set up for legal tax avoidance, trying to minimize the tax that the corporate structure pays as a whole. There are undoubtedly some situations where these are used to step over the line and illegally evade tax.

Senator NELSON. Mr. Chairman, we have to put a stop to this nonsense.

The CHAIRMAN. We do. It is an outrage. It is an absolute outrage.

Senator NELSON. It is part of the way that we can solve the budgetary deficit problem, get the tax that is owed instead of allowing all of this tax avoidance.

The CHAIRMAN. I think that is true. As Mr. Brostek said, first we have to distinguish between individual tax evasion, and then corporate, with respect to tax havens. There is a difference. But nevertheless, the tax gap in each case is very, very large, and it is about time. This country has given lip service to that for a while. We have made several attempts at it, but we have never really done enough significantly about it. Now is the time to do it.

Senator Enzi, you are next.

Senator ENZI. Thank you, Mr. Chairman. I appreciate you holding this hearing today. It has already been educational, and I appreciate Commissioner Shulman's explanation and clarity on the announcement on the tax treatment.

But it is clear that there is massive undersight of this fraud by both the Securities and Exchange Commission, charged with investor protection, and the Financial Industry Regulatory Authority, charged with oversight of the broker/dealer members.

Can you give me a little idea of your authority as IRS Commissioner in investigating false income statements in this regard? Can you give us suggestions for ways the IRS can keep this from happening?

Commissioner SHULMAN. Well, at the end of the day, most of our enforcement resources are focused on making sure we collect the proper amount of tax. That is what we had been focused on. It is not our primary responsibility to oversee investment schemes.

With that said, we have, for instance, in our Criminal Investigation Division, some of the best forensic accountants who can follow the trail of money in criminal cases. We make those people available to the FBI, to other agencies who are investigating fraud, and we will continue to do so. I believe that information-sharing among Federal Government agencies, so we all view ourselves as the U.S.

Government trying to do right by the American citizens, is the way we should approach things.

So, to the extent we can either synthesize information or we can compare information on tax returns, albeit within a responsible way, not sharing taxpayer data and not breaking that trust, is important to do. So we have had conversations with a variety of our agencies about which of our resources we can offer to help them as they try to go after a whole number of frauds that have come to light around this current financial crisis that we are in.

Senator ENZI. It is estimated that we stand to lose about $17 billion on this tax scam in taxes that we will not be able to collect.

Commissioner SHULMAN. On—I am sorry?

Senator ENZI. On the Madoff scheme.

Commissioner SHULMAN. I had not seen that estimate. I am sorry.

Senator ENZI. All right. I would be interested in an estimate of what was probably lost by the time we do the tax adjustments that will be coming up.

Chairman Baucus's proposal for treatment of offshore funds transfers requires financial institutions to report to the IRS any amount of funds transferred out of the country. Based on my reading of the text, this includes transfers such as remittances to families living abroad and U.S. citizens making purchases overseas. Could you comment on that interpretation?

Commissioner SHULMAN. I cannot comment on the interpretation, because I think the legislation will still be hashed out. I would defer to committee staff.

The CHAIRMAN. Right.

Commissioner SHULMAN. What I would say is, I have had a lot of conversations with this committee, with the chairman. One of the keys to really getting after the tax gap, if not *the* key, is information reporting. So as a general concept, I am a big fan of information reporting. On this specific proposal, we look forward to working with the committee. Any time we get information reported to us, there is a responsibility for us to take that information and make sure we sort through it and pursue people who are involved in abusive transactions, and not pursue innocent people who are just in the business of doing financial transactions.

So, if that is in there, I think the onus will be on us to make sure we are not pursuing somebody who is wiring money to his daughter who happens to be studying abroad, but that we are actually following a money trail to people who are hiding assets overseas and trying to avoid paying taxes.

Senator ENZI. And what particular groups would those be?

Commissioner SHULMAN. Excuse me?

Senator ENZI. What particular groups would those be, that this would now target, that we are not already requiring reports for income transfers under the current law?

Commissioner SHULMAN. Well, as I understand it, the proposal is actually putting responsibility on the financial institution to send information to the IRS. Right now, every citizen has to voluntarily report what is happening overseas with their account, the taxes that are due. The problem with that system is, honest taxpayers are reporting and paying taxes; we often do not have a line

of sight to dishonest ones. So I think all these legislative proposals are trying to get us a line of sight so that honest taxpayers will not be footing the bill for the dishonest taxpayers.

Senator ENZI. Thank you. My time has expired. I look forward to working with the chairman on the proposal.

The CHAIRMAN. Thank you, Senator. I might say that clearly we are going to work this out so that some of the concerns you are implying are addressed. I think the main point being, this is third-party reporting, third-party information reporting. It kind of gets to the point that Mr. Brostek was making, that sometimes people do not voluntarily report everything. The average American taxpayer, I think, does. But I think to a large degree we are not talking about average American taxpayers. We need third-party information reporting. Thank you.

Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman. I want to thank you for holding this hearing, in part, at least, at the request of Senator Cantwell, Senator Menendez, and me, and I appreciate that.

The CHAIRMAN. Right. You are welcome. You bet.

Senator SCHUMER. I have a brief opening statement to make, and then I will ask some questions of the Commissioner.

OPENING STATEMENT OF HON. CHARLES E. SCHUMER, A U.S. SENATOR FROM NEW YORK

Senator SCHUMER. The perfidy of Bernie Madoff is now well known. His Ponzi scheme victimized not only well-known names such as Steven Spielberg and Fred Wilpon, the owner of the Mets, but hardworking middle-class people who thought they were making prudent investments for their retirement. Madoff's fraud has jeopardized dozens of union pension funds in upstate New York, as well as 150,000 philanthropical foundations. The fraud affected hardworking middle-class individuals who thought they were investing wisely and safely for their retirement years, and, just like that, they are wiped out.

I would like to ask the committee's permission to enter into the record personal stories of three Madoff victims: Adriane Biondo, Ronnie Sue Ambrosino, and Richard Friedman.

The CHAIRMAN. No objection.

[The information appears in the appendix on p. 75.]

Senator SCHUMER. The pain this man inflicted is as widespread as it is piercing. Two weeks ago today, I wrote you, along with Senators Menendez and Cantwell, asking for the Finance Committee to hold a hearing on the various tax issues related to the Madoff fraud. I asked for the hearing because I was worried that, not only had people lost their life's savings, but they also would have paid taxes on money they never received, and they should be able to get that money back. I want to thank you, Mr. Chairman, for agreeing to the request and scheduling the hearing so quickly.

After Madoff's arrest, several questions arose about provisions of the tax code related to the theft-loss deduction and when taxes paid in past years on phantom income might be eligible for a refund, among other issues. People were confused about what to do on their 2008 tax returns and needed guidance from the IRS. I am very pleased that in each area in which there was a major dispute,

the IRS sided with the victim. The IRS ruling says that people can take a theft-loss deduction in 2008 for any money directly invested with Madoff, including any reinvested gains, and that such losses can be carried back for 5 years and forward for 20 years.

By treating the theft losses this way, victims will not have to worry about filing amended returns for prior years. This means the victims will not owe taxes on income they never received. Victims will receive the most lenient tax treatment in a simple and straightforward way. The guidance the IRS is issuing today is clear, it is comprehensive, and it comes at a crucial time. I want to thank the Commissioner and your entire team for their good work, with my office and those of others.

There are some issues left unresolved, and I will explore those in questions. But for the most part, I believe the prominent issues have been addressed, and we are hearing from victims and their lawyers that they are very pleased with what the IRS has done.

So I want to thank you, Mr. Chairman. Now I would like to just, with my remaining time, ask a question or two.

First, to the Commissioner. Again, thank you, Commissioner. You did a very good job here. Your testimony states that the safe-harbor procedure outlined by the IRS says that taxpayers should deduct from their losses their expected SIPC recovery of $500,000 per investor. I can see how part of this guidance might raise questions, since it might be many years until the SIPC claims are paid or until it is clear what the SIPC recovery will be.

Does the IRS guidance allow taxpayers to simply decline to make an SIPC claim and assert the position by some form of affidavit and increase their eligible theft loss? Why would it not be preferable to allow people to defer the SIPC reimbursements and take the full tax loss now, but, if they receive an SIPC claim in the future, then the tax implications can be taken into account at that time? Because people are worried, they are desperate, and they do not know what the SIPC is going to do for them yet.

Commissioner SHULMAN. Yes. A couple of issues. One is, we have actually met with SIPC. I have met with the chairman. Unfortunately, in this tragic situation, probably the best chance of people getting some money back is through SIPC and then recovering some of the taxes that they have paid. So, it is important.

What I would say is, each taxpayer is a little different. SIPC is treating people directly invested differently than they are people not directly invested. So the way that our guidance reads—and again, it is not just Madoff; we are trying to cover Ponzi schemes in general because, in down economies, that is where you usually see more Ponzi schemes come to light—is that the loss is deductible except for reasonable prospect of recovery.

So what I guess I would say is, whether or not people expect to get SIPC, the facts and circumstances dictate actions, depending on where they were situated in this Madoff scheme. People are going to have to use their best judgment coming under the safe harbor. Again, there is a true-up at the end so, if they get money and they took a deduction, they are going to have to pay taxes on it. If they did not, if they thought they were going to get money and they never get it, they can take that as a deduction later.

Senator SCHUMER. I would just ask you, in this guidance, to be, again, as much on the victim's side as you can be, given the awful situation they are in.

The CHAIRMAN. Thank you. Thank you.

Senator Menendez?

Senator SCHUMER. Mr. Chairman, I have other questions. Are we going to have a second round?

The CHAIRMAN. Yes.

Senator SCHUMER. Great. Thank you.

The CHAIRMAN. Senator Menendez?

Senator MENENDEZ. Thank you, Mr. Chairman. I want to join my other colleagues who asked you for this hearing. I appreciate you doing it so quickly as well.

The CHAIRMAN. You bet.

Senator MENENDEZ. Bernie Madoff is probably the most visible and incredible example of a calamitous failure of the Federal Government's responsibility of its regulatory agencies to oversee the market. We have had some of those hearings in the Banking Committee. The failures of regulators to detect his crimes are pretty outstanding, and we are left with the aftermath of personal tragedies for people who have had their entire life and their nest eggs become empty shells, and face some real, real difficult choices in their lives. So I appreciate, Commissioner, the guidance that you are issuing today.

I want to follow up with one or two questions, and hopefully you will have the answers. If not, we will hear it subsequently. Just to follow up on Senator Schumer's question, according to your guidance, victims of the Madoff scandal who invested through feeder funds have to wait for those funds to file their tax returns and distribute the proceeds from the Securities Investor Protection Corporation payments and the deductions, proportionately.

Now, this leaves a lot of these victims, many of whom had no idea that they were even invested with Madoff, at the mercy of the prompt action of their funds. I know you said you had a meeting with the head of the SIPC. Is the IRS going to appropriately monitor the distribution of these proceeds through the feeder funds to ensure individual victims receive a timely and accurate payment from the funds?

Commissioner SHULMAN. Senator, we are pretty focused on this issue of direct investors, indirect investors, feeder funds. What I would say is, we did not make up any new law in putting out this guidance. We did our best interpretation of existing law. The way that any investor, in any kind of loss through a fund, gets that is usually through their K–1.

So it is really going to be up to the direct investor to claim this deduction and then flow through to their partners—or whomever else, however it is structured, LLC, partnership—the losses. So, if you invested in a partnership that then invested in Madoff, the only way you are going to know what the gains were in that partnership for other investments, what the other losses were, and what the Madoff issues were, is to get that partnership return through your K–1. What we will be doing is making sure that the loss is appropriate for the actual partnership when they file it with

us. So I am not sure if I answered your question, but the bottom line is, that is how they will do it.

Senator MENENDEZ. I am just concerned that, while they have to wait for the feeder funds to do their work and their reporting, that they are left out there waiting. So it is going to depend upon the diligence of the feeder funds at the end of the day?

Commissioner SHULMAN. At the end of the day. I mean, I think there is no other way, in any sort of partnership, that you can file a tax return. You have to know what the partnership has.

Senator MENENDEZ. We will have to look at it.

Commissioner SHULMAN. Yes. We will be happy to look at it and talk with you.

Senator MENENDEZ. Let me ask you, in terms of documentation of losses, what is going to be considered proper documentation to establish losses, in particular? I know that you are looking at Ponzi schemes in general, but due to the Madoff fraud—for example, is the IRS going to permit those who were feeder group victims to establish that they incurred losses by the use of statements and other documentations that they received from the feeder group?

Commissioner SHULMAN. Yes. I mean, in general, yes. This is general guidance. But in the Madoff case, we anticipate statements are good enough because people actually got this phantom income that they paid taxes on. The idea is, you can now get a deduction for it.

Senator MENENDEZ. Let me ask you, in our letter to you we asked whether or not you were going to establish a special unit to process claims related to the Madoff fraud and similar fraud, simply because of the efficiency and the size of this particular Ponzi scheme. Is that something that you are contemplating at the Agency?

Commissioner SHULMAN. What we have done across the board is, we have taken a look at this very significant economic downturn that we are in. Everything from NOL carry-backs for small businesses to individuals in hardship situations to those who have Ponzi schemes—we made sure that we have streamlined processes to take care of it.

So what we have done is, we already have units that can take care of this. You will notice that there is going to be a special form if you are looking to operate under the safe harbor, so you will self-identify that you are a victim of a Ponzi scheme, and those returns will be handled appropriately and expeditiously.

Senator MENENDEZ. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Grassley?

Senator GRASSLEY. Yes. Mr. Chairman, if I could, before I ask questions, reinforce the dialogue that we had at the opening of this hearing. You alluded to some ways in which we could make sure that the intent of a portion of the TARP legislation be carried out. In that legislation, the Finance Committee insisted that executive compensation be limited by way of: (1) the loss of tax deduction for the institution, and (2) a penalty tax for executives in the cases of excess golden parachutes.

Under the legislation as enacted, these tax limitations only applied in the case of an asset sale. But last year we were told that

Treasury would no longer purchase troubled assets in an auction sale. Instead, Treasury has and will continue to infuse taxpayers' funds into a financial institution largely through direct purchases. It is now high time that we apply the tax-related limitations to direct purchases.

I know that Treasury made an attempt to do this in Treasury guidance. In my opinion, that guidance falls short of enforcement. Enforcement would be stronger if the limitations were written in the code. While we are at it, we should write other limitations into the tax code, like claw-back policies and other penalty taxes on bonuses. So, I wish you would consider that, at least.

The CHAIRMAN. You bet.

Senator GRASSLEY. Mr. Commissioner, as I mentioned in my opening statement, I appreciate that the IRS is moving quickly to assist taxpayers during these difficult times, including victims of Ponzi schemes. However, I am concerned that the guidance issued today will cause tax cheats to consider taking abusive deductions. Could you tell me how the IRS intends to monitor theft loss deductions to ensure that only victims of actual Ponzi schemes can take advantage of the guidance that you are issuing today?

Commissioner SHULMAN. Yes. Sure, Senator. That is a great question. Anyone who takes advantage of the safe harbor and the streamlined implementation procedure we are putting out today has to attach a form, so they self-identify. That is the key. When people self-identify coming in that they are claiming a special deduction, we can identify that group. We can take samplings out of that group. We can look behind the returns there.

So we will balance expediting these so that people who are victims of devastating loss actually have the opportunity to get some relief, but we will also have enforcement and audit coverage to make sure we look behind these so that we do not have a lot of fraud.

Senator GRASSLEY. All right.

Next, let us take a look at the disheartening situation of billions being lost by charitable victims of Ponzi schemes. In Congress, in 1969, we provided the IRS with some tools to curb bad investment decisions by private foundations, including the section 4944 excise tax on jeopardy investments.

Can you tell me if the IRS is considering assessing this tax on individuals who ran some of these organizations, particularly the ones which have been shut down? I would also appreciate if you could tell me how often the IRS has assessed this tax in recent years.

Commissioner SHULMAN. Yes. I think you are referring to the private foundation jeopardy investment rules where we have the ability to assess a 10-percent excise tax on people who do not exercise due diligence and proper monitoring of investments.

Senator GRASSLEY. Yes.

Commissioner SHULMAN. I cannot tell you, because we have not gotten returns in yet around Ponzi schemes, how many investigations are open. What I will tell you is that it is a tool that is available to us that we certainly will consider. I do not have the answer. I will have to come back to you, if it is all right, on the number of times we have imposed the tax in recent years.

Senator GRASSLEY. That is very good. Thank you.

Mr. Josephson, your testimony troubles me, as you seem to indicate that many States are not minding the store when it comes to protecting charitable assets. Yet the panel on the nonprofit sector and others recommended that the IRS not be given authority to enforce State fiduciary duty rules. Can you briefly discuss the fiduciary duties that States are supposed to use to police? I would also appreciate hearing your thoughts on whether Congress should provide the IRS with authority to enforce State laws when the State is unable or unwilling to act.

Mr. JOSEPHSON. As you know, Senator Grassley, the State laws for charities are widely unenforced. Forty States have no charity enforcement capability at all, and very little interest in enforcing the State laws with respect to charities.

Of the 10 or so States that do, resources are very limited. State law does not provide effective means for enforcers because many State laws contain rules like the misjudgment rule and the exculpatory provisions in the Uniform Management of Institutional Funds Act, that make it extremely difficult—extremely difficult—for State charity officers to get results in these prudent investment and other abusive situations. That is why your committee staff, in 2004, and myself in my own testimony before the committee over many years, have advocated additional resources to the Internal Revenue Service for this purpose, and also a revenue sharing that might encourage States that do not enforce the charity laws to do so.

The vehicle for this, as you know, could well be the excise taxes and penalties that were provided in the 1969 Tax Reform Act, which were intended at that time to be used for charity oversight by the Internal Revenue Service. Unfortunately, that has never happened. So as my testimony indicates, for example, the exempt organizations' people have very few examiners, fewer than 500, and yet there are 1.8 million exempt organizations, and 70,000 exempt organization applications are filed each year. This is an enforcement burden that cannot be discharged.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Stabenow, you are next.

Senator STABENOW. Well, thank you, Mr. Chairman, for holding this hearing. Let me start by saying I appreciate President Obama's comments and leadership on these issues, and the chairman's leadership, and Senator Levin's, and others who are working very hard to address what has become an outrage.

I think the majority of Americans feels that we somehow now have created this culture of greed in this country, whether it is Bernie Madoff, or AIG bonuses, or the growth of offshore tax havens. The majority of people who are working hard every day and playing by the rules and just trying to have a good life for their family look around and go, what in the world is going on?

So, Commissioner Shulman, I want to thank you. It is kind of nice to hear positive things about the IRS and what you have been doing on behalf of victims, on behalf of people who find themselves in difficult times not of their making. I would encourage you to con-

tinue to keep them foremost in your actions as you think about what needs to be done, in particular right now, for people.

I would like to speak a little bit about what is happening globally, because this did not happen in a vacuum. We are in a global financial system. We have a global regulatory system, a global credit crisis. In the last quarter of 2008, the world economy shrank for the first time since 1945. The IMF expects global growth to be negative this year and the first annual global contraction for over 60 years.

So it is going to be very important next month, when we see the G–20 summit, to be doing everything possible to effectively work with other countries on this issue. It needs to be a coordinated effort. Every country has a vested stake in what is happening right now. I would expect that cracking down on abusive tax shelters and other issues would be a top priority at the G–20 summit.

So my first question would be, what suggestions do you have for international cooperation as we look at all these issues?

Commissioner SHULMAN. I have been very clear that we cannot have a go-it-alone strategy; that we certainly have interests that we need to pursue on behalf of the United States. But when you get to international tax evasion, the same institutions that are facilitating this behavior, the same people who are trying to hide assets, are either cheating our government of money and our citizens of money, or cheating other law-abiding citizens of money in other jurisdictions.

I think President Obama has been very clear that international tax enforcement, robust international tax enforcement, is high on his agenda. He has also talked about some tax policy around deferral and other things that will be forthcoming, as I said, in the next several months.

We have had a coordinated effort, through the OECD, on trying to bring bank secrecy jurisdictions and so-called tax havens into line with international standards. I am quite proud of the work we have done around the UBS case and others, to bring them to light and bring international attention.

Just last week, Liechtenstein, Switzerland, Austria, Hong Kong, and Singapore all agreed to comply with OECD standards. So I think it is that kind of combination of individual enforcement actions bringing to light these abuses, as well as international pressure. I know it was on the agenda last weekend when the finance ministers met at the G–20. I am assuming these agendas morph over time; clearly, the global financial crisis is a big issue. But I think everybody is very focused on making sure that everybody is playing by the rules, while every government is trying to take care of their citizens and be a global player in the financial crisis.

Senator STABENOW. Well, there is no question that we are seeing some increased transparency and more willingness to share information. I am wondering, specifically with tax haven countries, what we should be doing additionally to encourage or require some way for them to be sharing information, specific information, with us.

Commissioner SHULMAN. Yes. What I would say is, if there are tax haven countries that have been facilitating this—Liechtenstein, for instance, had some problems with enforcement a year ago——

Senator STABENOW. Right.

Commissioner SHULMAN [continuing]. They have now agreed to an information exchange agreement with us. The only way we would agree is that, within a year, they had to change their bank secrecy laws, so our information sharing agreement trumped their bank secrecy laws. We are monitoring that and assuming they do that. If not, we pull back our information exchange agreement. So those are the kinds of things we can do.

I will also tell you that I meet regularly with a group of 10 tax administrators globally, and we have started talking about things like more automatic information sharing, strengthening cooperation. A great example is, we have a thing called JITSIC, which is a Joint Information Tax Shelter Information Center, where we actually co-locate our people with people from other countries.

This year, by people comparing notes, we brought to light a corporate transaction issue that we are aggressively pursuing called foreign tax credit generators, where basically a corporation does one transaction in a foreign jurisdiction, claims a credit, both in the U.S. and somewhere else, which really perverts the foreign tax credit legislation that has been passed. I mean, foreign tax credits are designed so you do not pay taxes here and somewhere else, not so you can generate a tax somewhere else and get a deduction multiple places around the world.

That would not have happened if we were not co-locating people and in deeper dialogue with people. So I think it is going to be a combination of bilateral treaties, multilateral pressure, aggressive enforcement action, potential for policy changes, as well as real dialogue and cooperation amongst countries that have like interests.

Senator STABENOW. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman. Like everyone else, I share in the outrage over the payment by AIG and their announcement of bonuses. It certainly is a staggering insult to the American people. It is in total disregard of the reality of the magnitude of their unconscionable behavior in the first place that has wreaked havoc on the average American, upended and disrupted their lives, people who struggle every day to make ends meet, live by the rules, work by the rules, and now they are losing their jobs, they are losing the value of their pensions. So I think that this is something that we clearly have to focus on.

In fact, in talking about the bonuses, we had the opportunity during the stimulus debate—in fact, Senator Wyden really had legislation that was passed by a voice vote on the Senate floor that would have retroactively given choices to companies, and that would have applied to AIG in this circumstance, where they either would pay a 35-percent excise tax on those bonuses or they would have to return the TARP money, the money the taxpayers had given to AIG and all the other troubled institutions. We fought, during the conference, to maintain that provision. Regrettably, it was dropped. We could have been in a very different situation today had that provision become law.

So I would hope, Mr. Chairman, we would reconsider it. I would hope we could take action. Perhaps we could change even the tax-

ation. We use the top tax rate of 35 percent, but it would have applied in this instance, for AIG, for any contracts, any commitments that were made during the course of 2008, for any bonuses that were paid or were going to be paid. So we would have been in a different situation entirely today had that provision been enacted and accepted by the conference.

Mr. Shulman, UBS has paid $782 million in taxes and penalties for criminal offenses. As we know with AIG, disclosures transferred billions of dollars to financial institutions, one of which, of course, is UBS. I know that they have received $800 million, plus $1.7 billion, for a total of $2.5 billion. It is extraordinary to me that we would have had this kind of transfer to an institution that has secret bank accounts.

We know that they agreed, with our government, to disclose the 250 accounts and their identities, but at one point during the mid-2000s they had more than 5,200 accounts. I think this looks like we are simply laundering this money through AIG so that UBS can pay back their $782 million that they paid for criminal offenses to the U.S. Government. Would you respond, briefly?

Commissioner SHULMAN. Yes. Well, a few things. One, as I said before, I cannot really add much to what the President said yesterday about AIG, but as a citizen, I share your outrage about the bonus situation.

Regarding UBS, we are actually still in active litigation with them. We are pursuing, or the Justice Department is pursuing on our behalf, a John Doe summons to get all of the outstanding bank accounts. I have been very clear that we plan to continue to pursue that and to continue following this trail. I cannot really speak much more about the UBS case.

The Justice Department has asked me not to, so that I, as the leader of an agency, do not jeopardize that case, except to say, for the tax evasion case with UBS, we plan to pursue all the means we can. There has been a case against the institution, and now we are making sure we go after the U.S. citizens that were using that institution to facilitate tax evasion.

Senator SNOWE. It is inconceivable to me, though, that the Treasury Department did look at these cash flows. So on one hand, UBS is paying $782 million in criminal offenses and penalties to the U.S. Government. On the other hand, they have benefitted through the TARP funds of $2.5 billion as a result of the disclosures that were made by AIG. So, yes. I mean, that is something that should have been regarded at the outset. I do not know how it even happened in the first place. It does not make sense.

Commissioner SHULMAN. Yes.

Senator SNOWE. And frankly, it is preposterous. So I do not blame the American people about their anger. But this is something that, frankly, the Treasury Department should have considered in the first place rather than allowing this to happen.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Kerry?

Senator KERRY. Thank you, Mr. Chairman. Thanks a lot for doing this hearing and, again, bringing this subject up as you did earlier last year. We appreciate it enormously. This is a subject

that I have been interested in and following since the 1980s when I stumbled across these issues with the BCCI case. I have brought a number of pieces of legislation which were passed which have helped to increase the level of scrutiny that we have with respect to transfers, the $10,000 piece, the amendments with a number of countries on their cooperative efforts with us. But clearly—clearly—we have only scratched the surface, and I want to talk about that for a minute.

The UBS effort—well, we know there was sort of an initiative taken to reach out to some 20,000 wealthy Americans and actually flout the tax laws through the offshore banking services and evade over $300 million in taxes.

Now, you have mentioned the case is ongoing, but help us, from a legislative point of view and an oversight point of view. Last July when we had the hearing, Jack Blum testified here—and you were here, Mr. Shulman, you were here, Mr. Brostek—the problem of offshore tax evasion is exacerbated by the so-called revenue rule, the understanding that basically no government will help enforce the tax laws of another government. Do you, in fact, find that to be true?

Commissioner SHULMAN. I find it to be varying among governments. I do not necessarily find that blanket statement to be true, because I think there are a lot of like-minded governments that understand that, if one of our citizens is evading taxes and they do not help us, they are disadvantaged when one of theirs is evading taxes; they need to help us. We have treaties around that help us with information exchange.

Senator KERRY. Let me say, as the chair of the Foreign Relations Committee, we are going to look at those treaties, and we are going to start examining the degree to which they have been enforced, not enforced, or are impediments, in some cases.

Commissioner SHULMAN. Yes. No, I think that is a worthwhile effort. What I was going to say is, the model U.S. treaty for taxes has 30 provisions, everything from pensions to annuities to exchange of art, those kinds of things, around tax treatment. It only has one enforcement provision, article 26. That enforcement provision is generally designed. You need to know the name of the taxpayer, for example: Senator Kerry. You have a name. You have to name the account and go after them.

So, while treaties are useful, they do not necessarily spontaneously produce the kind of information that we would like to get. That is why we use a variety of other tools, like a John Doe summons, like other international cooperation, like the QI program, where we have other levers, and clearly the kind of legislation that this committee is considering are levers that we could use.

Senator KERRY. Well, it seems to me that we even have to go beyond that. I mean, I have found that a lot of these governments have just fundamental indifference. I remember going to visit with the Governor of the Bank of England with respect to offshore entities. This was about 10 years ago. I found a remarkable level of disinterest, and even hostility, towards the idea of getting involved.

Gordon Brown came here, now as Prime Minister, a couple of weeks ago and announced from the podium of the House that we have to end offshore accounts that are basically havens. How do we

do that? What is the cooperative effort necessary for you to be able to guarantee that those accounts the chairman referred to in the Cayman Islands are, in fact, legitimate business interests rather than just pass-throughs and cut-outs and shell corporations and so forth? Is there an international standard? This is at the G–20, even, that ought to be discussed in a week or so, that they ought to be talking about international, legitimate business standards, sham transaction standard, and level of scrutiny.

Commissioner SHULMAN. I guess I would say a couple of things. One is, I would say there is no silver bullet. There are going to be multiple pieces of a strategy that includes enforcement regulations, legislation, as well as international cooperation. Two is, I would separate individuals hiding income offshore through sham trusts and accounts, and corporations, because you have two different sets of issues. I think you are asking the question about the corporation set of issues.

As Mr. Brostek said, there are some corporations just doing some business transactions that make sense internationally. There are some that are doing aggressive, but legal, tax planning, and that gets to tax policy. Then there are some who are clearly being abusive and avoiding taxes, and those are the ones that we go after.

I think one of the issues that is on the table, that the President has put on the table in his 2010 budget, is the issue around deferral, because I think your conversation in the U.K.—countries compete on tax rates. Countries compete to have businesses and less regulation/more regulation.

I think what we have seen in recent days is that all countries are connected and that there need to be some standards globally. But probably the simplest things, and they are being discussed as the President signaled in his blueprint, are some of the deferral issues. Because, once a U.S. corporation has to pay taxes everywhere, my job as IRS Commissioner becomes much easier because there is not as much incentive to play games.

The CHAIRMAN. Senator Cantwell? Excuse me. Senator Carper. I am sorry. Senator Carper is next. Sorry.

Senator CARPER. Thanks very much.

Mr. Shulman, you were good to come by my office and meet with me almost a year ago. I think it was before you had been confirmed. You have been on your post for, I think, about a year now. Is that correct?

Commissioner SHULMAN. A dog year. It feels like 7. [Laughter.] Yes. Yes.

Senator CARPER. I was going to say, welcome to the pound. [Laughter.]

You serve a term of 5 years, as I recall. Is that correct?

Commissioner SHULMAN. That is correct.

Senator CARPER. Any idea how long that has been the case?

Commissioner SHULMAN. A 5-year term for the Commissioner?

Senator CARPER. Yes.

Commissioner SHULMAN. It was part of the IRS Restructuring and Reform Act. 1998 was the first 5-year term. So, I will be the third Commissioner who was confirmed for approximately 5 years.

Senator CARPER. I hesitate in asking this question, but do you think it is a good idea?

Commissioner SHULMAN. What is that?

Senator CARPER. Do you think it is a good idea to have a 5-year term that stretches across different terms of a President?

Commissioner SHULMAN. My belief is that the IRS needs to be a nonpartisan, by-the-books agency that enforces the law, that is removed from politics. It is also a large organization with very complex people and technology issues that take many years to actually get a strategy and stick with it.

Senator CARPER. The reason why I ask, I chair a subcommittee that has jurisdiction over, among other things, the Census Bureau. We are wrestling with whether or not the Director of the Bureau of Census should also serve an extended term, as you do, and other Commissioners well in the future. So, thank you very much. The parameters that you just described with your Agency are very similar to those that exist in the Census Bureau. So, thank you.

Commissioner SHULMAN. I will not comment on the Census Bureau.

Senator CARPER. All right. Just fill out your census form, and you will be fine, all right? [Laughter.] As you may recall when you visited with us, we talked a bit about the tax gap.

Commissioner SHULMAN. Yes.

Senator CARPER. We talked about how information is reported. We actually do a pretty good job of collecting taxes from those people. In the stimulus package that we passed, we recently went in a lot of different directions, a lot of it to put people to work. As far as I know, none of that money was directed to the Internal Revenue Service.

I am wondering, though, with respect to the omnibus appropriations bill which was just enacted, and I think just signed by the President, were there any resources provided in that legislation for the balance of this fiscal year that can help you and your colleagues at the IRS do your job better?

Commissioner SHULMAN. The answer is yes. Chairman Baucus and a number of other members of Congress have been incredibly supportive of the IRS and the IRS budget, to go after the tax gap. As we talked about with the tax gap, we have a proven return on investment as an agency: 5:1; for specific programs, it is 13:1, 14:1. So increasing our resources is going to be key.

There was an increase in enforcement resources in the current omnibus bill. President Obama's budget outlines a couple of things. One is robust IRS enforcement programs, but also, very clearly, a long-term commitment, because one of the things about Federal agencies is, if you give a bunch of money one year and then do not in the next, it takes a while to plan, to recruit. When we bring on an agent, we have to pull other agents off of cases to train them. We have to put them on simpler cases and pull different inventory off. So that is a piece of it.

The other thing that is quite helpful that is in the Emergency Economic Stabilization Act of 2008, and that this committee took leadership on, is credit card reporting and basis reporting. The real way to leap-frog and get a real grip on the tax gap is to leverage our resources and also, clearly, information reporting, because the more information we get from third parties, the better we are going to do at our job.

The last thing I would say is there was $51 million in the appropriations—or in the omnibus bill—that just passed for research for the IRS. The only real credible way to do tax gap research is to do audits of returns you would not otherwise do an audit for, because you do not know what is there unless you go and look in places you would not look. Usually we are auditing returns that have higher yields, where we see indicators that there will be collection. We actually do random audits. So this investment in research so we can continue to hone in and target our resources better is key. So, I think we have gotten a lot of support, and we are going to keep at it.

Senator CARPER. Good. I share the passion of our chairman, and that of a number of people on our committee, to go after as much of this tax money that is owed and not being collected. We want to make sure you have the resources, the personnel, the technology to do that work.

Mr. Brostek, you have been, I think, good enough to participate, as I recall, maybe in a round table that we had on this subject several months ago.

Mr. BROSTEK. Correct.

Senator CARPER. The same as the tax gap. Are there some points that you would like to share with us that you would have us focus on this year, particularly within this committee, to go after not just the low-hanging fruit, but the fruit that is a little higher on the tree?

Mr. BROSTEK. Well, there are a number of things that could be done. Looking for additional information reporting is clearly one of the best strategies.

Senator CARPER. When the information is reported, the IRS collects about 90 percent of what is owed.

Mr. BROSTEK. Or more. Yes. I think it is up to 96 percent on complete information reporting. IRS knows exactly the same income items that the taxpayer knows.

One area that I think is maybe a little under-appreciated is the role of the paid preparer community. Well over half of taxpayers use a paid preparer to prepare their returns. There is a pretty good body of evidence that the performance of that community is not stellar.

Senator CARPER. Yes.

Mr. BROSTEK. Sometimes that may be because a taxpayer is not providing good information, but there is also an emerging body of evidence that the preparers themselves are not always diligent and competent. I think that is one of the areas that might be worth paying some attention to.

The CHAIRMAN. Thank you very much.

Senator CARPER. Thank you very much.

The CHAIRMAN. Thank you, Senator.

Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman. I want to add my thanks for you holding this important hearing. Madoff fraud and schemes defrauded about 8,000 people and over $50 billion, so, on top of everything else we have been through, to have this incident happen is just unbelievable. Part of, I think, the importance of the

hearing today is to also look at the regulatory reforms that we need to put in place.

But first, I want to thank Commissioner Shulman for being here, and for the IRS Statement of Guidance that was issued today. I am very pleased that the IRS ruled and with the procedures that we are putting in place so that direct investors can have more predictability on how to handle these theft losses. So I very much appreciate the fact that the IRS has moved forward on that.

My question is in regards to the regulatory side of this equation. Stephen Harbeck, from the SIPC, told the House Financial Services Committee in January, "It became apparent very early in the Madoff case that the customer statements Mr. Madoff had been sending to investors bore little or no relation to reality. The records sent to customers were inaccurate when compared with the inventory of securities actually held by the brokerage firms."

So sometimes tax regulators themselves can help be the canary in the coal mine in showing signs of danger because they can get access to information that others cannot get access to. So while Madoff was sending bogus statements to his clients, they were also making real payments to the IRS. So my question is, could the IRS have connected some of these dots sooner and perhaps focused some of the attention on the right areas? How much interaction does the IRS, Treasury, and SEC have when it comes to coordinating these very complex investment firms?

Commissioner SHULMAN. Yes. A couple of issues. One is, the majority of our enforcement resources are focused on collecting taxes. As you said, one of the issues, the reason we are putting out guidance, is people actually were paying taxes on these. Frankly, we have a big enough job to do, and the complexity of the code is going up, that we need all the resources we can to make sure we collect the proper amount of tax. That is where we are very focused. Our first line of sight is not to look at investment schemes and those kinds of things.

With that said, I am a big believer that I am a public servant. I am here to serve the American people, and I need to coordinate with other leaders in the government to try to make sure it works as efficiently as possible. We have made our forensic investigators, especially our criminal investigators who are very good at following the money trail, available to other Federal agencies to coordinate on enforcement and fraud cases. We have a long tradition of that, but we are doing that especially in some Ponzi-related schemes. You might have seen, we filed some tax issues around another prominent Ponzi scheme just this week.

Senator CANTWELL. Do you think if you would have had the resources and we had better coordination, that we could have connected some of the dots?

Commissioner SHULMAN. I think it is always easy to look in the rear-view mirror. A lot of people were duped by Bernie Madoff, from Federal regulators to very sophisticated investors. We are going to continue to coordinate and assist where we can. We are certainly going to try to make our resources available.

I have actually had conversations with the chairman of the SEC about how we take tips in, and I know she is moving aggressively on getting better at synthesizing tips. So I am a believer that we

can all learn from each other and we should share as much information, expertise, and personnel as we can.

Senator CANTWELL. But do you think there are any legal obstacles for more coordination? Because, again, it seems to me that you have access to records and information that help piece the puzzle together.

Commissioner SHULMAN. Yes. Well, section 6103, which is a pretty locked-down provision around us not sharing taxpayer information, is quite important to the integrity of the whole tax system, that people feel like they are filing taxes, they are bringing information in, and it is not going to be shared.

With that said, that is sharing it with the public. There are some impediments sometimes to sharing with other agencies, and we are certainly open to exploring if the information we have can be helpful in fraud cases and, if so, how to get that into the hands of other authorities.

Senator CANTWELL. Well, I certainly want to explore that with you, because I think the inter-agency coordination and cooperation is critical on many fronts. I would assume with DOJ investigations you probably do that now to some degree but, if you did it across several agencies, that it would also help in identifying these sooner.

Commissioner SHULMAN. I will tell you, the other topic we are talking about with offshore, we are actually now very aggressively having conversations with other agencies around how to triage all the information that the Federal Government has in order to do a better job. So I very much agree with the direction you are headed.

Senator CANTWELL. Thank you.

And, Mr. Chairman, I know that we have had all of this economic crisis on individuals and the impact, but the amount of capital losses that taxpayers can write off against their income is limited to $3,000. I know my colleague, Senator Bunning, has brought this up before. But I think it is something really the committee should look at, maybe spend a little more time looking at this particular area and how we can help consumers.

The CHAIRMAN. Yes. Thank you, Senator.

I would just like to ask you a question, Commissioner Shulman, about UBS. As I understand it, at the urging of the Justice Department, the Justice Department won an agreement with UBS in which UBS agreed to turn over the names of about 250 customers suspected of tax evasion. We are not talking about avoidance here, we are talking about evasion. UBS also agreed to pay a fine of $780 million.

But Bradley Birkenfeld, a former UBS employee, said that U.S. persons had hidden more than $15 billion in assets with the assistance of the UBS Private Wealth Management Group. I think the IRS alleges that approximately 52,000 U.S. persons used UBS to hide assets in that Swiss bank alone, UBS.

What is going on here? They have only given us the names of 250. You think there are 52,000 more. What is happening here? How do we get the information we want?

Commissioner SHULMAN. Well, let me say a couple of things, Mr. Chairman. First of all, I would love to go into this case with you and brag about it, because I think the IRS actually found this, brought this to light. It created international attention.

The CHAIRMAN. And I compliment you for that.

Commissioner SHULMAN. And, as you know, I cannot really talk about specific taxpayer cases, et cetera.

The CHAIRMAN. Right.

Commissioner SHULMAN. What I will tell you is there were two things that happened. There was a deferred prosecution agreement that was around UBS being indicted criminally, that the Justice Department deferred that with a set of conditions that are all part of the public record.

The CHAIRMAN. Right.

Commissioner SHULMAN. There is also the IRS's John Doe summons to force UBS to produce all of the accounts, and that is being litigated through the courts now. So what is going on is, prosecution was deferred on the criminal matter, but we are pursuing the civil matter and continuing to try to get as many of the accounts as we can. My view is, we should get all the accounts.

The CHAIRMAN. Right.

Commissioner SHULMAN. But I cannot prejudge.

The CHAIRMAN. Right.

Commissioner SHULMAN. There is going to be a hearing in July with the judge.

The CHAIRMAN. Right. But how do we get at the Swiss problem? As I understand it, Switzerland makes its own decision whether or not the requested name, John Doe, is violating the law, U.S. law.

Commissioner SHULMAN. Yes.

The CHAIRMAN. They are making their own determination themselves. If they determine, well, gee, maybe this person John Doe is not violating the law, we are not going to send the name to the IRS.

Commissioner SHULMAN. Yes.

The CHAIRMAN. That is a problem. That is not their judgment as to whether U.S. law is being violated, that is the judgment of the United States, it would seem to me.

Commissioner SHULMAN. Yes. One of the problems—and we talked about treaties a little bit before—is sovereign law often trumps treaties. These indications we have gotten from some of the bank secrecy jurisdictions, including Switzerland, to comply with the OECD standards would actually have our information exchange potentially trump sovereign law. So that is one of the ways to get at it. Bank secrecy is a big issue for us at the IRS.

In the Swiss case, as I understand it, for us, you send in a tax return, you sign your tax return. If you do not, if you basically lied on the tax return, it is tax evasion. The Swiss interpretation is not the same. You actually have to actively—it is not just about signing a tax return and sending it in—you have to actively conceal assets, set up phony trusts, and have acts of commission rather than omission.

The CHAIRMAN. Right. So to what degree would the information reporting actually trump sovereign Swiss law?

Commissioner SHULMAN. What information?

The CHAIRMAN. To what degree would information—if we require—if this legislation we are contemplating here were to be enacted, to what degree would that help?

Commissioner SHULMAN. Well, I think what it would do is, I am not sure it trumps Swiss law, but we would actually see the flows going out of the U.S. and be able to connect that to U.S. citizens. What we are doing with the John Doe summons is trying to get the names of the U.S. citizens. So what it would actually do is potentially give us a line of sight when the money left, not years later when we are trying to grab back the money that is already gone. So I think this kind of information reporting is definitely worth exploring and could be a great tool for us.

The CHAIRMAN. So how many other havens are there? Liechtenstein is stepping forward, as I understand it. Monaco has not, as I understand it.

Commissioner SHULMAN. I read in the papers that they say they are, but that is all I know.

The CHAIRMAN. All right. I hear the current position of Monaco is "to make no comment at all," said a state official. Now, I do not know what "no comment" means. It is just what he said. Then there is Singapore. We have a problem with Singapore. What are some of the countries we have problems with here?

Commissioner SHULMAN. Well, I guess I would rather——

The CHAIRMAN. I know you would rather not name them.

Commissioner SHULMAN. Yes. Listing the names of countries is the purview of Treasury, the State Department. Obviously we have our eyes on it. I mean, I guess what I would say is——

The CHAIRMAN. If we name names, that puts sunshine on those countries, put a little glow on them. If it embarrasses them, they might do something.

Commissioner SHULMAN. Well, let me just say I am probably not going to be doing a lot of ski vacations in the Swiss Alps. [Laughter.] I think bank secrecy is an issue, so places that have bank secrecy laws, places that do not have information exchange agreements with us, are a problem. And then by definition, places that hold themselves out as low- or no-tax jurisdictions. So I am more focused on a set of criteria. The ones you listed are all ones that are on our radar that, when we see transactions going on there, we go there.

The CHAIRMAN. My time is expiring. I would just urge you to go for it. You have such support in this country. Be very, very vigorous. Very vigorous. Almost embarrassingly vigorous. I think that American taxpayers would be very proud. I know I will, personally, if you do.

Senator Schumer is next.

Senator SCHUMER. Thank you, Mr. Chairman. I really appreciate your having the hearing. I think it is on two very important subjects, and I appreciate the second round and all the witnesses.

I am going to return to the issue that I care about. Well, I care about both, but I am questioning about, because I agree it is—what did you say, Mr. Chairman? It is embarrassingly——

The CHAIRMAN. Well, I know I would like him to be embarrassingly vigorous.

Senator SCHUMER. Embarrassingly vigorous on offshore stuff. I agree. All right.

The CHAIRMAN. I mean, back off a little, but just be very vigorous. [Laughter.]

Commissioner SHULMAN. For this year.

Senator SCHUMER. The man from Montana has spoken.

Next question. This is back on helping the victims of Madoff. This one sounds innocuous, but it is very important, technically, to a lot of people. How will the IRS handle theft losses for individual taxpayers who invested with Madoff directly, but did so inside a retirement vehicle like an IRA or Roth IRA? This is sort of uncharted waters. But a lot of victims were affected inside these accounts, average, middle-class people.

Commissioner SHULMAN. Yes. 401(k)s, IRAs, retirement vehicles. If an investment was deductible going in, you cannot take a loss going out because there were not taxes paid on it.

Senator SCHUMER. Right.

Commissioner SHULMAN. There are some exceptions, as you mentioned, like a Roth IRA. The rules get very complicated. But, if it is after-tax money, there may be the ability to take losses, but mostly you take losses at the time of distribution. So I would just encourage people to look at the guidance and to have conversations with our counsel's office.

Senator SCHUMER. Right. Again, I would just urge you to be as helpful as you can to the victims in this regard, particularly with the Roth IRA situation.

Commissioner SHULMAN. Can I make just one clarifying comment about your earlier comment, Senator?

Senator SCHUMER. Please. Yes.

Commissioner SHULMAN. You talked about a 5-year carry-back and indefinite carry-forward of the loss.

Senator SCHUMER. Twenty-year, I think.

Commissioner SHULMAN. Under general rules it is a 3-year carry-back, because you have investment theft loss. It is defined as a business loss under the code, and you can carry it back for 3 years. A unique twist of the American Recovery and Reinvestment Act says, for 2008, if you have gross receipts of less than $15 million, you get a 5-year carry-back. So I did not want people listening to this to be confused.

Senator SCHUMER. Right.

Commissioner SHULMAN. So they are going to need to look at their circumstances, look when they discover it, and——

Senator SCHUMER. But, if you are below $15 million, you are all right with the 5 years?

Commissioner SHULMAN. In 2008.

Senator SCHUMER. Yes. All right. Good.

The one point about the IRA. The money in the IRA was still stolen. It was in an IRA, but it is still gone, so anything you can do to be helpful—all right.

Third, does the guidance say anything about potential claw-back payments that the victims who had previously withdrawn funds may have had to make? What is the tax treatment of such claw-backs under current law? Would taxpayers receive a deduction for such payments?

Commissioner SHULMAN. Sir, the ruling tries to clarify existing law, not make up law. It is deductible in the year discovered, except for reasonable prospects of recovery. I think people need to determine in all Ponzi schemes—and I think the Madoff people will

understand the situation better than I will because they are in contact with the trustee—how much there is a reasonable prospect of recovery.

What I will tell you, though, is there is a true-up at the end. So, if people take a deduction and get that loss, they are going to be able—if they then get some sort of payment, they will just be taxed on it. If they do not take the deduction because they think they are going to get it and they never get any sort of recovery, then they can take that loss.

Senator SCHUMER. All right. Again, I have to repeat that all of the rulings and guidance that you have given are really helpful to the victims. I do not know if I have mentioned this. We have heard from victims themselves already since yesterday—because we shared what you had shared with us ahead of time—we have heard from some of their lawyers that they are really happy with what the IRS is trying to do here. It is a rare day when someone can be very happy with the IRS, and this is it.

Commissioner SHULMAN. It is a good day.

Senator SCHUMER. In a difficult situation. So, thank you.

The CHAIRMAN. All right.

Senator Snowe?

Senator SNOWE. Thank you again, Commissioner Shulman. I want to follow up again on UBS, because I think it is extremely disturbing, frankly. I realize it is a matter of the Justice Department and the IRS at this point regarding UBS and its unwillingness to disclose all of these accounts. But regardless, we have a situation where we have given the bank $2.5 billion in Federal taxpayers' money and they are paying $782 million in criminal penalties and taxes to the U.S. Government for tax evasion.

So the bottom line is, we are giving money to an institution that has been involved in tax evasion. There is nobody in America who can understand that. So we had better make it abundantly clear to the Swiss government. Even so, whether we have a treaty or not, we should make it abundantly clear. We, frankly, should rescind that money. I just think it is absolutely preposterous that we are in this situation today.

We are dealing, on the one hand, with the bonuses, and then on the other hand we are dealing with a situation that we are giving money to an institution that has been engaged in tax evasion. I know that Secretary Geithner will be making this a priority for the G–20 meeting in April, absolutely, in terms of bank secrecy laws and tax evasion.

But nevertheless, in this situation, we need to address it. I do not think it is something that we can defer, and go forward in the future. We are dealing with a bank that refuses to disclose all of its accounts. They say it is a matter for diplomatic chains between the U.S. Government and the Swiss government. But it is also a matter for the U.S. Congress, and I do not think it is something that we can ever justify or accept. So I know that, going forward we need to address this now and retroactively, in my estimation, because I just do not think it is at all tolerable under these circumstances.

To that point, this has been something that UBS has been engaged in for the better part of a decade, since 2000. At any point

do you know, to your knowledge, if anybody ever approached the IRS, similar to Harry Markopolos who approached the SEC regarding Bernie Madoff? Was there anybody who ever approached IRS about UBS and these secret bank accounts at any point between 2000 and 2007, before the IRS identified this problem?

Commissioner SHULMAN. Not to my knowledge.

Senator SNOWE. It is hard to imagine, actually, because this institution not only failed to pay $220 million in taxes, obviously paying penalties and interest up to $782 million. So at no point during that decade did anybody ever approach the IRS or was there any indication that there was anything wrong?

Commissioner SHULMAN. Well, I will tell you, it is in the public record, and I can only talk about the public record. But we actually, through informants, through going after, aggressively, other cases, got onto this issue. So, again, this is something that I think that the Agency has, with our stepped-up focus on international tax evasion, gotten laser-like focus in this, started pursuing the John Doe summons, started to bring international pressure.

So this is one where there are plenty of things that we do not do perfectly, and we are always looking to improve. This is one where we got on top of it and are continuing to pursue it, as I said. I want to tell you that you have my personnel commitment to continue to pursue these matters.

Senator SNOWE. I appreciate that, too. I appreciate the work.

Mr. Josephson, on the Pension Benefit Guaranty Corporation, which is responsible for pension plans when a company becomes insolvent, there is the case of the East River Management Company, which is no longer in operation and defunct, and PBGC had to take it over in December. Is it routine for the PBGC to assume fiduciary responsibility for a company that did not even diversify? I mean, should there be any standards with respect to that? Because it is clear in this case, they turned over all of their money to Bernie Madoff and there was no diversification within its plan. Now PBGC is obviously having to assume responsibility for this now-defunct plan.

Mr. JOSEPHSON. It depends where you think, Senator, the risk of loss should fall. Obviously, diversification is required by the applicable State law. For the failure to diversify, there would be State penalties against the insolvent corporation that did not diversify. But where is the Pension Benefit Guaranty Corporation going to be able to collect that?

Senator SNOWE. Right.

Mr. JOSEPHSON. There is a conundrum here. I do not know that there is, under State law or Federal law, any effective remedy in that situation. But particularly in response to the dialogue between Senator Carper, Mr. Brostek, and Ms. Cantwell's questions, I think we also need to focus on whether or not the accounting profession, in auditing exempt organizations—publicly supported charities, private foundations, pension plans—is actually doing its job.

In my 5 years as head of the Charities Bureau in New York, I found that the resources that accounting firms—even the Big Four accounting firms—devoted to this kind of work were meager compared to what they purported to devote to the major publicly held companies. But even in that case, Senator, you will certainly re-

member that the failures of the auditing function for publicly held companies, in effect, required the Federal Government to federalize those accounting standards in the Public Companies Accounting Oversight Board.

There is another analogy here that I think is relevant, because of Mr. Brostek's remark about the incidence of tax evasion in returns prepared by paid preparers. There are, in fact, no Federal standards for auditors that account for exempt organizations. That is an aspect that the committee ought to take into account.

For example, there is a recent precedent. The Treasury, in response to the committee's initiative with respect to donated property, has issued regulations that really require appraisers of donated property to meet set qualifications and to express their opinions in a set form. No such requirement exists with respect to the paid preparers that prepare returns for exempt organizations.

As I said before, my experience in the Charities Bureau is, they do not devote the same kind of resources and the same kind of acumen. There is no evidence, for example, that any of the accountants who audited any of the Madoff funds ever did a walk-through to try to determine whether or not the statements he was providing were actually backed by transaction slips. Madoff's trustee, Mr. Picard, has said publicly that there are no transaction slips for Madoff transactions over the whole 13 years of the scandal. I cannot understand why the auditing function did not at some point uncover that. This is an important subject, it seems to me, for IRS and committee oversight.

Senator SNOWE. You are absolutely correct, and I thank you very much for those very constructive suggestions. Thank you.

Senator CARPER. Gentlemen, I have just a couple of questions to wrap up, at least for me. Again, thank you very much for being here today and for your responses, and for your service, too.

When I was Governor of Delaware, every year we had an award that was provided, sort of like a State version of a national award, that was offered to either businesses—a quality award for best quality, and the business operation could be nonprofit, it could be actually a public entity that won.

I think in my last year as Governor, the winner was the Delaware Division of Revenue because they did a very good job of collecting taxes that were owed. They also did a pretty good job of providing customer service. I think you demonstrated again here today that we can do both. We applaud you and the folks who are a part of your team.

Mr. Shulman, I believe you mentioned that, in the omnibus appropriations bill to fund the IRS for the balance of this fiscal year, there was maybe $50 million that was appropriated, I think you said, that could be used for research.

Commissioner SHULMAN. Yes.

Senator CARPER. And you welcomed that. I think the last time we actually had an extensive study of the tax gap may have been in tax year 2001. I would just ask if the IRS might have any plans to use some portion of that $50 million to update the tax gap. Are you aware of any other initiatives under way to do so?

Commissioner SHULMAN. Yes. The tax gap number, as I have gotten under it, is very difficult to estimate. The current numbers that

are public are 2001 numbers. Very few of those are actual 2001 numbers. A lot of them are extrapolated numbers from 1986, when we used to do very extensive, kind of random audits to really, really get under it.

We have a commitment to update the tax gap more regularly, focus on some areas where research had not been done, and also to do things like I mentioned before—do some random audits, rather than just targeting the areas where we normally try to do audits and have low- or no-change rates—so we target it correctly. So the answer is yes. It is all focused in what we call our National Research Program, which gets under reasons for noncompliance, where there is noncompliance, and eventually it leads us to data-driven resource-allocation decisions about how to go after noncompliance, which, as you said, is a combination of good service for people who are confused by a very complicated tax code and aggressive enforcement for those who are trying to evade the law.

Senator CARPER. Good. Thank you.

A question to Mr. Brostek, and also for you, Commissioner. Sticking with the tax gap again, we all know we need additional third-party reporting in areas that go beyond the measures that are already enacted. We talked about some others today: basis reporting is one, and we have talked, I think, today, about credit card reporting. I also believe that it is important to make sure that we are talking about what I would describe as the right people.

With respect to the statutory authority the IRS has already been given, and may be given in the future, how does the IRS, if you will, thread the needle between increasing enforcement targeted on unscrupulous taxpayers, while not accidentally imposing undue hardships on taxpayers who are trying to comply with the law?

Mr. BROSTEK. Maybe I will start and pass it over. The research that the Commissioner has referred to is fundamental to their being able to determine which taxpayers are most likely to be non-compliant. GAO has long supported the type of research that IRS is undertaking; it improves their selection process to ensure that they are bothering the fewest number of taxpayers who are completely compliant.

In addition to that, the IRS personnel do have informants and receive tips. They receive tips through the enhanced whistle-blower protections that this committee was responsible for. All those things help IRS in identifying the most likely non-compliant taxpayers.

If I could, I would like to mention one other thing in relation to the research that I think is sometimes under-appreciated, and that is that it helps in constructing systemic solutions. The basis reporting provision that is being implemented now, that IRS has proposed regulations out on and is being commented on, grew out of research that we did using the National Research Program database from the 2001 tax year.

We were able to go into the files from that research to develop the case that basis reporting was practical and would have an effect on the tax gap related to that particular problem. So it is not just that that research helps with the selection of routine audits, it also helps us revise regulations and create statutory solutions to the problem.

Senator CARPER. Thank you.

Mr. Commissioner, if you would just respond briefly, please.

Commissioner SHULMAN. Yes. I mean, I do not think it is necessarily a choice, is the way I think about it. Basis reporting, for example. Anyone who is compliant has nothing to fear. There are a lot of compliant taxpayers who spend a lot of time, when they sell a stock, digging around and trying to figure out, what was their basis when they bought it, and if they reinvested dividends.

So I think a lot of people who are trying to be compliant are actually going to welcome reporting. The third party sends it to us, the third party sends it to you, you attach it, and you are done, versus the rigmarole you go through now trying to figure out what your basis was. So, if done right, information reporting—rather than us suspecting you and going and doing an extensive audit, which is more burdensome, actually—if done right, is less burdensome, gives us the information, allows us to do our compliance job without a full-blown audit, and so should be quite helpful. But like I said before, our job is, as we get information, to make sure that we use it appropriately and only with people who are not—or as much as possible with people who are not—compliant.

The other thing I would just say is there is something about information reporting that has a direct enforcement effect. People's behavior changes when they think you can see. So with the W–2, people are very compliant, not because we are running so many W–2 versus income checks. We do it automatically, so we see all your W–2s. No one, I think, would think about lying about their wages because they know it is sent right to the IRS. So it has a real effect on voluntary compliance, as well as on our direct compliance program.

Senator CARPER. That is a very good point.

Again, thank you for your testimony today. Mr. Chairman, I have another question I would like to submit for the record. But you have been very helpful. We appreciate your participation and your testimony.

[The question appears in the appendix on p. 56.]

The CHAIRMAN. Thank you, Senator.

Mr. Commissioner, I just have a question about your budget. You are getting a big increase in your budget, which is great. I think, instead of $11 billion, is that correct, you will have $13 billion, if the President's proposal is agreed to?

Commissioner SHULMAN. It is a significant increase. The details have not come out. They will come out——

The CHAIRMAN. All right. I understand it is very significant. The question is, how do you intend to put this extra funding to work? What are you going to do with it? What about offshore enforcement? What component is offshore enforcement? The third question is, what goals and milestones, what measures, what benchmarks will you put in place to determine whether or not you are successful?

Commissioner SHULMAN. Sure. I am happy to go through that with you. We are going to put the budget to work by making sure we get the right personnel to do what we need to do. We are going to hire examiners, agents, special agents, some of whom we will put offshore in other localities. We are going to hire economists, fi-

nancial product specialists, appraisers, lawyers, all the people we need to go after the complex trail of money that is involved, both in the U.S. and overseas.

We are also going to use it to perfect the data we have in house, so that we are doing data modeling correctly, innovate around data modeling so we are going after the evasion that happens both here at home and overseas, and get third-party information in and combine it with our data so we can, again, be better at targeting and using data from other agencies and other countries to make sure we are triangulating in on enforcement issues.

We are also, just in a gross sense, going to open more cases, look at more issues. Large business, for instance. Every major corporation has an audit every year. We are now going to be able to look at more issues and go deeper into issues, and some of the things in your legislation should allow us some more time to go deeper.

And then on partnerships, right now we audit a partnership. A partnership is usually a web of multiple, sometimes hundreds, of partners. We are going to use those resources and the new people we have to be able to look further to actually trace the money so that we are looking at the whole economic picture, not just the entity on which we are doing a tax return. So it is really: people, technology, do our job better.

There are measures that we will use. We have our traditional measures: coverage, case closures, audit by type, enforcement dollars. Clearly, the President has set out a 5:1 return, or depending on where the money is going for enforcement, a 7:1 return, a 13:1 return. We are going to need to monitor that.

I think we also need to work on measures around earlier identification of issues. Before, I talked about foreign tax credit generators. We got on top of that. So, having better trained people, more of them, pursuing more issues, getting to issues earlier so we stop problems before they start, those are somewhat intangibles and they are not going to show up in our traditional metrics, but they are things that we are going to need to look at.

Then I guess the last thing I would say is, as we develop measures, I am very anxious to work with you and others on legislation because, depending on what kind of new tools we get, we will be able to have a much higher bar for ourselves to go after.

I just want to emphasize, a significant portion will be international. As you know, the President has set out $210 billion, a combination of policy and enforcement. Frankly, we are going to take, year after year, pretty much as many resources as we can absorb into the international arena, get trained, and get up to speed in that year and continue focusing there.

I actually, last October 1st when we were under a budget freeze and we were basically under a hiring freeze, took some attrition money from other areas and put it into international because I thought it was so important that we continue to invest in that area and not fall behind.

The CHAIRMAN. All right.

I guess there are a lot of pretty bright people out there trying to evade taxes, a lot of preparers, tax lawyers, others. Do you feel when you hire, that you will be able to hire people with sufficient

competence, talent, expertise, and know-how and all this on how taxes are being evaded?

Commissioner SHULMAN. Yes. I mean, we have talked before, Mr. Chairman. One of my highest priorities is our workforce, getting the right people, training them, making sure they are motivated, making sure they have the right tools. I actually have a centralized unit that is reporting directly to me to revamp a variety of workforce efforts.

For our hiring, we have now pulled it out of the business units and are centralizing our hiring infrastructure. I think one of the, I would not call it silver linings, but one of the realities in this economic downturn is we have time right now. We are getting more applicants for every opening than we have ever gotten in our history of incredibly qualified people, so I plan to take advantage of this.

The CHAIRMAN. Now, that may be true, and there may be a major opportunity there. I run across this in several different circumstances. In fact, I was talking to one of the top lawyers in the Obama administration, and he said they thought that, after the President was elected, they would get a lot of applicants for jobs in his shop, and very talented people. He was wrong: they were flooded with applicants, people who were just more talented, and just the brightest people one could possibly hope for.

Second, I was talking to the President of Harvard University not too long ago and she said, it is amazing. Not too many years ago—I do not know what school it was, whether it was Harvard College, or maybe it was some other unit—that a large majority of their students wanted to go to Wall Street because that is where the money was. But, she said, frankly, a lot of people are going because there is peer pressure to go.

But now that Wall Street is sort of on the down side, a lot of students say, gee, that is great, because I really did not want to do that anyway. I want to go into public service, I want to go to Africa, I want to go help people, help do these things. I run into it anecdotally, people in Wall Street and elsewhere saying, hey, now I do not have to chase the dollar as much. There is so much pressure to chase the dollar, but now I can do some things I kind of want to do.

So I think there is a real opportunity here. A lot of people want to serve. They care about our country. They want to help serve our country. I just urge you to take advantage of that, get the best and the brightest, and make sure they have their heads screwed on straight, too, as they are doing the work.

But thank you, Commissioner, very much. I think you are doing a really good job. We will just keep working together to address some of these problems.

Commissioner SHULMAN. I appreciate all the support.

The CHAIRMAN. The hearing is adjourned.

[Whereupon, at 12:14 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance,
U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EST
Tuesday, March 17, 2009

TAX COMPLIANCE

Offshore Financial Activity Creates Enforcement Issues for IRS

Statement of Michael Brostek, Director
Strategic Issues Team

GAO-09-478T

Highlights

Highlights of GAO-09-478T, a testimony before the Committee on Finance, U.S. Senate

Why GAO Did This Study

Much offshore financial activity by individual U.S. taxpayers is not illegal, but numerous schemes have been devised to hide the true ownership of funds held offshore and income moving between the United States and offshore jurisdictions.

In recent years, GAO has reported on several aspects of offshore financial activity and the tax compliance and tax administration challenges such activity raises for the Internal Revenue Service (IRS). To assist the Congress in understanding these issues and to support Congress's consideration of possible legislative changes, GAO was asked to summarize its recent work describing individual offshore tax noncompliance, factors that enable offshore noncompliance, and the challenges that U.S. taxpayers' financial activity in offshore jurisdictions pose for IRS. This statement was primarily drawn from previously issued GAO products.

What GAO Recommends

GAO makes no recommendations in this testimony. GAO reiterates previous recommendations regarding the Qualified Intermediary (QI) program and refers to a previous matter that Congress consider extending the statute of limitations for offshore cases. IRS generally agreed with the recommendations about the QI program and with the suggestion about the statute of limitations. Legislation to extend the statute of limitations has been introduced but not enacted.

View GAO-09-478T or key components. For more information, contact Michael Brostek on (202) 512-9110 or brostekm@gao.gov.

March 17 2009

TAX COMPLIANCE

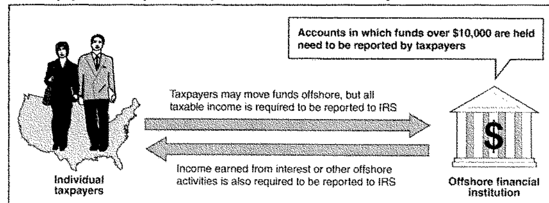
Offshore Financial Activity Creates Enforcement Issues for IRS

What GAO Found

Individual U.S. taxpayers engage in financial activity involving offshore jurisdictions for a variety of reasons. When they do, they are obligated to report any income earned in the course of those activities. They are also required to report when they control more than $10,000 in assets outside of the country. However, much of this required reporting depends on taxpayers knowing their reporting obligations and voluntarily complying. Some taxpayers do not comply with their income and asset reporting obligations. Limited transparency, the relative ease and low cost of establishing offshore entities, and an array of financial advisors can facilitate tax evasion. IRS's Qualified Intermediary program has helped IRS obtain information about U.S. taxpayers' offshore financial activity, but as the recent case against the large Swiss bank UBS AG underscores, the program alone is insufficient to address all offshore tax evasion. Earlier, GAO had recommended changes to improve QI reporting, make better use of reports, and enhance assurance that any fraudulent QI activity is detected.

IRS examinations that include offshore tax issues can take much longer than other examinations. GAO's past work has shown that from 2002 through 2005, IRS examinations involving offshore tax evasion took a median of 500 more calendar days to develop and examine than other examinations. The amount of time required to complete offshore examinations is lengthy for several reasons, such as technical complexity and the difficulty of obtaining information from foreign sources. However, the same statute of limitations preventing IRS from assessing taxes or penalties more than 3 years after a return is filed applies to both domestic and offshore financial activity. The additional time needed to complete an offshore examination means that IRS sometimes has to prematurely end offshore examinations and sometimes chooses not to open them at all, despite evidence of likely noncompliance. In testimony before Congress, the Commissioner of Internal Revenue has said that in cases involving offshore bank and investment accounts in bank secrecy jurisdictions, it would be helpful for Congress to extend the time to assess a tax liability with respect to offshore issues from 3 to 6 years.

U.S. Taxpayers Are Required to Report Offshore Financial Activity



Sources: GAO summary of IRS information; Art Explosion (map).

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to discuss offshore financial activity and the problem of offshore tax evasion by individual taxpayers. International financial activity is common in our increasingly global economy, it is encouraged or facilitated by various federal policies, and the number of U.S. taxpayers with foreign financial accounts is growing. Financial activity across foreign jurisdictions poses challenges for both tax policy and administration. Like all forms of noncompliance, offshore schemes add to the tax gap—the difference between taxes owed and taxes voluntarily paid on time—and shifts more of the tax burden onto compliant taxpayers. Honest taxpayers may then find reason to reexamine their own willingness to stay compliant. Offshore tax evasion can be especially difficult to identify because of the layers of obfuscation that can come with doing business in overseas locations outside the jurisdiction of the United States. Doing business outside of the country is, of course, perfectly legal, but hiding income or assets in offshore locations in order to evade taxes is not. As is the case with all tax evasion, the Internal Revenue Service's (IRS) success in helping taxpayers who want to comply with the tax laws as they pertain to offshore financial activity is of critical importance. Likewise, IRS's ability to identify and pursue those who choose not to comply is essential to combating abusive offshore transactions.

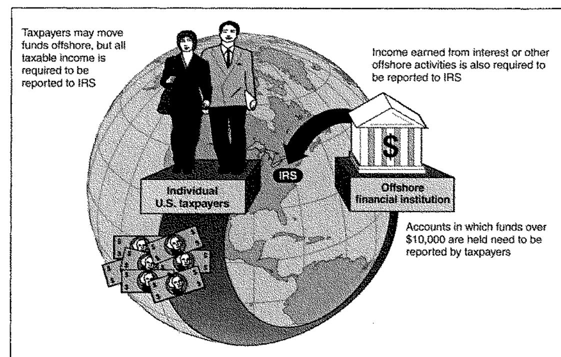
My statement today will largely draw from our prior work, often done for this committee, to describe individuals and the characteristics of their offshore tax noncompliance, factors that enable offshore noncompliance, and the challenges that U.S. taxpayers' financial activities in offshore jurisdictions pose for IRS.

Our reports on the Qualified Intermediary (QI) program, the Offshore Voluntary Compliance Initiative (OVCI), offshore examinations, and the Cayman Islands upon which this statement is based were prepared in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on the audit objectives for those reports.

Characteristics of Noncompliant Individual Taxpayers and the Size and Nature of Their Offshore Noncompliance Vary Widely

It is perfectly legal for U.S. persons to hold money offshore. Taxpayers may hold foreign accounts and credit cards for a number of legitimate reasons. For example, taxpayers may have worked or traveled overseas extensively or inherited money from a foreign relative. As shown in figure 1, although holding money offshore is legal, taxpayers must generally report their control over accounts valued at more than $10,000. Taxpayers must also report income, whether earned in the United States, or offshore.

Figure 1: U.S. Taxpayers Are Required To Report Offshore Financial Activity



Sources: GAO summary of IRS information; Art Explosion (map).

The type and extent of individual taxpayers' illegal offshore activity varies. In 2004, we reviewed OVCI[1] to provide information to Congress on the

[1] Launched in January 2003, OVCI was an attempt to quickly bring taxpayers who were hiding funds offshore back into compliance while simultaneously gathering more information about those taxpayers as well as the promoters of these offshore arrangements. As an incentive to come forward, IRS said it would not impose the civil fraud penalty for filing a false tax return, the failure to file penalty, or any information return penalties for unreported or underreported income earned in one or more of the tax years ending after December 31, 1998. However, taxpayers were required to pay applicable back taxes, interest, and certain accuracy or delinquency penalties. Taxpayers were also required to disclose information about themselves and those who promoted or solicited their offshore arrangements.

characteristics of taxpayers who came forward regarding their noncompliant offshore activities, and to understand how those taxpayers became noncompliant. According to IRS data, OVCI applicants were a diverse group, for instance with wide variations in income and occupation. In each of the 3 years of OVCI we reviewed, at least 10 percent of the OVCI applicants had original adjusted gross incomes (AGI) of more than half a million dollars, while the median original AGI of applicants ranged from $39,000 in tax year 2001 to $52,000 in tax year 2000. Applicants listed over 200 occupations on their federal tax returns, including accountants, members of the clergy, builders, physicians, and teachers.[2]

Some OVCI applicants' noncompliance appeared to be intentional, while others' appeared to be inadvertent. Those applicants who had hidden money offshore through fairly elaborate schemes involving, for instance, multiple offshore bank accounts, appeared to be deliberately noncompliant. Other applicants appeared to have fallen into noncompliance inadvertently, for example, by inheriting money held in a foreign bank account and not realizing that income earned on the account had to be reported to IRS on their tax returns.

OVCI applicants' median adjustment to taxes due was relatively modest. For tax year 2001, the median additional taxes owed were $4,401, median penalties assessed were $657, and median interest owed was $301.

However, other examples of offshore evasion have involved very substantial sums, complex structures and clear nefarious intent. For example, in 2006, Congress found several cases involving taxpayers with relatively large sums involved in abusive offshore transactions, including a U.S. businessman who, with the guidance of a prominent offshore promoter, moved from $400,000 to $500,000 in untaxed business income offshore.[3] In another case, in 2006 a wealthy American pled guilty to tax evasion accomplished by creating offshore corporations and trusts, and

[2] GAO, *Taxpayer Information: Data Sharing and Analysis May Enhance Tax Compliance and Improve Immigration Eligibility Decisions*, GAO-04-972T (Washington, D.C.: July 21, 2004).

[3] Permanent Subcommittee on Investigations, Senate Committee on Homeland Security and Governmental Affairs, *Tax Haven Abuses: The Enablers, The Tools and Secrecy* (Washington, D.C.: August 2006). The subcommittee's review of cases involved consultation with experts, interviews with parties related to the case histories, and review of documents and materials such as financial records, correspondence, legal pleadings, court documents, and Securities and Exchange Commission filings.

then using a series of assignments, sales and transfers to place about $450 million in cash and stock offshore. According to the indictment, the businessman used these methods to evade more than $200 million in federal and District of Columbia income taxes.

Several Factors May Facilitate the Use of Offshore Jurisdictions to Avoid Paying Taxes

Limited transparency regarding U.S. persons' financial activities in foreign jurisdictions contributes to the risk that some persons may use offshore entities to hide illegal activity from U.S. regulators and enforcement officials. For instance, individuals can sometimes use corporate entities to disguise ownership or income. Abusive offshore schemes are often accomplished through the use of limited liability corporations (LLC), limited liability partnerships and international business corporations, as well as trusts, foreign financial accounts, debit or credit cards, and other similar instruments. According to IRS, offshore schemes can be complex, often involving multiple layers and multiple transactions used to hide the true nature and ownership of the assets or income that the taxpayer is attempting to hide from IRS.

In addition, creation of offshore entities and structures can be relatively easy and inexpensive. For example, establishing a Cayman Islands exempted company can be accomplished for less than $600 (not taking into account service providers' fees), and the company is not required to maintain its register of shareholders in the Cayman Islands or hold an annual shareholders meeting.[4] Other offshore jurisdictions provide similar services to those wishing to set up offshore entities.

Another factor that makes it easier for individuals to avoid paying taxes through the use of offshore jurisdictions is that taxpayers' compliance is largely based on voluntary self-reporting. When reporting is entirely voluntary, compliance can suffer. IRS has found that when there is little or no reporting of taxpayers' income by third parties to taxpayers and IRS, taxpayers include less than half of the income on their tax returns.[5]

[4] This is not unique to offshore locations. As we previously reported in GAO, *Company Formations: Minimal Ownership Information Is Collected and Available*, GAO-06-376 (Washington, D.C.: Apr. 2006), most U.S. states do not require ownership information at the time a company is formed.

[5] IRS found that for non-farm sole proprietor income subject to little or no third-party reporting, taxpayers misreported more than half of such income in 2001, according to IRS's most recent tax gap estimates.

One way that taxpayers are required to self-report foreign holdings is through the Report of Foreign Bank and Financial Accounts (FBAR) form.[6] Citizens, residents, or persons doing business in the United States with authority over a financial account or accounts in another country exceeding $10,000 in value at any time during the year are to report the account to the Department of the Treasury (Treasury). U.S. persons transferring assets to or receiving distributions from a foreign trust are required to report the activity to IRS on Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. From 2000 through 2007, the number of FBARs received by Treasury has increased by nearly 85 percent, according to IRS. In 2008, IRS also said that, despite the significant increase in filings, concern remains about the degree of reporting compliance for those who are required to file FBARs. Also in 2008, the U.S. Senate Joint Committee on Taxation (JCT) reported that three categories of U.S. persons are potentially not filing FBARs and Form 3520s as required by law: taxpayers who are unaware or confused about filing requirements, taxpayers who are concealing criminal activity and taxpayers who are structuring transactions to avoid triggering the filing requirements.

Our 2004 review of applicants who came forward to declare offshore income under OVCI also suggested a high level of FBAR nonreporting, even by those individuals who reported all of their income to IRS.[7] For instance, for each year covered by OVCI, more than half of the applicants had generally reported all of their income and paid taxes due—even on their offshore income—but had failed to disclose the existence of their foreign bank accounts as required by Treasury.

Finally, financial advisors often facilitate abusive transactions by enabling taxpayers' offshore schemes. We have reported that most possible offshore tax evasion cases are discovered through IRS's investigations of promoters of offshore schemes.[8] During our 2004 review of OVCI, we examined Web sites promoting offshore investments and found that most provided off-the-shelf offshore companies or package deals, including the ability to incorporate offshore within the next day by buying an off-the-

[6] The FBAR form, TD F 90-22.1, is a Department of the Treasury form that is filed separately from the taxpayer's tax return.

[7] GAO-04-972T

[8] GAO, *Tax Administration: Additional Time Needed to Complete Offshore Tax Evasion Examinations*, GAO-07-237 (Washington, D.C.: Mar. 30, 2007).

shelf company at a cost of $1,500. These promoters provided taxpayers a way to quickly and easily move money offshore and repatriate it without reporting that money to IRS.

Congress also has found promoters behind several offshore evasion schemes such as the Equity Development Group (EDG), an offshore promoter based in Dallas, that recruited clients through the Internet and helped them create offshore structures.[9] With few resources and no employees, EDG enabled clients to move assets offshore, maintain control of them, obscure their ownership, and conceal their existence from family, courts, creditors and IRS and other government agencies. In another case, a Seattle-based securities firm, Quellos Group, LLC, designed, promoted, and implemented securities transactions to shelter over $2 billion in capital gains from U.S. taxes, relying in part on offshore secrecy to shield its workings from U.S. law enforcement. This scheme was estimated to cost the U.S. Treasury about $300 million in lost revenue.

Large financial firms also have been found to have advised U.S. clients on the use of offshore structures to hide assets and evade U.S. taxes. For example, in 2008 IRS announced that Liechtenstein Global Trust Group (LGT), a leading Liechtenstein financial institution, had assisted U.S. citizens in evading taxes. In June 2008, Bradley Birkenfeld pled guilty in federal district court to conspiring with an American billionaire real estate developer, Swiss bankers and his co-defendant, Mario Staggl, to help the developer evade paying $7.2 million in taxes by assisting in concealing $200 million of assets in Switzerland and Liechtenstein. Birkenfeld admitted that from 2001 through 2006, while he was employed as a director in the private banking division of LGT, he routinely traveled to and had contacts within the United States to help wealthy Americans conceal their ownership of assets held offshore and evade paying taxes on the income generated from those assets.

In a more recent case, UBS AG, Switzerland's largest bank, entered into a deferred prosecution agreement for conspiring to defraud the U.S. government by helping U.S. citizens to conceal assets through UBS accounts held in the names of nominees and/or sham entities. In announcing the deferred prosecution agreement, the Department of Justice (Justice) alleged that Swiss bankers routinely traveled to the United States to market Swiss bank secrecy to U.S. clients interested in

[9] Permanent Subcommittee on Investigations, 2006.

attempting to evade U.S. income taxes. Court documents assert that, in 2004 alone, Swiss bankers allegedly traveled to the United States approximately 3,800 times to discuss their clients' Swiss bank accounts. UBS agreed to pay $780 million in fines, penalties, interest and restitution for its actions.

IRS Faces Significant Challenges in Identifying the Nature and Extent of Offshore Noncompliance

IRS has several initiatives that target offshore tax evasion, but tax evasion and crimes involving offshore entities are difficult to detect and to prosecute. We have reported that offshore activity presents challenges related to oversight and enforcement, such as issues involved in self-reporting, the complexity of offshore financial transactions and relationships among entities, the lengthy processes involved with completing offshore examinations, the lack of jurisdictional authority to pursue information, the specificity required by information-sharing agreements, and issues with third-party financial institution reporting.[10]

As noted earlier, individual U.S. taxpayers and corporations generally are required to self-report their foreign taxable income to IRS. Self-reporting is inherently unreliable, for several reasons. Because financial activity carried out in foreign jurisdictions often is not subject to third-party reporting requirements, in many cases persons who intend to evade U.S. taxes are better able to avoid detection. For example, foreign corporations with no trade or business in the United States are not generally required to report to IRS any dividend payments they make to shareholders, even if those payments go to U.S. taxpayers. Therefore, a U.S. shareholder could fail to report the dividend payment with little chance of IRS detection. In addition, when self-reporting does occur, the completeness and accuracy of reported information is not easily verified.

In addition, the complexity of offshore financial transactions can complicate IRS investigation and examination efforts. Specifically, offshore schemes can involve multiple entities and accounts established in different jurisdictions in an attempt to conceal income and the identity of the beneficial owners.[11] For instance, we have previously reported on

[10] GAO, *Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist*, GAO-08-778 (Washington, D.C.: July 24, 2008).

[11] The beneficial owner is the true owner of the income, corporation, partnership, trust, or transaction who receives or has the right to receive the proceeds or advantages of ownership.

offshore schemes involving "tiered" structures of foreign corporations and domestic and foreign trusts in jurisdictions that allowed individuals to hide taxable income or make false deductions, such as in the case of *United States v. Taylor*.[12] The defendants in *United States v. Taylor* and *United States v. Petersen* pleaded guilty in U.S. District Court to crimes related to an illegal tax evasion scheme involving offshore entities.[13] As part of the scheme, the defendants participated in establishing a "web" of domestic and offshore entities that was used to conceal the beneficial owners of assets, and to conduct fictitious business activity that created false business losses, and thus false tax deductions, for clients.

Given the characteristics of offshore evasion, IRS examinations that include offshore tax issues for an individual can take much longer than other examinations. Specifically, our past work has shown that from 2002 through 2005, IRS examinations involving offshore tax evasion took a median of 500 more calendar days to develop and examine than other examinations.[14] The amount of time required to complete offshore examinations is lengthy for several reasons, such as technical complexity and the difficulty of obtaining information from foreign sources. For instance, many abusive offshore transactions are identified through IRS examination of promoters, and IRS officials have said that it can take years to get a client list from a promoter and, even with a client list, there is still much work that IRS needs to do before the participants of the offshore schemes can be audited. Because of the 3-year statute of limitations on assessments,[15] the additional time needed to complete an offshore examination means that IRS sometimes has to prematurely end offshore examinations and sometimes chooses not to open them at all, despite evidence of likely noncompliance.

We said that to provide IRS with additional flexibility in combating offshore tax evasion schemes, Congress should make an exception to the 3-year civil statute of limitations assessment period for taxpayers involved

[12] GAO-08-778.

[13] Statement by Defendant in Advance of Plea Guilty, *United States v. Taylor*, No. 2:08-cr-00064-TC (D. Utah, Jan. 24, 2008); Statement by Defendant in Advance of Plea Guilty, *United States v. Petersen*, No. 2:05-cr-00805-TC-DN (D. Utah, Jan. 18, 2008).

[14] GAO-07-237.

[15] In most cases, the law gives IRS 3 years from the date a taxpayer files a tax return to complete an examination and make an assessment of any additional tax. This is known as the 3-year statute of limitations on assessments.

in offshore financial activity. IRS agreed that this would be useful. In testimony before Congress, the Commissioner of Internal Revenue has said that in cases involving offshore bank and investment accounts in bank secrecy jurisdictions, it would be helpful for Congress to extend the time for assessing a tax liability with respect to offshore issues from 3 to 6 years. Legislation was introduced in 2007, but not enacted, to increase the statute of limitations from 3 to 6 years for examinations of returns that involve offshore activity in financial secrecy jurisdictions.

At a more fundamental level, jurisdictional limitations also make it difficult for IRS to identify potential noncompliance associated with offshore activity. Money is mobile and once it has moved offshore, the U.S. government generally does not have the authority to require foreign governments or foreign financial institutions to help IRS collect tax on income generated from that money. In prior work we have reported that a Deputy Commissioner of IRS's Large and Midsized Business Division said that a primary challenge related to U.S. persons' uses of offshore jurisdictions is simply that when a foreign corporation is encountered or involved, IRS has difficulty pursuing beneficial ownership any further because of a lack of jurisdiction. IRS officials told us that IRS does not have jurisdiction over foreign entities whose incomes are not effectively connected with a trade or business in the United States. Thus, if a noncompliant U.S. person established a foreign entity to carry out non-U.S. business, it would be difficult for IRS to identify that person as the beneficial owner.

In addition, while the U.S. government has useful information-sharing agreements in place to facilitate the exchange of information on possible noncompliance by U.S. persons with offshore jurisdictions, agreements involving the exchange of information on request generally require IRS to know a substantial amount about the noncompliance before other nations will provide information. For example, the U.S. government uses Tax Information Exchange Agreements (TIEA) as the dedicated channel for exchange of tax information, while Mutual Legal Assistance Treaties (MLAT) remain the channel for exchanging information for offenses involving nontax criminal violations. Nevertheless, the Commissioner of Internal Revenue recently said that in some instances the process to obtain names of account holders is inefficient, and IRS must rely on other legal and investigative techniques. As we have reported previously with regard to the use of these channels with the Cayman Islands government, neither TIEAs nor MLATs allow for "fishing expeditions," or general inquiries about a large group of accounts or entities. Rather, as is standard with arrangements providing for exchange of information on request, each

request must involve a particular target. For example, IRS cannot send a request for information on all corporations established in the Cayman Islands over the past year. The request must be specific enough to identify the taxpayer and the tax purpose for which the information is sought, as well as state the reasonable grounds for believing that the information is in the territory of the other party.

One program IRS established to help ensure compliance when offshore transactions occur is the QI program. Under the QI program, foreign financial institutions voluntarily report to IRS income earned and taxes withheld on U.S. source income, providing some assurance that taxes on U.S. source income sent offshore are properly withheld and income is properly reported. However, significant gaps exist in the information available to IRS about the owners of offshore accounts. Perhaps most important, a low percentage of U.S. source income sent offshore flows through QIs. For tax year 2003, about 12.5 percent of $293 billion in U.S. income flowed through QIs. The rest, or about $256 billion, flowed through U.S. withholding agents. While QIs are required to verify account owners' identities, U.S. withholding agents can accept owners' self-certification of their identities at face value.

Reliance on self-certification leads to a greater potential for improper withholding because of misinformation or fraud. IRS does not measure the extent to which U.S. withholding agents rely on self-certifications. In our 2007 report we recommended that IRS perform this measurement and use these data in its compliance efforts.[16] For instance, IRS could increase oversight for U.S. withholding agents who primarily rely on self-certifications in determining whether withholding should occur. IRS has taken some steps to measure such reliance, but IRS's approach thus far has not been systemic and also does not address improving the efficiency of its compliance efforts.

The previously discussed case of Swiss bank UBS provides a stark example of the QI program's vulnerabilities. In February 2009, UBS entered into a deferred prosecution agreement with Justice and agreed to pay $780 million in fines, penalties, interest and restitution for defrauding the U.S. government by helping United States taxpayers hide assets

[16] GAO, *Tax Compliance: Qualified Intermediary Program Provides Some Assurance That Taxes on Foreign Investors Are Withheld and Reported, but Can Be Improved*, GAO-08-99 (Washington, D.C. Dec. 2007).

through UBS accounts held in the names of nominees and/or sham entities. UBS entered into a QI program agreement with IRS in 2001, and was required to report U.S. citizens' income to the IRS during the time that it conspired to defraud the U.S. government.

We also recommended that IRS require the QI program's external auditors report on any indications of fraud or illegal acts that could significantly affect the results of their reviews of the QIs' compliance with their agreements.[17] However, it should be noted that we can not say that having this reporting requirement in place would have forestalled UBS's efforts to defraud the United States or detected them earlier. IRS has proposed some amendments to the QI program that would somewhat enhance QI auditors' responsibilities in this area.

In our 2007 report on the QI program,[18] we also recommended that IRS determine why U.S. withholding agents and QIs report billions of dollars in funds flowing to unknown jurisdictions and unidentified recipients, and recover any withholding taxes that should have been paid. IRS has taken steps toward implementing this recommendation. We also recommended that IRS modify QI contracts to require electronic filing of forms and invest the funds necessary to perfect the data. IRS is including an application for filing information returns electronically in all QI applications and renewals but has not measured whether including the forms in the applications has had an impact on the number electronic filers.

Multiple Coordinated Strategies Are Necessary to Address the Challenges Posed by Offshore Tax Evasion

In our 2004 review of OVCI, we noted that the diverse types of individuals involved in offshore noncompliance may require multiple compliance strategies on the part of IRS.[19] The limited transparency involved in U.S. persons' activities in offshore jurisdictions also presents several challenges to IRS and Treasury. As Commissioner of Internal Revenue Shulman recently commented, "There is general agreement in the tax administration community that there is no 'silver bullet' or one strategy that will alone solve the problems of offshore tax avoidance."

[17] GAO-08-99.

[18] GAO-08-99

[19] GAO-04-972T

Mr. Chairman, this concludes my statement. I would be happy to answer any questions you or other members of the committee may have at this time.

Contacts and Acknowledgments

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Responses From Michael Brostek to Questions for the Record
Senate Finance Committee Hearing of March 17, 2009

Question from Senator Grassley

Please compare and contrast OECD standards to the Senate Finance Committee staff proposal and Senator Levin's bill (S.506).

Answer: OECD has a number of different resources that provide guidance on combating tax evasion, including principles on exchange of information for tax purposes and a categorization of jurisdictions designated as tax havens due to their refusal to commit to standards of transparency and information exchange. The Stop Tax Haven Abuse Act[1] (the bill) includes a list of jurisdictions based on a definition that differs from OECD's categorization, while the Senate Finance Committee staff proposal (the proposal) does not limit its applicability to specific countries.

Specifically, the bill creates a category of offshore secrecy jurisdictions, a definition for determining which jurisdictions are included within the category, and an initial list of offshore secrecy jurisdictions. In addition, the bill establishes certain presumptions for reporting on accounts with a financial institution formed, domiciled, or operating in the jurisdictions included on the list. On the other hand, provisions in the proposal, such as those for financial transfers outside of the United States and the reporting of financial accounts, apply more generally to foreign financial activity and are not restricted in applicability to specific jurisdictions.

We have previously reported that OECD has developed a list that includes jurisdictions that have made commitments to address issues related to transparency and the effective exchange of information, and jurisdictions that remain uncooperative tax haven jurisdictions.[2] As of February 2008 OECD stipulated four major features of tax haven jurisdictions: (1) no income tax or only a nominal income tax; (2) rules that prevent the effective exchange of information with foreign tax authorities; (3) a lack of transparency in the operation of legislative, legal, or administrative provisions; and (4) the absence of a requirement for a substantive local presence. OECD classified a country as a tax haven if it met the criteria of no or nominal income tax and at least one of the three other criteria. In February 2008 OECD listed 35 cooperative jurisdictions on the list and 3 uncooperative tax haven jurisdictions. In April 2009, OECD also released a progress report on a parallel project to improve access to banking information for tax authorities with OECD membership.[3] The report lists jurisdictions by their degree of implementation of the

[1] Stop Tax Haven Abuse Act, S. 506, 111th Congress (2009).
[2] GAO, *International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions*, GAO-09-157 (Washington, D.C.: Dec. 18, 2008).
[3] OECD, *A Progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard* (April 2, 2009).

internationally agreed tax standard relating to the exchange of information in tax matters.[4] The list includes 40 jurisdictions that have substantially implemented the standard, 38 that have committed to the standard but have not yet substantially implemented it, and 4 that have not committed to the standard. Thirty of these 38 committed jurisdictions were previously identified by OECD as meeting OECD's tax haven criteria. As of mid-April 2009, OECD has indicated that 42 total countries have committed to the information exchange standard.[5]

While similar in nature to the OECD , the definition of offshore secrecy jurisdictions in the bill states that the jurisdiction has corporate, business, bank or tax secrecy rules and practices which unreasonably restrict the ability of the United States to obtain information relevant to enforcement and includes an initial list of 34 jurisdictions. This standard does not incorporate OECD criteria relating to no or nominal tax or the absence of a requirement for a substantive legal presence.

Question from Senator Carper

How much of a factor is the overly complicated tax Code – which runs to tens of thousands of pages – in the tax gap? Can you suggest to this Committee some ways in which the IRS's tax enforcement efforts might be aided by a simplification or reform of the Code in general? Are there certain provisions in the Code for which simplification or reform might benefit enforcement and compliance efforts?

Answer: GAO has reported previously that the current tax system is widely viewed as overly complex, thereby reducing the ability of individuals to understand and comply with the tax laws.[6] The complexity of, and frequent revisions to, the tax system make it more difficult and costly for taxpayers who want to comply to do so and for IRS to explain and enforce tax laws. Complexity also creates a fertile ground for those intentionally seeking to evade taxes and often trips others into unintentional noncompliance.

Efforts to simplify the tax code and otherwise alter current tax policies may help reduce the tax gap by making it easier for individuals and businesses to understand and voluntarily comply with their tax obligations. Among the many causes of tax code complexity is the growing number of preferential provisions in the tax code, such as exemptions and exclusions from taxation, deductions, credits, deferral of tax liability, and preferential tax rates.[7] While these tax

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[4] This standard requires the exchange of information on request in all tax matters for the administration of domestic tax law without regard to a domestic tax interest requirement or bank secrecy for tax purposes.
[5] OECD, *Four More Countries Commit to OECD Tax Standards* (April 7, 2009).
[6] GAO, Understanding the Tax Reform Debate: Background, Criteria & Questions, GAO-05-1009SP (Washington, D.C.: Sept. 2005); GAO, Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies, GAO-05-527T (Washington, D.C.: Apr. 14, 2005); GAO, Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions, GAO-06-453T (Washington, D.C.: Feb. 15, 2006); and GAO, Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap, GAO-07-488T (Washington, D.C.: Feb. 16, 2007).
[7] GAO, Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to be Reexamined, GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

expenditures can be a tool to further some federal goals and objectives, such as financing higher education or funding research and development, their aggregate number contributes to the complexity that taxpayers face in preparing their tax returns and planning their financial decisions. Reducing the multiple tax preferences for retirement savings or education assistance might ease taxpayers' burden in understanding and complying with the rules associated with these options. In our July 2005 report on postsecondary tax preferences, we estimated that hundreds of thousands of taxpayers appear to have made suboptimal decisions when selecting education-related tax preferences.[8] One explanation of these taxpayers' choices may be the complexity of postsecondary tax preferences, which experts have commonly identified as difficult for tax filers to use.

Simplification could mean simplifying existing laws. For example, in our report on postsecondary tax preferences, we noted that the definition of a qualifying postsecondary education expense differed somewhat among some tax code provisions, for instance with some including the cost to purchase books and others not. Making definitions consistent across code provisions may reduce taxpayer errors.[9]

Another form of simplification could be to broaden the tax base while reducing tax rates, which could minimize incentives for not complying. This base-broadening could include a review of whether existing tax expenditures are achieving intended results at a reasonable cost in lost revenue and added burden and eliminating or consolidating those that are not.

IRS's recent tax gap estimate includes a $32 billion loss in individual income taxes for tax year 2001 because of noncompliance with tax expenditure provisions. Simplifying these provisions of the tax code would not likely yield $32 billion in revenue because even simplified provisions likely would have some associated noncompliance. Nevertheless, the estimate suggests that simplification could have important tax gap consequences, particularly if simplification also accounted for any noncompliance that arises because of complexity on the income side of the tax gap for individuals.[10] Despite the potential benefits that simplification may yield, these credits and deductions serve purposes that Congress has judged to be important to advance federal goals. Eliminating them or consolidating them likely would be complicated, and would likely create winners and losers. Elimination also could conflict with other objectives such as encouraging certain economic activity or improving equity.

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[8]GAO, Student Aid and Postsecondary Tax Preferences: Limited Research Exists on the Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences, GAO-05-684 (Washington, D.C.: July 29, 2005).
[9] GAO-05-684.
[10]The tax gap for underreported individual income taxes exceeded $150 billion for tax year 2001. However, IRS does not have data on how much of this noncompliance arose because of complexity.

United States Senate
Committee on Finance

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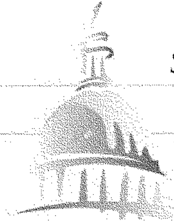

Sen. Chuck Grassley · Iowa
Ranking Member

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Opening Statement of Senator Grassley
Hearing, Tax Issues Related to Ponzi Schemes
March 17, 2009

It has been the tradition of this Committee for some years now to hold an annual hearing on issues that IRS faces during its tax return filing season. It's called filing season because between January 1st and April 15th of every year, the IRS processes almost 100 million tax returns and related payments or refunds.

Last year, the IRS processed these returns, payments and refunds while also developing and implementing a complex system to issue millions of stimulus payments. In addition, the agency was breaking in a new Commissioner at the same time. Despite these challenges, the GAO and others agree that IRS employees exceeded expectations to pull off a generally successful filing season. I commend them for that.

This year's filing season, however, brings new and different challenges. More than 4 million people have lost their jobs since last April 15th, and millions more have realized significant losses on their investments. As a result, millions of taxpayers are eagerly awaiting their refunds while others are worried about how they are going to pay the taxes they owe. The Commissioner recognized these hardships early on and issued a statement on January 6th highlighting the various ways that taxpayers could get assistance if they were experiencing financial difficulties.

Today, the IRS will issue additional guidance specifically to help victims of ponzi schemes. There are thousands of victims who have collectively lost tens of billions of dollars through dozens of these schemes. I look forward to Commissioner Schulman's testimony on this timely and important guidance. In addition to individuals, the victims of ponzi schemes include small businesses, retirement funds and charities. As many in this room are aware, I am committed to strengthening charities through increased transparency and accountability. It troubles me that charities have cut back on their charitable activities or have closed up shop altogether because of their ponzi scheme losses. Some of the charities that invested with Bernie Madoff, including universities and those funded by Hollywood big shots, would presumably have sophisticated advisors.

This raises questions for me about whether the board members of these organizations were more interested in helping their friend than furthering their charitable work. Mr. Josephson has testified before this Committee before. I appreciate his willingness to be here again today to discuss due diligence requirements for charities' trustees or boards of directors as well as the tax implications for board misconduct under the Internal Revenue Code.

In addition to conducting oversight of charitable organizations, I have also been committed to combating offshore tax evasion. This Committee has held several hearings on this topic, and Committee staff has worked to develop proposals to assist the IRS in its fight.

The proposals include improved reporting for foreign bank accounts and foreign transactions in general. They also give the IRS new tools to fight offshore tax evasion. The staff proposals are good, common-sense reforms that will help the IRS uncover abusive tax avoidance, but these proposals do not change longstanding tax policy governing the recognition of income. The GAO has done extensive research on the issue of offshore financial activity, so I welcome Mr. Brostek's testimony today.

Mr. Chairman, thank you for calling this hearing today to discuss these important issues.

Statement of William Josephson

Committee on Finance

United States Senate

March 17, 2009

> In the 1960s, and for many years thereafter, I believed that regulation of charities was the proper province of state government, even suggesting federal subsidies to support state programs that met minimum federal standards and reliance on state attorneys general to do the regulating. I would not advocate such measures now for two reasons. The first is a practical one: in 1964 there were ten states actively regulating charities and now, forty years later, there is only one more. The second is more basic: namely, the important change in the nature of federal regulation that has made it more suitable to police charities. Exempt organizations are no longer the stepchildren of the Service; the entire structure of the exempt organizations division has been radically altered so that it is no longer a branch avoided by Service personnel. Rather, TE/GE is staffed by specialists at the national level and for the most part in the regions who view their role as assuring that exempt charitable organizations continue to make the contributions to our society that are the rationale for the special status they are afforded in the tax system.[1]

Mr. Chairman, Senator Grassley,

I am grateful for, and honored by, your invitation yet again to appear before your Committee, this time on "Tax Issues related to Ponzi Schemes." As the head of the New York State Attorney General's Charities Bureau from 1999 to 2004, I shall testify about those issues as they relate to donors, charities and their regulators for which the Madoff scandal has had, and will continue to have, profound bad consequences.

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[1] Marion R. Fremont-Smith, *Governing Nonprofit Organizations* xiii (2004)

The damage has already forced several charities to close, JEHT, Robert I. Lappin Charitable Foundation and Chais Family Foundation.[2]

As Senators Schumer, Menendez and Cantwell requested in their March 1, 2009 letter to you, I will also try to address some of the issues that relate to whether or not:

> . . . the more than 150 private foundations that invested with Madoff . . . will be forced to pay onerous taxes as a result of the fraud.

In order to prevent future Madoff charity investment scandals, the Committee should consider what further regulation should be required:

(1) Of those charities, and of their donating individuals, trustees and officers, investment advisors that invested materially, let alone entirely, with Madoff?[3]

(2) Of the many different public accounting firms that audited those charities and the funds through which some of them invested materially with Madoff, that apparently never discovered, as the Madoff bankruptcy trustee, Irving Picard, says,[4] that Madoff bought no repeat no securities during the past 13 years. Did none of them ever test the "Controls over related party transactions" or do the periodically required physical "walk throughs"?[5] I would have

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[2] See Kristi Heim, Madoff investment exposure hurts 2 area foundations, Seattle Times, Feb. 4. 2008, at http://seattletimes.newsource.com/cgi-bin/PrintStory.pl?document_id=2008704577&zsection.

[3] See Nicholas Kristof, Madoff and America's (Poorer) Foundations, http://kristof.blogs.nytimes.com/2009/01/29/madoff-and-americas-poor-foundations/?pag (listing 147 private foundations whose Madoff investments were more than material, 100 percent in far too many cases).

[4] See Tom Hays, Madoff Trustee Says No Securities Bought in Past 13 Years, *N.Y.L.J.*, Feb. 23, 2009, at 2.

[5] Cf. Public Company Accounting Oversight Board [hereinafter "PCAOB"], Auditing and Related Professional Practice Standard No. 5 passim (June 12, 2007 as of Oct. 1, 2008) & PCAOB Staff Views, Guidance for Auditors of Smaller Public Companies passim (Jan. 23, 2009). (While the foregoing apply only to public held companies, they cite and incorporate the many AUs and Financial Accounting Standards Board Statements that

thought that after nearly 50 years we would have learned something from, for but one example, the $24 million Billie Sol Estes salad oil scandal in 1962, let alone Enron, namely that one has periodically actually to measure the oil in the tanks.[6]

(3) Of lawyers, some of whom represented both the charities and their substantial contributors, both of which invested materially with Madoff, if they perceived no conflict of interest or ever exercised even ordinary due diligence.

(4) Of the Public Companies Accounting Oversight Board, why did it exempt from registration auditors of nonpublic broker-dealers, which exemption it only revoked on February 19, 2009?[7]

(5) Of the Securities and Exchange Commission, why?[8]

A good place to start to address the Senate's concerns is the Committee's Staff Discussion Draft of June, 2004. Many of these proposed reforms have been enacted, but many have not. I will not here talk about all the unfinished business of charity reform, but will discuss the three Staff proposals that I think most relevant to the Madoff scandal.

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govern professional auditing in all contexts. For some reason, those professional issuances are not readily available to non-accountants like myself); see also Leslie Wayne and William K. Rashbaum, Investigation Into Madoff Fraud Turns to a Small Circle of Accountants, N.Y. Times, March 12, 2009, at B6. Many of the lawyers mentioned in this news story are leading members of the white collar crime defense bar.

6 http://en.wikipedia.org/wiki/Billy_Sol_Estes

7 See Bureau of Natural Affairs Daily Tax Report, All Broker-Dealer Auditors Must Register with PCAOB, Staff Says in New Guidance, http://www.pcaobs.org/News_and_Events/News/2009/02-19.aspx.

8 See Letter from Charles Grassley to SEC Inspector General David Kotz (Dec. 17, 2008), described in Bureau of National Affairs Daily Tax Report, Dec. 18, 2008, at http://news.bna.com/DTLNWB/doc_display.adp?fedfid=11153637&vname=dtrnot; Gregory Zuckerman & Kara Scannell, Madoff Misled SEC in '06, Got off, Wall Street Journal, Dec. 18, 2008, at A1; Gretchen Morganstern, Following Clues the SEC Didn't, N.Y. Times, Feb 1, 2009, at MB L1; Marcy Gordon, Lawmakers Say SEC Is Hindering Their Probe of Madoff, N.Y.L.J., Feb. 5, 2009, at 2.

I. "Apply private foundation self-dealing rules to public charities and modify intermediate sanction compensation rules."[9]

A. Self-Dealing. Most states' nonprofit corporate and trust self-dealing laws are remarkably weak. New York's Not-for-Profit Corporation Law, like its for-profit corporation law, requires only good faith disclosure and a board vote not counting the votes of any interested director or officer.[10] New York's Estates, Powers and Trusts Law, which applies to its charitable trusts, does not even regulate self-dealing.[11] Delaware's General Corporation Law does not distinguish between the fiduciaries of for profit and nonprofit corporations, although it does require that "the transaction be fair to the corporation."[12] When Attorney General Eliot Spitzer proposed such a requirement in New York, the charities shot it down. The American Bar Association's Revised Model Nonprofit Corporation Act has an "optional" section that says that only 51 percent of the individual directors of a not-for-profit corporation must be "Financially Disinterested."[13] Otherwise, substantively its generally applicable section 8.31 is like Delaware's.

All states and the District of Columbia have complied with the Internal Revenue Code section requiring them to incorporate in state law the self-dealing and certain other private foundation excise tax provisions.[14] However, I recently had to try to determine if any state had actually ever tried to enforce the Code's excise tax provisions and found no reported case. There is an officially unreported New York case brought by the Attorney General, but the court

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[9] Senate Finance Committee, Staff Discussion Draft, June, 2004, at 3.

[10] N.Y. Not-for-Profit Corp. L. § 715(a) & (b).

[11] N.Y. Estates, Powers & Trusts L. art. 8.

[12] Del. Gen. Corp. Law § 144; see Oberly v. Kirby, 592 A.2d 445 (Del. 1991).

[13] Revised Model Nonprofit Corp. Act. § 8.13 (1988) ("optional").

[14] Internal Revenue Code § 508(e).

deferred to any Internal Revenue Service enforcement, clearly an error, and, unfortunately, the State did not appeal.[15]

Putting to one side the important issue of haphazard and ineffective states' charity oversight,[16] to which we will return, had the self-dealing Code section applied to public charities, Yeshiva University's investment in J. Ezra Merkin's Ascot Partners LP, which in turn invested via Madoff, probably would not have occurred. According to Bloomberg, Madoff was then a Yeshiva trustee, and Mr. Merkin was also a board member and investment committee chair.[17] If the self-dealing rules had applied to public charities, this transaction probably could not have happened, because none of the exceptions to self-dealing appear applicable.[18]

Applying to public charities the self-dealing (as well as the excess business holdings, jeopardy investment and taxable expenditure Code sections) makes public policy sense, as I have previously advocated and testified. Such conduct is abusive whether done by a private foundation or a public charity. Second, whether or not the distinction between public charities and private foundations made sense in 1969, forty years later the distinction certainly has blurred, if only as evidenced by the reforms this Committee successfully initiated with respect to certain Code section 509 supporting organizations and donor advised funds,[19] which

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[15] Abrams v. Arcadapine, 112 N.Y.L.J. 22, col. 1 (Aug. 25, 1994).

[16] See supra note 1.

[17] Janet Frankston Lorin, Millstein Letter Helped Keep Yeshiva Money on Path to Madoff, Bloomberg.com, Jan. 1, 2009. According to this report, Ira M. Millstein, Esq., gave Yeshiva an opinion letter, which I have not seen, saying that disclosure and abstention were legally sufficient. If so, this would have been in accordance with New York law as described supra note 10. Even though Yeshiva University may be incorporated by the New York State Regents, the NPCL provisions apply. N.Y. Ed. L. § 216-a.

[18] Internal Revenue Code 4941(d)(2).

[19] See Pension Protection Act of 2006 §§ 1231, 1232, 1233 and 1241, 1242, 1243, 1244, respectively, adding Code §§ 4966, 4967 and amending §§ 509, 4942, 4943, 4945, 4958, 6033. What is the status of the Treasury study of donor advised funds and supporting organizations that was mandated by section 1226 of the Pension Protection Act of 2006?

hitherto had enabled substantial contributors and their disqualified persons to evade the private foundation excise tax rules. Finally, this Committee's own investigations have uncovered many public charity self-dealing abuses, for example, by the Nature Conservancy, American University and even the Smithsonian Institution. Indeed, both the federal tax and state law status of many of the federally incorporated charities is unclear and should be the subject of further federal legislation.[20]

B. Compensation and Benefits. The current private foundation self-dealing regulations with respect to compensation and benefits for disqualified persons are subjective and weak as compared to the excess compensation and benefits standards of Code section 4958 and the regulations thereunder which apply to public charities. There is no reason why one body of compensation and benefits law should not apply to all exempt organizations, and if section 4958 is made so applicable, it should also provide for incorporation into the states' laws and be enforceable by the states' charities officers by amendment to section 508(e).

Section 4958 is surely correct in imposing its excise taxes on the responsible individuals instead of on the charity. But the $20,000 maximum liability provision for a 200 percent excise tax clearly is for too low, even though it was doubled by the Pension Protection Act.[21]

C. Excess Business Holdings, Jeopardy Investments and Taxable Expenditures. As I said, it seems self-evident that the excess business holdings and taxable expenditure provisions should apply to all public charities, not just to donor advised funds and

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[20] See William Josephson, American Red Cross Governance, 55 Exempt Org. Tax Rev. 71 (2007).

[21] Internal Revenue Code 4958(d)(2).

certain supporting organizations, in addition to their current application only to private foundations. A few more words need to be said about jeopardy investments.

First, no one knows what Code section 4944 truly means, and the all-too succinct regulations thereunder, which have not been revised since they were promulgated in 1972, are not helpful.[22] Second, contrary to the Panel's analysis infra, and despite vast public education efforts, apparently the prudent investor state laws rules are ineffective to insure diversification, due diligence and reduction of risk by charities. How could charities have made such material Madoff investments, up to 100 percent of their portfolios in some cases, over long periods of time, without doing any meaningful oversight? Third, from my own experience the state laws are too difficult to enforce. Calculation of investment losses for state law damages purposes is not simple nor easy, even if one could prove, by a preponderance of the evidence, imprudence. Such proof is particularly difficult because of state law business judgment rules and other defenses based on the state law exculpating provisions of the Uniform Management of Institutional Funds Act,[23] now, alas, to be further extended by the misleadingly named Uniform Prudent Management of Institutional Funds Act (emphasis added).

The excise tax percentages in section 4944, recently doubled at this Committee's initiative by the Pension Protection Act of 2006,[24] are objective and have teeth. But like the Code section 4958 maximum discussed above, the maximum foundation manager limitations of $10,000 and $20,000, in light of the Madoff scandal, now seem far, far too low. If the

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[22] The Independent Sector's Panel called for their revision. See Panel on the Nonprofit Sector, Strengthening Transparency Governance Accountability of Charitable Organizations, a supplement to the final report to Congress and the Nonprofit Sector 16, col 2. (April, 2006) [hereinafter "IS Panel Supplement"].

[23] See, e.g., N.Y. Not-for-Profit Corp. Law §§ 512, 513, 514, 717. The Revised Model Nonprofit Corporation Act does not even deal specifically with prudent investment.

[24] Pension Protection Act of 2006 § 1212(d)

substantive standard of section 4944 were rewritten, as it should be, to provide a comprehensive prudent investor standard for all exempt organizations, and liability were extended to all disqualified persons, not just to the charity's managers, future Madoffs scandals should be deterred.

As the Independent Sector Panel observed, "Standards of care vary from state to state, and even within a state, depending on whether the charitable organization is a trust or a corporation. As a result, directors and trustees of otherwise similar organizations may be held to different standards of care for investment decisions." Does it not follow that the Independent Sector Panel needs to reconsider its opposition to "a federal standard of care for investment for public charities to be enforced by the IRS."?[25]

II. "Funding of Exempt Organizations and State Enforcement and Education."[26]

A. Internal Revenue Service. As the Committee well knows, the excise tax provisions of Code section 4940 were originally enacted to provide funds for IRS charity oversight. That has not happened, yet the charity oversight responsibilities of the Service have grown exponentially.

The Service, Steve Miller, Lois Lerner and their colleagues should be commended for following this Committee's leadership in strengthening form 990 disclosure and concerning themselves with exempt organization governance issues, despite especially self- or client- or

[25] See Is Panel Supplement supra note 21, at 16-17.

[26] See Staff Discussion Draft, supra note 9, at 15.

both interested push-back from its own Advisory Committee[27] and from Marcus S. Owens, Esq., a former high IRS exempt organizations official.[28]

But what is the IRS to do with this avalanche of new information and data, let alone after it revises form 990 P[rivate]F[oundation] along similar lines, as it has promised to do? According to Director Lerner, Exempt Organizations has only 838 employees total, and Examinations has only 461. The number of returns examined from fiscal 2004 to fiscal 2008 rose from 5,800 to 7,861 and the number of compliance contacts from 1,475 to 7,466. But there are already 1.8 million exempt organizations of various kinds, and the IRS receives more than 70,000 exempt organization applications annually.[29]

How many non-filers are there? We do not know. How many filers answer the excise tax questions on form 990 and 990 PF truthfully and file form 4720 when required? Very few, in my experience. Does the IRS examine every return for which a form 4720 is filed?

B. State Enforcement. As indicated in the quotation that leads my statement, state enforcement is spotty and unpredictable. In New York Attorney General Cuomo has started a Madoff investigation by the Investor Protection and Charities Bureau.[30] Has any other state charity officer?

The section 4940 excise taxes, and why not also the other private foundation and excess compensation and benefits excise taxes, plus interest and penalties, should be statutorily

[27] Advisory Committee on Tax Exempt . . . Entities, The Appropriate Role of the Internal Revenue Service With Respect to Tax-Exempt Good Governance Issues (June 11, 2008), Bureau of National Affairs Tax CORE IRS Development Reports. No. 113 (June 12, 2008).

[28] Letter from Marcus S. Owens to Eric H. Solomon, Assistant [Treasury] Secretary (Tax Policy) (Jan. 14, 2009).

[29] These data came from Letter from Lois G. Lerner to Dear Colleagues (Nov. 2008).

[30] Daniel Wise, Cuomo Probes Placement of Investments With Madoff, *N.Y.L.J.*, Jan. 22, 2009, at 1.

allocated for IRS charity oversight, together with a carefully drawn provision for revenue sharing with the states charities officers that equitably rewards these states that already enforce and induces those states that do not to do so. I did a draft for your staff some time ago.

Such enactment would also further the Committee's successful effort to amend the Code to enable the Service and the state charity officers to share taxpayer information.[31]

The Independent Sector Panel supported both increased resources for the IRS and a federally funded program to help states establish oversight and education.[32]

I defer completely to Commissioner Shulman about certain technical issues raised by the Senators, for example, should private foundations be able to obtain refunds for Code section 4940 taxes and some sort of credit for distributions in excess of those required by section 4942.

With respect to any jeopardy investment excise tax imposition, at least some private foundations do appear to have invested amounts "in such manner as to jeopardize the carrying out of exempt purposes"[33] and thus are subject to the initial and additional taxes imposed by section 4944(a)(1) and (b)(1). I defer to the Commissioner as to whether or not the Service will exercise discretion with respect to enforcement.

However, when I was head of the Charities Bureau, I felt that our assignment was to protect and enhance the funds available for charity, not to collect charitable funds for the

[31] See Pension Protection Act § 1224, amending Code §§ 6103, 6104, 7213, 7213A, 7431.

[32] See Independent Sector's Panel on the Nonprofit Sector, Interim Report, 46-47 (March, 2005); see also Independent Sector's Panel on the Nonprofit Sector, Strengthening Transparency Governance Accountability of Charitable Organizations Final Report 4-5, 24-25 (June, 2005).

[33] Code § 4944(a)(1).

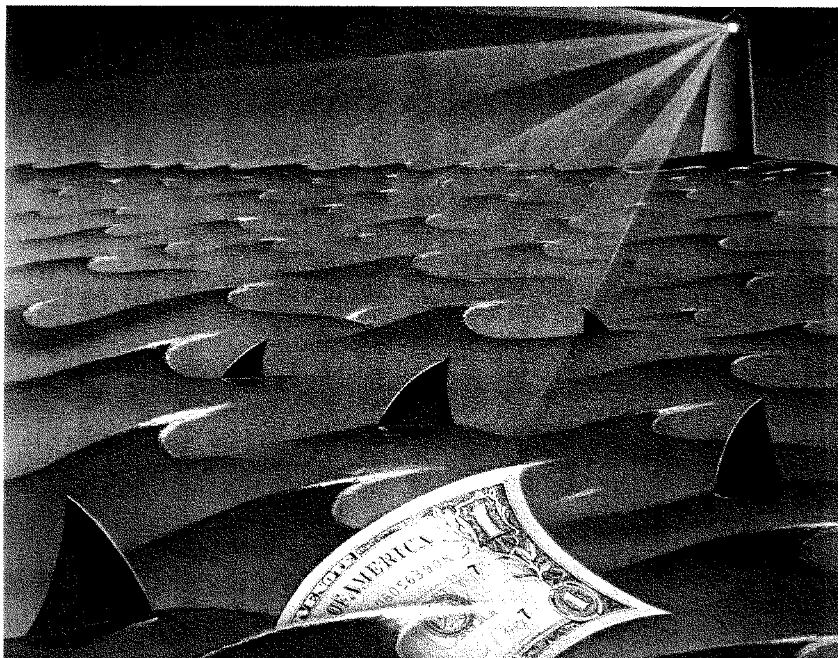
State. Thus, I thought, and think, it was correct that Code section 4941, like later enacted section 4958, imposed excise taxes on the self-dealer and the self-dealing foundation manager, not the private foundation.

I thought, and think, that it is bad public policy to impose on the private foundations themselves Code section 4943 excise taxes on excess business holdings, section 4944 jeopardy investments and section 4945 taxable expenditures. Private foundations can only act through their managers and other disqualified persons, and they should bear the entire liability, as they do for Code section 4941 self-dealing.

In particular, the Code section 4944 jeopardy investment limitation on the excise tax imposed on management to " . . . any case in which tax is imposed by paragraph (1)," i.e. on the private foundation, should be repealed. Such repeal would not only be good public policy but would be consistent with the excise taxes imposed on management by sections 4941, 4945 and 4958 which contains no such limitation.

Such repeal, as well as the amendment of sections 4943, 4944 and 4945 to eliminate the excise taxes imposed on charities, while retaining the excise taxes imposed on managers and extending them to disqualified persons, should deter future Madoff charity scandals.

Thank you very much for your invitation and attention.



Will CPAs Become Madoff's Next Victims?

By Dan L. Goldwasser and John H. Eickemeyer

As the extent of the schemes perpetrated by Bernard L. Madoff continues to unfold, one must ask where it will lead next. Are CPAs in line to be victims of Madoff? This seems like a silly question, because Madoff admitted he operated a Ponzi scheme estimated at $65 billion; pleaded guilty to 11 counts of fraud, money laundering, and perjury; will be sentenced to up to 150 years in jail; and will never be allowed to reenter the securities business. Moreover, CPAs are trained to be skeptical in matters of financial fraud and do not readily fit the profile of a Ponzi scheme victim. The sad fact, however, is that many CPAs are likely to be drawn into the financial black hole created by Madoff's scheme because their clients entrusted their investments to Madoff, either directly or indirectly. In fact, at least three dozen New York accounting firms and another two dozen individual accountants were identified in court filings as having received account statements from Madoff's investment firm.

The huge losses resulting from the Madoff scheme will no doubt result in an equally huge flood of litigation. Anyone who served as an auditor or professional advisor of a Madoff investor stands a good chance of becoming a defendant and, thus, being added to the list of Madoff's victims. In fact, this process has already begun,

as lawsuits have been brought against Ernst & Young, McGladrey & Pullen, KPMG, and BDO Seidman.

Who Is at Risk

The accounting firm most closely tied to the Madoff scheme was Madoff's own auditor, Friehling & Horowitz, which consisted of three people (only one was an active CPA, one was a secretary, and the third was approximately 80 years old and living in Florida) and operated out of a 13' by 18' storefront office in New City, New York. In addition to auditing Madoff's operations, this firm invested in Madoff's fund (further calling into question its audit independence) and also served as the accountant for scores of other Madoff investors.

Beyond this obvious target are the auditors for the numerous feeder funds that invested all or a substantial portion of their investors' monies with Madoff. These audit firms are likely to be sued by their fund clients and their clients' investors for having failed to properly audit the funds' financial holdings. Although auditors are generally able to rely on the audit reports of investee entities such as Madoff, the plaintiffs will undoubtedly allege that the auditors failed to heed numerous "red flags" that something was amiss in Madoff's enterprise. The following are among the red flags that have been alleged in an existing lawsuit:

- Madoff's claimed investment strategy was incapable of delivering the returns he was reporting;
- The options contracts in which Madoff supposedly invested were not reflected in the trading of the options exchanges;
- The value of the reported listed call options was insufficient to allow Madoff to hedge the exposure of the $65 billion in assets which Madoff claimed;
- Madoff operated under a veil of secrecy and did not allow outside audits by significant investors;
- Madoff went to 100% cash every December 31, irrespective of market conditions;
- Investors had no electronic access to their accounts at Madoff; and
- Madoff did not have an independent custodian hold its investment securities.

Entities that invested directly with Madoff will likely also seek to recoup their losses by suing their accountants and auditors. These entities will include educational and charitable organizations, foundations, pension plans, and other benefit funds that invested in Madoff's fund. While their losses are substantially less than those of the feeder funds in absolute terms (which ran as high as several billion dollars), they are devastatingly large to many such investors that placed most, if not all, of their entire investment portfolios with Madoff. These institutional investors will undoubtedly assert that such a concentration of assets with a single fund manager requires much greater scrutiny on the part of the entity's auditors, that the auditors had a duty to disclose the large concentration in a single investment vehicle, or that such concentration was in violation of the fund's stated policy of investment diversification. Whether such blame should fall on the fund managers rather than their auditors is subject to debate.

Also included among Madoff's victims were many thousands of individual investors. Although the vast majority of these investors did not have their financial statements audited, they may have employed accountants to prepare their tax returns or to offer business and investment advice. Many individual investors had copies of their Madoff monthly statements sent directly to their accountants; others simply forwarded those statements to their accountants in order to prepare their tax returns. Those accountants who offered investment advice (regardless of whether they were specifically retained as an investment advisor) will be particularly susceptible to lawsuits by their clients, who will likely claim that the accountants failed to adequately investigate what Madoff was doing. Even those accountants who only performed tax-preparation services are likely to be charged with having failed to notice various irregularities on their clients' monthly statements from Madoff. Although tax preparers rarely assume responsibility for bringing such anomalies to their clients' attention, this is unlikely to deter a defrauded widow from commencing a lawsuit alleging that she relied on her accountant to protect her, or a jury from finding that the accountant had a duty to do so.

CPAs who served as trustees, executors, or administrators of trusts, estates, and foundations that invested with Madoff are in even greater danger of being sued. These accountants would be considered fiduciaries and subject to assessment for their entity's losses. In such cases, plaintiffs need not prove that CPA fiduciaries had a duty to investigate, discover, and report anomalies in the way Madoff conducted his operations, but only that they failed to use reasonable prudence in making their investment decisions. An investment that paid 10% to 15% annual returns might be considered inherently too risky for such entities.

Madoff did not simply rely upon his reputation for high returns to attract the investors necessary to keep his Ponzi scheme alive. Madoff is said to have paid substantial finders' fees to solicit new investors. Any CPA who may have accepted such fees will have a difficult time convincing a jury that he did not compromise his objectivity in advising clients to invest with Madoff. This will be especially true of any firms that did not advise their clients that they were receiving remuneration from Madoff, with respect to their clients' investments.

Plaintiffs' Burden of Proof

Most of the suits against accounting firms will be brought by the accounting firms' clients themselves. These will normally be asserted on a negligence theory. In such cases, a client will have to allege that an accounting firm had a duty to investigate Madoff's fund and that, had the accounting firm done so, it would have discovered that Madoff was operating a Ponzi scheme. Such a claim poses some fairly high hurdles for plaintiffs, especially considering the number of sophisticated investors and regulatory officials who also failed to detect a scheme that Madoff operated for more than 15 years.

Some suits by CPAs' clients will be brought on a breach of fiduciary duty theory. In these cases, the plaintiff will have the burden of proving that the defendant accountant or accounting firm was a fiduciary with respect to the client. The law is clear, however, that the normal auditor-client relationship does not create a fiduciary relationship. Indeed, it has been successfully argued that a fiduciary relationship is incompatible with the independent auditor role. This does not mean that a CPA must manage a client's money or be an executor or trustee in order to be considered a fiduciary. A fiduciary rela-

tionship may exist when there is a significant disparity in financial expertise between the client and the professional, where the professional has undertaken to provide advice or other expertise for the client, and where the client is clearly relying upon the professional's greater expertise in making his investments or other business decisions. While it is not unusual for a client to claim that he was wholly dependent upon a professional's financial advice, the determination of whether a CPA owed a fiduciary duty to a client will likely turn on the facts of each individual case.

A breach of fiduciary duty claim is particularly dangerous for accounting firms if a client can surmount the hurdle of proving that the accountant served in a fiduciary capacity. As a fiduciary, an accountant not only would have had a duty to act prudently and with reasonable care, but also to advise a client of matters which come to her attention that could have an adverse impact on the client. This would not only require an accounting firm to disclose any fees which it had received in connection with the client's investment with Madoff, but also to disclose any anomalies that the accounting firm may have noticed in the way the fund conducted its operations—such as the steady returns reported when the broader market generally was suffering losses, the fact that Madoff's fund did not publish its financial statements, and that fact that the monthly financial reports sent out by Madoff had various anomalies on their face.

A few accounting firms may also be confronted by class actions brought on behalf of investors in the various feeder funds that invested with Madoff. Because these would not be client suits, the plaintiffs would have to plead and prove that the defendant accounting firm had acted fraudulently or recklessly. This is a heavy burden for any plaintiff to sustain. But it is not an impossible one, especially considering that a jury could easily find that, when it comes to a $65 billion investment company, relying on the audit opinion of a three-person accounting firm is inherently unreasonable. Moreover, the damages likely to be sought in such suits are so high that few accounting firms will be able to risk a jury verdict. Thus, such cases would seemingly have a very high likelihood of settlement if the plaintiff's suit is not dismissed by the court in its earliest stages.

Protecting Liability Coverage

Faced with the prospect of being another Madoff victim, accounting firms must take precautions to minimize their liability exposure. For most firms, the first and foremost line of defense is their professional liability insurance policy. Accountants who may have exposure to Madoff-related claims should make sure that their coverage remains in place and that their insurer is promptly notified of any potential, threatened, or actual claims. The good news is that most claims that arise out of the Madoff scandal will fall within the coverage of most policies. Claims that are based solely on investment advice may fall within an exclusion contained in some policies. It is likely, however, that most claims will be based on alleged negligence in connection with the provision of tax or audit services, in which case there will likely be coverage or, at worst, the provision of a defense under a reservation of rights by the insurer.

It is vital that CPAs do not jeopardize their coverage by failing to promptly notify their insurers about actual or potential claims.

It is vital that CPAs do not jeopardize their coverage by failing to promptly notify their insurers about actual or potential claims. If a lawsuit is received, the insurer should be notified immediately, as provided in the policy. Accountants should also promptly notify their insurers about threats to bring Madoff-related claims or demand letters directed to the accounting firm. Prompt notice of these incidents not only allows the insurer and the accounting firm to begin to plan a defense at the earliest possible time, but it ensures that the insurer cannot later seek to avoid providing coverage—if suit is eventually brought—on the grounds that the firm did not give notice to the insurer as soon as it learned that a claim might be brought.

CPAs may also receive subpoenas from parties already involved in Madoff-related litigations or from trustees, receivers, or creditors in connection with bankruptcy proceedings resulting from the Madoff fiasco. Recipients of such a subpoena should promptly notify their insurers and explain in an accompanying letter their involvement with the person or entity involved in the Madoff-related proceeding. Many policies offer some form of coverage for subpoena responses, which can help defray at least some of the related expense. More importantly, notice of the subpoena will generally serve as notice of a potential claim, ensuring that if a suit is subsequently brought against the accounting firm, there will be no grounds for a denial of coverage due to late notice. CPAs who receive subpoenas or informal requests for testimony, documents, or other information pertaining to Madoff-related claims should always consult counsel before responding.

Not surprisingly, liability insurers are already deeply concerned about their potential exposure arising out of Madoff claims and are requesting information in their renewal applications about their insureds' exposure. A failure to respond truthfully to such inquiries could jeopardize a firm's liability coverage. On the other hand, a firm that reports a large number of clients who sustained losses in the Madoff scandal could find that its insurer has declined to renew its policy.

The best way to respond to such inquiries is to report in detail all Madoff-related suits that have actually been initiated or threatened, or in which a subpoena or other request for documents or testimony has been made. As discussed above, this already should have been done prior to the time of the renewal application. These will constitute "claims" under the firm's existing poli-

cy and will have to be covered by the insurer up to the limits of the firm's policy. For the most part, however, accounting firms will not have been sued or even threatened with a lawsuit by clients who invested in the Madoff fund. With respect to these clients, it is recommended that the firm simply list each of these clients, with the amount invested by each and the nature of the services the firm provided. This list should be accompanied by a statement that the firm has not been threatened by any of the listed clients and that the list is simply being provided to allow the insurer to assess its potential exposure.

There is, of course, a risk that some insurers may be frightened by these disclosures and decline to renew a firm's coverage. If this happens, the firm will have difficulty finding a new insurer that will cover claims by the listed clients because a new insurer will likely treat them as existing claims and assert that they are the responsibility of the previous insurer. To protect itself in this situation, an accounting firm will have to make a further submission to its current insurer prior to the expiration of its policy (or the extended reporting period related to the policy), explaining why it believes that claims may arise with respect to each of the listed clients. (In the case of a firm that provides attest services to a client who has invested with Madoff, its independence will likely be impaired by any threat of litigation.) The insurer will have the burden of proving that a claim could not have been reasonably foreseen at the time the policy expired—a very difficult burden to sustain after it has dropped coverage. In this way, an accounting firm can maximize its chances of being covered if a suit is later commenced against it.

Under New York law, an insurer may not terminate coverage on less than 45 days' notice. This is not a lot of time in which to secure replacement coverage, especially coverage for potential Madoff claims. Should an accounting firm receive notice that its insurance will be cancelled or not renewed, it must immediately contact its legal counsel and insurance broker and give serious consideration to purchasing extended reporting—known as tail coverage—on its existing policy.

Other Damage Control Measures

In addition to ensuring that any Madoff-related claims are covered by their professional liability insurance, accounting firms that may face such claims should also take steps now to assess, and possibly limit, their exposure. For example, firms that have Madoff investors or feeder funds among their clients should carefully collect and review all of their files related to those clients. Attest engagement workpapers are subject to retention requirements—seven years, in the case of New York State Board of Regents Rule 29.10(a)(11). This provision also requires that any substantive alterations to workpapers made more than 45 days after issuance of the financial statements must be clearly documented and include both the date of and the reason for the alteration. While a review of workpapers may indicate the need for additional documentation, any substantive alterations should be made in strict conformity with the rule, and may not include the discarding of any portion of the workpapers.

While it may be tempting to discard certain material during this review process, the destruction of any materials at this time—when there are numerous investigations by a variety of governmental agencies under way—could be hazardous and might itself become the subject of investigation. Even if the discarded material never becomes the subject of an investigation, the destruction of any relevant material could be examined in future litigation and construed as harmful to the firm. The emphasis at this time should be on the gathering, preservation, and review of all physical and electronic information related to engagements that could give rise to Madoff-related claims. This material should be placed under the control of a person or small group designated by firm management. Access to the material should be strictly controlled, and the firm's outside counsel should be consulted with respect to any potentially damaging material that is identified.

Of particular importance will be the firm's engagement letter and correspondence with clients. One of the most important issues to be considered by firms whose clients invested with Madoff will be whether the firm undertook to, or did, provide investment advice, regardless of what the nature of the engagement may have been. It will also be important to assess what kind of information the firm received concerning its clients' investments with Madoff—in particular, whether the firm received any Madoff-generated account statements—and whether that information contained anything that could be construed, in hindsight, as a red flag.

In addition, further communications with clients who had Madoff investments should be carefully restricted, and firm personnel should be warned not to make any statement to the client that could be construed as admitting that the firm could or should have detected the Madoff fraud. This will be difficult, because most clients who are Madoff victims will now need the firm's help more than ever. Such communications should be well planned in advance, and the persons engaging in those discussions with the client should be thoroughly familiar with all prior client communications so as to avoid making any admissions against the firm's interests. In such conversations, the client is likely to have a distinct—even if erroneous—recollection of having discussed her Madoff investment with one or more of the firm's professionals.

In any event, accounting firms will undoubtedly have to assist clients in filing for tax refunds and applying investment losses to other taxable income. CPAs may also be asked to help individuals make claims in the Madoff bankruptcy proceeding and defend claims by the bankruptcy trustee to recover any monies that may have been withdrawn from the Madoff fund. A firm that lacks the competence to provide this type of advice should not do so because a client who may not be able to hold his accounting firm responsible for his losses may nevertheless seek to hold the firm responsible for failing to provide the necessary advice to mitigate his losses to the maximum extent possible. ❑

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SUBMITTED BY SENATOR SCHUMER

Adriane Biondo Statement

I am a single 41-year-old woman currently living in Los Angeles. My family and I, as a family partnership, first invested with Bernard Madoff a number of years ago. Through the years, as a result of additional contributions, we amassed just over $800,000. This is a fortune to us and represents our life savings. We were introduced to Mr. Madoff's firm by a friend of the family and based upon what we were told, we felt lucky to have been able to place our money there. We were told that Madoff only took on very few clients and that they were always very high dollar amounts, we came to understand that he was a brilliant business man and we were in good hands.

My family always felt that we were small investors and due to that we were concerned that our account would not be traded as actively as larger ones. Four years ago, my aunt decided we should go up to the Madoff offices and introduce ourselves. She felt if they had more than the phone, mail and fax communications, that if we had a face-to-face meeting, they might make sure to trade our account and give it as much attention as "the big guys." I took her to a meeting with Frank DiPascali, who took us around, showed us the trading operation, and we waved at the Madoff sons, who were overseeing the day-to-day trading operation. Mr. DiPascali looked me dead in the eye and told me that all the funds were traded in one group, that the trades were executed via the

trading side of the business, and that Mr. Madoff himself was invested as well. We left that day feeling very comfortable. This was a source of great comfort to us.

The amount of money that I personally lost through Madoff was $180,000. My only remaining assets are a condo in South Florida which I am fighting to hang on to, and a tiny IRA which is down to almost nothing. I have already moved out of my condo and have a friend living there, helping to pay the mortgage and expenses, which I still have to contribute to monthly.

I am living in Los Angeles with old friends who are helping me get back on my feet. I work in concert touring production and my current economic situation requires that I stay in Los Angeles to get work. I have a mortgage, a home equity line, credit cards, a car note and the other expenses that the average American has. I am fighting tooth and nail to find work as so many others are in this economic climate.

I took a home equity line on my condo in 2005 and bought a second property in Florida, which I ultimately rented to a wonderful family who were victims of Hurricane Katrina. I gave them a rental rate that they could afford as they still had a mortgage they could not get out of on their destroyed house in Kenner, Louisiana. The rent they paid me didn't cover my taxes or insurance on that house, but I knew I could utilize my resources coming in from my investment with Madoff if necessary, and I wanted to do what I could for these people who lost their home in Hurricane Katrina. They were a lovely family, the father a truck driver, the mother a retail store manager, a son in college, a daughter in high school, and another son fighting in Iraq. Isn't that what we are taught to do? Do what you can for your fellow man? I sold that house after the real estate bubble popped having held on to it longer than I intended because of my tenants, and barely broke even.

My family members who contributed to the Madoff account included my aunt, my grandmother's sister, who is 87. She has lost virtually everything she had. She is a widow and lives alone in a very modest two-bedroom condo in New Jersey. My late uncle was a retired business man and all of their hard work has vanished with Madoff, leaving my aunt under great stress which is affecting her health badly. Her blood pressure is dangerously high, she has retinal hemorrhaging, and medication isn't working to lower it. These issues did not exist prior to the day she found out everything we had was suddenly not here. It is so sad to see her, in her twilight years, overcome with worry. She has calculated that she is $75.00 a month under the amount she needs to cover her expenses, which are covered by her Social Security and the tiny amount she will draw against her other savings monthly, but even that will only last until she is 92.

There are hundreds and maybe thousands like my Aunt , who now agonize over the fact that the SIPC might find a reason to come victimize them again, because at some point they may have felt they needed funds from their accounts. She said she hopes to be gone before she runs out of money or "they come clawing back at me." I suggested that she try to get her meals through the charity "Meals on Wheels" and she explained that she "drives for them on days when she feels well enough" in her ten-year-old Toyota. My aunt and uncle were active in many charities in their 60's and 70's, acting as guardians ad litem for children in the family court system and greeting children at Orlando airport in Florida who were terminally ill with cancer on their way to Disney World through the "Give Kids The World" program. It is painful to know her short future is at best, uncertain. It is agonizing to hear her wish her own demise in a time when she should be at peace and just trying to enjoy the few remaining years of her life.

My aunt's daughter, who is my cousin, and her husband have also been wiped out. She has been a special education teacher for 25+ years. Her husband is a retired New York City school teacher who worked for 38 years with inner city children. They had taken out a $100,000.00 home equity loan to pay for the college tuition of their two sons currently in school, and added it to their Madoff account. The third son will be starting college this Fall. But now, there is no money for tuition and they have the additional mortgage on their house.

My cousin's husband has been battling illness this past year and cannot return to work, if the need arises. They live off her salary and his pension. They are distraught that the money they planned to use for the education of their three sons is now gone. Sixty three cumulative years of hard work as public school teachers in New York City, with sacrifices, difficult daily choices about personal spending and nurturing future generations all to not be able to educate their own children.

Cousins of my aunt, who were part of the Madoff investment, are also in their 80's and in very poor health. They live in a modest two- bedroom condo in Florida. Without being able to utilize funds from their Madoff account, they have no funds to live on other than their Social Security. They have applied for food stamps but were told they are just over the limit, because of their Social Security income. They already have a reverse mortgage on their home to cover their medical expenses. They have an adult, emotionally-disabled daughter living at home as well and are borrowing from old friends to keep afloat. My cousin Bob has been hospitalized twice since this all unfolded, due to chest pains caused by stress. I am powerless to help them in any way. Bob is bent over at the waist, walks with a cane, and can't just pick up and get a job to help pay the bills.

The money I lost was what was left after my Grandmother had a lengthy illness and was able to stay in her one bedroom rental apartment, until her passing. The same for my mother who was also able to stay at home, where I looked after her in her rental apartment until she passed away as well. All my family has tried to do for the last 40-50 years is just allow for dignified retirements and hopefully have a bit to pass on. I will never forget the moment that I realized everything my family worked for, over decades, was just gone. It was a feeling of free falling with no end. I then had to call my elderly relatives and deliver this devastating blow to them, long distance via the phone. It was a horrible and surreal moment. We have nothing left but our homes and in some cases a modest bit of savings.

We feel that the government has failed us. There is no explanation for the SEC's utter failure to understand the fraud. If they, in fact, investigated Madoff, how could they not have demanded to see his trading confirmations. If they had asked for them, they would have realized they were non-existent. Madoff's firm was not a small time investment firm. Madoff was a luminary on Wall Street and we and so many others felt fortunate to be involved with him. The SEC's failure to follow up on Mr. Markopolos' detailed submissions to the SEC is inexplicable.

My family now understands that any SIPC recovery in a Ponzi Scheme, is based on principal less withdrawals. My family hopes that they will be able to recover the full amount that SIPC will allow.

Moreover, under the bankruptcy law, the SIPC trustee has the power to sue any investor to recover the payments that were made to them, if they were in excess of their original investments. This has paralyzed many innocent investors, who are now victims,

with fear, ultimately will re-victimize them. Many will not exercise their "right of expectation" as investors, and out of clawback fear will not even file a claim for much needed recovery. Most are not left with enough funds to hire a lawyer to defend themselves. They are counting on you to see that does not happen.

There are four ways that Congress can help my family and others cope with this tragedy.

First, the government could return to us the taxes we paid since 1992 on phantom income. The government collected income taxes on our capital gains since 1992. Under current law, we can only file amended returns to obtain refunds of the taxes paid on phantom income for three years. Although we could carry the loss forward for 20 years, that does nothing for my family and other elderly victims who have no prospect of future income. Thus, under current law, the government is the beneficiary of Madoff's Ponzi scheme. I am asking you, on behalf of myself and my family, to change the law so that, in a situation where the SEC allows a Ponzi scheme to go undetected, the government will refund to the victims all taxes paid on phantom income. Surely, as representatives of the people, you don't want the government to enrich itself from the dishonesty of people like Madoff.

Second, the law could be changed to allow every investor to be covered by SIPC insurance for the balance on the last statement, even if the investor took out more money than they contributed. Many small investors desperately need full SIPC recovery according to current guidelines. The current SIPA laws state the investors have a "right to reasonable expectation". All of us received monthly statements and confirmations and any decisions that were made about our accounts were made based on our statements and

confirmations. Yet, the current cash in cash out basis that Trustee Picard has said he will use will negate that.

Third, the $500,000 limit on SIPC insurance could be increased, just as the cost of living has increased. If there had been cost of living adjustments to SIPC insurance, I believe the coverage would be $1 million now.

Fourth, the law could be changed to prevent the SIPC trustee from suing innocent investors who took out money to support themselves. Based on current law, the SIPC trustee can sue to recover the last six years' withdrawals. Investors had no knowledge of his fraud. People invested in good faith and withdrew funds in good faith. The funds many withdrew were used to pay the taxes that were obligated to be paid on phantom income, as well as living expenses. It is terrible that innocent investors can be forced to pay back money taken out in good faith which they believed was theirs.

Thank you for hearing the smaller voices.

Statement of Ronnie Sue Ambrosino

My name is Ronnie Sue Ambrosino. I am 56 years old. I presently reside in a motor home which I have parked in an RV park in Surprise, Arizona.

I began investing with Madoff approximately 30 years ago, during my first marriage. At the time, I was living in New York. My first husband was working for a sporting goods company on Long Island , which had its profit sharing and pension plan with Madoff. After watching the positive returns of Madoff and the ease of withdrawal, we opened our personal account and slowly, over a period of years, increased the amount we invested.

I was divorced from my first husband in 1992 and took most of the money I got in my divorce and started my own account at Madoff. In 2004, I married my present husband, Dominic Ambrosino, who worked for the New York City Department of Corrections. Through the period from 1992 on, I worked as a computer analyst and did not take any withdrawals from my Madoff account because I wanted to have that money to fund my retirement. We knew my husband would retire with a small pension but we invested our lives' savings in Madoff because the account was growing so steadily.

We knew that Madoff was a member of SIPC and thus felt secure with this insurance protection. We felt we had even greater protection, however, because we had heard that people had complained to the SEC that there was something wrong with Madoff and we knew that the SEC had investigated Madoff and found nothing wrong. In fact, Madoff advertised on his website that he had been cleared of any wrongdoing by the SEC. We are not sophisticated investors and, in our view, if the SEC had investigated Madoff and found nothing wrong, we would have felt totally comfortable that our retirement was assured. We received monthly stock purchase and sale confirmations

from Madoff showing that he was investing our money in Fortune 500 companies for short periods of time, in between which he invested our money in US Treasury Notes. Thus, we felt we had a diversified, secure retirement portfolio.

In 2004, we retired, sold our house in New York, and made Florida our home. We took all of the profits from the sale of our house and invested those funds in Madoff as well. We purchased a motor home which we financed with a mortgage so that we could keep as much money as possible in Madoff. For four years, we had an ideal retirement. We traveled around the country in our motor home. We spent four months in Alaska and Canada this past summer and then were heading through Arizona en route back to Florida when, on December 11, 2008, we learned that Madoff had operated a Ponzi scheme and that the $1,660,000 in our Madoff account had all been stolen. At that point, we were stranded in Arizona because we literally could not afford to fill our 150 gallon fuel tank with diesel gasoline.

My husband has a small pension from the New York City Department of Corrections which covers the mortgage on our motor home and our food costs. Now that we have lost our life savings, we have cut our spending down to a bare minimum. Some friends offered to let us park our recreational vehicle at their site through the summer, without having to pay rent. This is a God send because it enables us to stay here. Needless to say, we can no longer afford to retire. We are both actively seeking employment so that we can support ourselves.

We are not looking for a handout from Congress in these terrible economic times. But we cannot avoid the fact that the Internal Revenue Service was the single largest beneficiary of Madoff's fraud. Every year we had our Madoff account, we paid income

taxes on the alleged income in our Madoff account which was taxed at the highest rate as short term capital gains. We feel that the United States must accept responsibility for the utter failure of the SEC to fulfill its statutory function. If the Internal Revenue Service would refund to us the taxes we paid on phantom income for the years Madoff sent us fraudulent statements showing earnings in our account, we would at least have a nest egg of savings to cover some of our living costs. This is money that the government has no business holding because the taxes were paid on phantom income.

I realize this refund would not even come close to recovering my initial investment, nor the value of my account as of Nov 30, 2008, but I feel that this is a step toward enabling me, and the other victims, to begin to pick up the shattered pieces of our lives that the SEC brought upon us.

We are hoping that you will recognize the monumental devastation that the SEC has caused to hard-working honest American citizens who relied upon the SEC's stamp of approval placed upon Madoff, despite detailed submissions from Harry Markopolos laying out the Madoff fraud from 1992 on. In fact, it now appears that the SEC did not even confirm that Madoff had purchased any securities because we now know that, despite the monthly stock purchase and sale confirmations that we received, Madoff never purchased a single security with our money for a period going back 13 years. From their website, "The SEC is concerned primarily with promoting the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud." This obviously did not occur.

I am appealing to you, from the bottom of my heart, to use your legislative power to restore to the victims of the SEC's incompetence some of the funds that we lost.

Statement of Richard Friedman

I am a self-employed certified public accountant living in Jericho, New York. I am 59 years old. My wife worked as a teacher in the public school system and retired from teaching in 2005. She receives a pension of $2,000 per month and has a retirement account with approximately $275,000 in it. My wife could have worked another five years and then retired with a pension of approximately $4,000 per month but, because of our Madoff account, we felt that we had enough money for our retirement and so my wife chose to work on an unpaid basis as the caregiver for our baby grandson, so that our daughter could continue her career.

We have worked very hard all our lives. We put our two children through college and one through medical school. We invested virtually all of our money in Madoff. As of November 30, 2008, we thought we had $3,100,000 in our two Madoff accounts: an IRA account with $1,300,000 and a regular account with $1,800,000. No money was ever withdrawn from the IRA account, but $100,000 was taken out of the other account. As of December 11, 2008, when we learned that our entire Madoff investment was lost, I was in the process of retiring. At the present time, most of my accounting work is being done at greatly reduced fees for former clients who had invested much of their life savings in Madoff.

My father was a great provider, having been a CPA who worked his entire life, from 18 to 84, and invested his money very successfully. When my father died, he left my mother with two Madoff accounts: an IRA account, whose balance on 11/30/08 was around $5.5 million; and a non-IRA account with approximately $7 million. Thus, we thought my mother had assets of $12.5 million.

My mother, who suffers from moderate Alzheimer's, had been living on withdrawals from her Madoff accounts. Now she has to survive on Social Security. Her only remaining asset is a bank account with approximately $350,000 in it. She will probably outlive this money. She requires a full-time caregiver, food and shelter. She cannot possibly afford all of this on her Social Security so we are forced to draw from her savings. Now I am concerned about SIPC clawing back tens of thousands of dollars of money innocently withdrawn from Madoff.

If Trustee Picard's devastating interpretation of how SIPC funds are to be distributed to victims is permitted to stand, the chances are excellent that my poor mother will be forced to sell her home someday.

My sister was a beneficiary of the generosity of my father. He established with Madoff a $500,000 Trust in her name so that she would be provided for. Since she has had two hip replacement operations and a third operation to correct the damage done by an earlier one, she is unable to work anymore. She is a single parent of two young children who receives little child support. With the Madoff money gone, she is only a couple of months away from being completely destitute. She is applying for food stamps. She will be forced to sell her home in a few months if Trustee Picard is permitted to continue to ignore the very law he claims he is following.

With respect to the $7 million in the regular account my mother had at Madoff, over the years, we paid an enormous amount of money in taxes to the government based upon the short term capital gains we were told Madoff was generating. To give you some idea of the amount, Madoff generated approximately 10% per year in short term capital gains which were taxed at 35 – 40%. Thus, each year, my mother paid

approximately $250,000 in taxes to the federal government based on the fraudulent 1099 that was issued by Madoff with respect to her non-IRA account. I, similarly, paid an enormous amount of money to the government in taxes on the fictitious income reported by Madoff.

I'm sure many of you are thinking how foolish it was for my father and me to have put virtually all of our assets into Madoff. But Madoff had been in business since the 1960's and he had an impeccable record. We were aware that some people had complained to the SEC that Madoff's returns were impossible to achieve. But every time the SEC investigated Madoff, he came out clean and we concluded, therefore, that people were just jealous of his results. In fact, according to published reports of the December 16, 1992 issue of the Wall Street Journal, the SEC feared a scandal when they discovered that two Florida accountants had gotten investors to invest $440 million dollars into an investment pool, and that money went to Madoff. A court appointed trustee investigated this matter and found all the money was there. The SEC was satisfied and this apparently satisfied thousands of other people who then felt even safer investing their money with Madoff.

Moreover, we felt we were fully diversified in Madoff because his trading strategy, as laid out in the mass of stock purchase and sale confirmations that we received each year, was to go into the market five or six times a year, buy positions in about 33 different Fortune 500 companies; hold those positions for about six weeks; and then sell the stock and put the money in US Treasury Notes. Thus, we believed we had a fully diversified investment portfolio handled by someone who had repeatedly received the SEC's blessing. What safer investment choice could we have made?

Even Harry Marcopolos' 29 red flags, that the SEC missed, were signs of fraud that had nothing to do with the statements that Madoff sent out each month. All the SEC had to do was ask to see stock certificates (which we could not do) and this scam would have been busted over 16 years ago.

Under present law, we have no means of recovering a dime on the IRA account of my mother. That money is totally lost. My mother cannot even recover SIPC insurance because my parents withdrew the statutorily-mandated amount from that account every year. Thus, they withdrew more than they invested by 2004 and under SIPC's procedures, we have no right to recover a dime. My IRA recovery is limited to what I put in. Seventeen years of appreciated growth with Madoff has been wiped out, which also included the investments and appreciation of the previous fifteen years. Thus, altogether, I lost 32 years of savings.

In fairness, the government should not retain any of the taxes paid by Madoff investors on phantom income. As a practical matter, I know how difficult it would be for the IRS to refund all these taxes. It amounts to tens of billions of dollars. The United States Government should not play "gotcha" taxes. Income taxes were paid on phantom income that the SEC said was legitimate income, so that the IRS, also an agency of the U.S. government should not be permitted to keep. There is nothing sacred about the three years of amended returns or three year carryback rule for treating theft losses. However, if we could at least carry back a theft loss for ten years, and be permitted to amend more than three years back phantom income reported as real income, we would be able to recover at least a portion of the taxes we paid on phantom income in the past ten years.

Please be properly advised that the Securities Investor Protection Act (SIPA) was to honor the "reasonable expectations" of the securities customer. If an investor received confirmations of purchases of securities, even if the broker never purchased any securities, that investor is entitled to up to $500,000 SIPC coverage for securities, because the investor reasonably believed that he had securities in his account. That is the law. Any interpretation other than that is a disservice to all Americans. Imagine, if you will, if a person had $250,000 in a bank that failed, and the FDIC said that they had reinterpreted the law that anyone who had money in that bank, would only be entitled to 20% of their holdings. The U.S. banking system would be destroyed in one day as an avalanche of panicked investors raced to the bank to get all their money. The United States economy is based upon trust. Permitting SIPC to destroy this trust will send the message to the American investor and the public at large that the Government of the United States cannot be trusted. The integrity of our system is on trial here and cannot be left in the hands of two self-serving men, Stephen Harbeck, the head of SIPC, and Irving Picard, the Trustee in the Madoff case.

PREPARED TESTIMONY OF
DOUG SHULMAN
COMMISSIONER
INTERNAL REVENUE SERVICE
BEFORE THE
SENATE FINANCE COMMITTEE
TAX ISSUES RELATED TO PONZI SCHEMES AND AN UPDATE ON OFFSHORE TAX EVASION LEGISLATION
MARCH 17, 2009

INTRODUCTION

Mr. Chairman, Ranking Member Grassley and Members of the Committee, I want to thank you for the opportunity to testify today on tax issues related to Ponzi schemes and the Internal Revenue Service's ongoing efforts to detect and stop unlawful offshore tax avoidance.

It is unfortunate in these otherwise difficult economic times that we are here today to discuss a situation where thousands of taxpayers have been victimized by dozens of fraudulent investment schemes.

These too-good-to-be true investment ruses have often taken the form of so-called "Ponzi schemes." The perpetrator of the fraud promises returns, and sometimes even provides official-looking statements showing interest, dividends, or capital gains, some or all of which is fictitious.

According to news reports, the recent Madoff scandal has affected a very large and diverse pool of investors, some of whom are reported to have lost most of their life savings. Beyond the toll in human suffering – as entire life savings and retirements appear to have been wiped out – the Madoff case raises numerous tax and pension implications for the victims.

To help provide clarity in this very complicated and tangled matter and to assist taxpayers, the IRS is today issuing guidance articulating the tax rules that apply and providing "safe harbor" procedures for taxpayers who sustained losses in certain investment arrangements discovered to be criminally fraudulent. I will discuss each one separately. The IRS will provide a copy of the guidance for the hearing record.

Mr. Chairman, turning to the second subject of today's hearing, international issues are a major strategic focus of the IRS. It is of paramount importance to our system of voluntary compliance with the tax law that citizens of this country have confidence that the system is fair. We cannot allow an environment to develop where wealthy individuals can go offshore and avoid paying taxes with impunity. As you will hear from my testimony today, the IRS is aggressively pursuing these individuals and institutions that facilitate unlawful tax avoidance.

These issues are so important to the IRS that I have both increased the number of audits in this area over the last five months and prioritized stepped-up hiring of international experts and investigators. This occurred during a time when staffing levels were effectively frozen because of the Continuing Resolution.

While it is true that IRS agents and investigators will ultimately generate net enforcement revenues for the government, we view our international compliance strategy to date as much more focused on protecting approximately $2 trillion in revenue that the IRS collects than the incremental enforcement revenue that we collect from these specific activities. We cannot allow corrosive behavior to undermine the fundamental fairness of our tax system. Going forward, the administration will be outlining further initiatives to step up international tax enforcement and improve our revenue collection.

Moreover, seen through the prism of the current economic crisis, it is scandalous that wealthy individuals are hiding assets overseas and unlawfully avoiding US tax. It is an affront to the honest taxpayers of America, many of whom are struggling to pay their bills, who play by the rules and expect others to do the same.

PONZI SCHEME PUBLISHED GUIDANCE

Summary

The IRS is issuing two guidance items to assist taxpayers who are victims of losses from Ponzi-type investment schemes. While I recognize that the Committee is today focused on one specific case, the IRS guidance is not specific to this case. The first item is a revenue ruling that clarifies the income tax law governing the treatment of losses in such schemes. The second is a revenue procedure that provides a safe-harbor method of computing and reporting the losses.

The revenue ruling is important because determining the amount and timing of losses from these schemes is factually difficult and dependent on the prospect of recovering the lost money (which may not become known for several years). In addition, it clarifies the reach of older guidance on these losses that is somewhat obsolete.

The revenue procedure simplifies compliance for taxpayers (and administration for the IRS) by providing a safe-harbor means of determining the year in which the loss is deemed to occur and a simplified means of computing the amount of the loss.

Revenue Ruling

The revenue sets forth the formal legal position of the IRS and Treasury Department:

- **The investor is entitled to a theft loss, which is not a capital loss.** In other words, a theft loss from a Ponzi-type investment scheme is not subject to the normal limits on losses from investments, which typically limit the loss deduction to $3,000 per year when it exceeds capital gains from investments.

- **The revenue ruling clarifies that "investment" theft losses are not subject to limitations that are applicable to "personal" casualty and theft losses.** The loss is deductible as an itemized deduction, but is not subject to the 10 percent of AGI reduction or the $100 reduction that applies to many casualty and theft loss deductions.

- **The theft loss is deductible in the year the fraud is discovered, except to the extent there is a claim with a reasonable prospect of recovery.** Determining the year of discovery and applying the "reasonable prospect of recovery" test to any particular theft is highly fact-intensive and can be the source of controversy. The revenue procedure accompanying this revenue ruling provides a safe-harbor approach that the IRS will accept for reporting Ponzi-type theft losses.

- **The amount of the theft loss includes the investor's unrecovered investment – *including income as reported in past years.*** The ruling concludes that the investor generally can claim a theft loss deduction not only for the net amount invested, but also for the so-called "fictitious income" that the promoter of the scheme credited to the investor's account and on which the investor reported as income on his or her tax returns for years prior to discovery of the theft.

  Some taxpayers have argued that they should be permitted to amend tax returns for years prior to the discovery of the theft to exclude the phantom income and receive a refund of tax in those years. The revenue ruling does not address this argument, and the safe-harbor revenue procedure is conditioned on taxpayers not amending prior year returns.

- **A theft loss deduction that creates a net operating loss for the taxpayer can be carried back and forward according to the timeframes prescribed by law to generate a refund of taxes paid in other taxable years.**

Revenue Procedure

In light of the number of investment arrangements recently discovered to be fraudulent and the number of taxpayers affected, the revenue procedure is intended to: (1) provide a uniform approach for determining the proper time and amount of the theft loss; (2) avoid difficult problems of proof in determining how much income reported from the scheme was fictitious, and how much was real; and (3) alleviate compliance burdens on taxpayers and administrative burdens on the IRS that would otherwise result.

The revenue procedure provides two simplifying assumptions that taxpayers may use to report their losses:

- **Deemed theft loss.** Although the law does not require a criminal conviction of the promoter to establish a theft loss, it often is difficult to determine how extensive the evidence of theft must be to justify a claimed theft loss.

  The revenue procedure provides that the IRS will deem the loss to be the result of theft if: (1) the promoter was charged under state or federal law with the commission of fraud, embezzlement or a similar crime that would meet the definition of theft; or (2) the promoter was the subject of a state or federal criminal complaint alleging the commission of such a crime, and (3) either there was some evidence of an admission of guilt by the promoter or a trustee was appointed to freeze the assets of the scheme.

- **Safe harbor prospect of recovery.** Once theft is discovered, it often is difficult to establish the investor's prospect of recovery. Prospect of recovery is important because it limits the amount of the investor's theft loss deduction. Prospect of recovery is difficult to determine, particularly where litigation against the promoter and other potentially liable third parties extends into future taxable years.

  The revenue procedure generally permits taxpayers to deduct in the year of discovery 95 percent of their net investment less the amount of any actual recovery in the year of discovery and the amount of any recovery expected from private or other insurance, such as that provided by the Securities Investor Protection Corporation (SIPC). A special rule applies to investors who are suing persons other than the promoter. These investors compute their deduction by substituting "75 percent" for "95 percent" in the formula above.

IRS Enforcement: Tightening the Net

Mr. Chairman, I am also pleased to be here today to describe the unprecedented focus that the Internal Revenue Service has placed on detecting and bringing to justice those who unlawfully hide assets overseas to avoid paying tax.

In today's economic environment, it is more important than ever that citizens feel confident that individuals and corporations are playing by the rules and paying the taxes that they owe.

When the American public is confronted with stories of financial institutions helping US citizens to maintain secret overseas accounts involving sham trusts to improperly avoid US tax, they should be outraged, as I am. But they should also know that the US government is taking new measures, and there is much more in the works.

In the wake of some recent well-publicized cases, the media has been full of speculation from those who are advising US taxpayers who have undeclared offshore accounts and income.

My advice to those taxpayers is very simple. The IRS has been steadily increasing the pressure on offshore financial institutions that facilitate concealment of taxable income by US citizens. That pressure will only increase under my watch. Those who are unlawfully hiding assets should come and get right with their government through our voluntary disclosure process

An Integrated Approach

Mr. Chairman, there is no "silver bullet" or one strategy that will alone solve the problems of offshore tax avoidance. Rather, an integrated approach is needed, made up of separate but complementary programs that will tighten the net around these tax cheats.

I am pleased to discuss several proposals that we are currently considering to improve our existing administrative programs.

First, I can also tell you that offshore issues are high priority to the President and his Administration. The President's budget committed to identifying $210 billion in savings over the next decade from international enforcement, reforming deferral and other tax reform policies. It also includes funding for a robust portfolio of IRS international tax compliance initiatives. The Administration will have more detailed and specific announcements in this area in the near future.

Second, the IRS is already devoting significant resources to international issues. As previously noted, I have both increased the number of audits in this area over the last five months and prioritized stepped-up hiring of international experts and investigators.

Third, the IRS is exploring how to improve information reporting and sharing. In this regard, the IRS is looking closely at how to continue to improve our Qualified Intermediary – or Q.I. – program. QI gives the IRS an important line of sight into the activities of US taxpayers at foreign banks and financial institutions that we previously did not have.

As with any large and complex program, we must strive to continuously improve the QI system, and address weaknesses as they become apparent. Accordingly, the IRS and Treasury Department are considering enhancements to strengthen the QI program, including:

- Expanding information reporting requirements to include more sources of income for US persons with accounts at QI banks
- Strengthening documentation rules to ensure that the program is delivering on its original intent
- Requiring withholding for accounts with documentation that is considered insufficient

Additionally, the IRS has already proposed changes that would shore up the independent review of the QI program in substantial ways. This proposal is currently out for comment, and the IRS looks forward to reviewing these comments.

As you can see, the IRS and Treasury are considering a wide range of measures to ensure that the QI program is working as intended. However, there will always be instances where the IRS discovers a potential violation of the tax law after the fact. In these cases, there are administrative and legislative changes that may be helpful to the IRS as we investigate potential wrongdoing.

Draft Legislation

Mr. Chairman, we understand that you are considering legislation designed to improve tax compliance with respect to offshore transactions.

My staff and I look forward to working with you and other members of this committee on such legislation.

Conclusion

Mr. Chairman, I want to thank you for this opportunity to provide an update on IRS' efforts to clarify issues relating to issues involving Ponzi schemes and also our activities to combat illegal tax avoidance schemes relating to offshore accounts and transactions. I would be happy to respond to your questions.

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105 Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

(Also Part I, §§ 165; 1.165-8(c))

Rev. Proc. 2009-20

SECTION 1. PURPOSE

This revenue procedure provides an optional safe harbor treatment for taxpayers that experienced losses in certain investment arrangements discovered to be criminally fraudulent. This revenue procedure also describes how the Internal Revenue Service will treat a return that claims a deduction for such a loss and does not use the safe harbor treatment described in this revenue procedure.

SECTION 2. BACKGROUND

.01 The Service and Treasury Department are aware of investment arrangements that have been discovered to be fraudulent, resulting in significant losses to taxpayers. These arrangements often take the form of so-called "Ponzi" schemes, in which the party perpetrating the fraud receives cash or property from investors, purports to earn income for the investors, and reports to

the investors income amounts that are wholly or partially fictitious. Payments, if any, of purported income or principal to investors are made from cash or property that other investors invested in the fraudulent arrangement. The party perpetrating the fraud criminally appropriates some or all of the investors' cash or property.

.02 Rev. Rul. 2009-9, 2009 I.R.B (April 6, 2009), describes the proper income tax treatment for losses resulting from these Ponzi schemes.

.03 The Service and Treasury Department recognize that whether and when investors meet the requirements for claiming a theft loss for an investment in a Ponzi scheme are highly factual determinations that often cannot be made by taxpayers with certainty in the year the loss is discovered.

.04 In view of the number of investment arrangements recently discovered to be fraudulent and the extent of the potential losses, this revenue procedure provides an optional safe harbor under which qualified investors (as defined in § 4.03 of this revenue procedure) may treat a loss as a theft loss deduction when certain conditions are met. This treatment provides qualified investors with a uniform manner for determining their theft losses. In addition, this treatment avoids potentially difficult problems of proof in determining how much income reported in prior years was fictitious or a return of capital, and alleviates compliance and administrative burdens on both taxpayers and the Service.

SECTION 3. SCOPE

The safe harbor procedures of this revenue procedure apply to taxpayers that are qualified investors within the meaning of section 4.03 of this revenue procedure.

SECTION 4. DEFINITIONS

The following definitions apply solely for purposes of this revenue procedure.

.01 Specified fraudulent arrangement. A specified fraudulent arrangement is an arrangement in which a party (the lead figure) receives cash or property from investors; purports to earn income for the investors; reports income amounts to the investors that are partially or wholly fictitious; makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and appropriates some or all of the investors' cash or property. For example, the fraudulent investment arrangement described in Rev. Rul. 2009-9 is a specified fraudulent arrangement.

.02 Qualified loss. A qualified loss is a loss resulting from a specified fraudulent arrangement in which, as a result of the conduct that caused the loss—

(1) The lead figure (or one of the lead figures, if more than one) was charged by indictment or information (not withdrawn or dismissed) under state or federal law with the commission of fraud, embezzlement or a similar crime that, if proven, would meet the definition of theft for purposes of § 165 of

the Internal Revenue Code and § 1.165-8(d) of the Income Tax Regulations, under the law of the jurisdiction in which the theft occurred; or

(2) The lead figure was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging the commission of a crime described in section 4.02(1) of this revenue procedure, and either –

(a) The complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or

(b) A receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.

.03 Qualified investor. A qualified investor means a United States person, as defined in § 7701(a)(30) --

(1) That generally qualifies to deduct theft losses under § 165 and § 1.165-8;

(2) That did not have actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public;

(3) With respect to which the specified fraudulent arrangement is not a tax shelter, as defined in § 6662(d)(2)(C)(ii); and

(4) That transferred cash or property to a specified fraudulent arrangement. A qualified investor does not include a person that invested solely in a fund or other entity (separate from the investor for federal income tax purposes) that invested in the specified fraudulent arrangement. However, the fund or entity itself may be a qualified investor within the scope of this revenue procedure.

.04 Discovery year. A qualified investor's discovery year is the taxable year of the investor in which the indictment, information, or complaint described in section 4.02 of this revenue procedure is filed.

.05 Responsible group. Responsible group means, for any specified fraudulent arrangement, one or more of the following:

(1) The individual or individuals (including the lead figure) who conducted the specified fraudulent arrangement;

(2) Any investment vehicle or other entity that conducted the specified fraudulent arrangement, and employees, officers, or directors of that entity or entities;

(3) A liquidation, receivership, bankruptcy or similar estate established with respect to individuals or entities who conducted the specified fraudulent arrangement, in order to recover assets for the benefit of investors and creditors; or

(4) Parties that are subject to claims brought by a trustee, receiver, or other fiduciary on behalf of the liquidation, receivership, bankruptcy or similar estate described in section 4.05(3) of this revenue procedure.

.06 Qualified investment.

(1) Qualified investment means the excess, if any, of --

(a) The sum of --

(i) The total amount of cash, or the basis of property, that the qualified investor invested in the arrangement in all years; plus

(ii) The total amount of net income with respect to the specified fraudulent arrangement that, consistent with information received from the specified fraudulent arrangement, the qualified investor included in income for federal tax purposes for all taxable years prior to the discovery year, including taxable years for which a refund is barred by the statute of limitations; over

(b) The total amount of cash or property that the qualified investor withdrew in all years from the specified fraudulent arrangement (whether designated as income or principal).

(2) Qualified investment does not include any of the following—

(a) Amounts borrowed from the responsible group and invested in the specified fraudulent arrangement, to the extent the borrowed amounts were not repaid at the time the theft was discovered;

(b) Amounts such as fees that were paid to the responsible group and deducted for federal income tax purposes;

(c) Amounts reported to the qualified investor as taxable income that were not included in gross income on the investor's federal income tax returns; or

(d) Cash or property that the qualified investor invested in a fund or other entity (separate from the qualified investor for federal income tax purposes) that invested in a specified fraudulent arrangement.

.07 Actual recovery. Actual recovery means any amount a qualified investor actually receives in the discovery year from any source as reimbursement or recovery for the qualified loss.

.08 Potential insurance/SIPC recovery. Potential insurance/SIPC recovery means the sum of the amounts of all actual or potential claims for reimbursement for a qualified loss that, as of the last day of the discovery year, are attributable to--

(1) Insurance policies in the name of the qualified investor;

(2) Contractual arrangements other than insurance that guaranteed or otherwise protected against loss of the qualified investment; or

(3) Amounts payable from the Securities Investor Protection Corporation (SIPC), as advances for customer claims under 15 U.S.C. § 78fff-3(a) (the Securities Investor Protection Act of 1970), or by a similar entity under a similar provision.

.09 Potential direct recovery. Potential direct recovery means the amount of all actual or potential claims for recovery for a qualified loss, as of the last day of the discovery year, against the responsible group.

.10 Potential third-party recovery. Potential third-party recovery means the amount of all actual or potential claims for recovery for a qualified loss, as of the last day of the discovery year, that are not described in section 4.08 or 4.09 of this revenue procedure.

SECTION 5. APPLICATION

.01 In general. If a qualified investor follows the procedures described in section 6 of this revenue procedure, the Service will not challenge the following treatment by the qualified investor of a qualified loss—

(1) The loss is deducted as a theft loss;

(2) The taxable year in which the theft was discovered within the meaning of § 165(e) is the discovery year described in section 4.04 of this revenue procedure; and

(3) The amount of the deduction is the amount specified in section 5.02 of this revenue procedure.

.02 Amount to be deducted. The amount specified in this section 5.02 is calculated as follows—

(1) Multiply the amount of the qualified investment by—

(a) 95 percent, for a qualified investor that does not pursue any potential third-party recovery; or

(b) 75 percent, for a qualified investor that is pursuing or intends to pursue any potential third-party recovery; and

(2) Subtract from this product the sum of any actual recovery and any potential insurance/SIPC recovery.

The amount of the deduction calculated under this section 5.02 is not further reduced by potential direct recovery or potential third-party recovery.

.03 Future recoveries. The qualified investor may have income or an additional deduction in a year subsequent to the discovery year depending on the actual amount of the loss that is eventually recovered. See § 1.165-1(d); Rev. Rul. 2009-9.

SECTION 6. PROCEDURE

.01 A qualified investor that uses the safe harbor treatment described in section 5 of this revenue procedure must –

(1) Mark "Revenue Procedure 2009-20" at the top of the Form 4684, Casualties and Thefts, for the federal income tax return for the discovery year. The taxpayer must enter the "deductible theft loss" amount from line 10 in Part II of Appendix A of this revenue procedure on line 34, section B, Part I, of the Form 4684 and should not complete the remainder of section B, Part I, of the Form 4684;

(2) Complete and sign the statement provided in Appendix A of this revenue procedure; and

(3) Attach the executed statement provided in Appendix A of this revenue procedure to the qualified investor's timely filed (including extensions) federal income tax return for the discovery year. Notwithstanding the preceding sentence, if, before April 17, 2009, the taxpayer has filed a return for the discovery year or an amended return for a prior year that is inconsistent with the safe harbor treatment provided by this revenue procedure, the taxpayer must indicate this fact on the executed statement and must attach the statement to the return (or amended return) for the discovery year that is consistent with the safe harbor treatment provided by this revenue procedure and that is filed on or before May 15, 2009.

.02 By executing the statement provided in Appendix A of this revenue procedure, the taxpayer agrees—

(1) Not to deduct in the discovery year any amount of the theft loss in excess of the deduction permitted by section 5 of this revenue procedure;

(2) Not to file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year;

(3) Not to apply the alternative computation in § 1341 with respect to the theft loss deduction allowed by this revenue procedure; and

(4) Not to apply the doctrine of equitable recoupment or the mitigation provisions in §§ 1311-1314 with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred by the period of limitations on filing a claim for refund under § 6511.

SECTION 7. EFFECTIVE DATE

This revenue procedure applies to losses for which the discovery year is a taxable year beginning after December 31, 2007.

SECTION 8. TAXPAYERS THAT DO NOT USE THE SAFE HARBOR TREATMENT PROVIDED BY THIS REVENUE PROCEDURE

.01 A taxpayer that chooses not to apply the safe harbor treatment provided by this revenue procedure to a claimed theft loss is subject to all of the generally applicable provisions governing the deductibility of losses under § 165. For example, a taxpayer seeking a theft loss deduction must establish that the loss was from theft and that the theft was discovered in the year the taxpayer claims the deduction. The taxpayer must also establish, through sufficient documentation, the amount of the claimed loss and must establish that no claim for reimbursement of any portion of the loss exists with respect to which there is

a reasonable prospect of recovery in the taxable year in which the taxpayer claims the loss.

.02 A taxpayer that chooses not to apply the safe harbor treatment of this revenue procedure to a claimed theft loss and that files or amends federal income tax returns for years prior to the discovery year to exclude amounts reported as income to the taxpayer from the investment arrangement must establish that the amounts sought to be excluded in fact were not income that was actually or constructively received by the taxpayer (or accrued by the taxpayer, in the case of a taxpayer using an accrual method of accounting). However, provided a taxpayer can establish the amount of net income from the investment arrangement that was reported and included in the taxpayer's gross income consistent with information received from the specified fraudulent arrangement in taxable years for which the period of limitation on filing a claim for refund under § 6511 has expired, the Service will not challenge the taxpayer's inclusion of that amount in basis for determining the amount of any allowable theft loss, whether or not the income was genuine.

.03 Returns claiming theft loss deductions from fraudulent investment arrangements are subject to examination by the Service.

SECTION 9. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-0074. Please refer to the Paperwork Reduction Act statement

accompanying Form 1040, U.S. Individual Income Tax Return, for further information.

DRAFTING INFORMATION

The principal author of this revenue procedure is Norma Rotunno of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Rotunno at (202) 622-7900.

APPENDIX A

Statement by Taxpayer Using the Procedures in Rev. Proc. 2009-20 to Determine a Theft Loss Deduction Related to a Fraudulent Investment Arrangement

Part 1. Identification

1. Name of Taxpayer ______________________________________

2. Taxpayer Identification Number ______________________________

Part II. Computation of deduction

(See Rev. Proc. 2009-20 for the definitions of the terms used in this worksheet.)

Line	Computation of Deductible Theft Loss Pursuant to Rev. Proc. 2009-20		
1	Initial investment		
2	Plus: Subsequent investments		
3	Plus: Income reported in prior years		
4	Less: Withdrawals	( )	
5	Total qualified investment (combine lines 1 through 4)		
6	Percentage of qualified investment (95% of line 5 for investors with no potential third-party recovery; 75% of line 5 for investors with potential third-party recovery)		
7	Actual recovery		
8	Potential insurance/SIPC recovery		
9	Total recoveries (add lines 7 and 8)		( )
10	Deductible theft loss (line 6 minus line 9)		

Part III. Required statements and declarations

1. I am claiming a theft loss deduction pursuant to Rev. Proc. 2009-20 from a specified fraudulent arrangement conducted by the following individual or entity (provide the name, address, and taxpayer identification number (if known)).

____

2 I have written documentation to support the amounts reported in Part II of this document.

3. I am a qualified investor as defined in § 4.03 of Rev. Proc. 2009-20.

4. If I have determined the amount of my theft loss deduction under § 5.02(1)(a) of Rev. Proc. 2009-20, I declare that I have not pursued and do not intend to

pursue any potential third-party recovery, as that term is defined in § 4.10 of Rev. Proc. 2009-20.

5. If I have already filed a return or amended return that does not satisfy the conditions in § 6.02 of Rev. Proc 2009-20, I agree to all adjustments or actions that are necessary to comply with those conditions. The tax year or years for which I filed the return(s) or amended return(s) and the date(s) on which they were filed are as follows:

____
____
____
____

Part IV. Signature

I make the following agreements and declarations:

1. I agree to comply with the conditions and agreements set forth in Rev. Proc. 2009-20 and this document.

2. Under penalties of perjury, I declare that the information provided in Parts I-III of this document is, to the best of my knowledge and belief, true, correct and complete.

Your signature here ________________________ Date signed: _______
Your spouse's signature here ____________________ Date signed: ______

Corporate Name ______________________________
Corporate Officer's signature __________________________
Title __________________________
Date signed ________

Entity Name ____
S-corporation, Partnership, Limited Liability Company, Trust
Entity Officer's signature ___________________________________
Date signed ___________

Signature of executor ____
Date signed ____

COMMUNICATION

Edward T. & Kathleen M. Coughlin

March 30, 2009

Senate Committee on Finance
Attn. Editorial and Document Section
Rm. SD – 219
Dirksen Senate Office Building
Washington, DC 20510-6200

Subject Comments on:
March 17, 2009 Hearing: Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion

We are among the people who had an investment account with Bernard L. Madoff Investment Securities LLC. Mr. Madoff was arrested on December 11, 2008 and accused of operating a Ponzi scheme. At a U.S. District Court hearing in New York on March 12, 2009 Mr. Madoff plead guilt to 11 Federal felony counts. The Bankruptcy court has appointed the Securities Investment Protection Corporation (SIPC) to liquidating the firm. The SIPC Trustee has stated that there is no evidence that Madoff ever bought or sold securities for his customers.

I attended the March 17 hearing and my comments pertain to the inequities in the Federal Income Tax rules and procedures adopted by the Internal Revenue Service on losses suffered by investors from Ponzi schemes. The tax guidance and rules were described in IRS Commissioner Douglas Shulman's testimony at the subject hearing.

Our Madoff account was opened 14 years ago in 1994 and the account remained open on December 11, 2008. Each year from 1994 through 2007 Madoff sent me Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions* and Form 1099-DIV, *Dividends and Distributions*. We used the information in the forms to prepare our Federal and State tax returns. Every year we reported capital gains and dividend income from our Madoff account on our Federal and State income tax returns. For 14 years we paid all taxes due on the fictitious Madoff income. **Under the tax guidance and rules issued by IRS we are unable to recover $263,000 in Federal taxes that we paid on phantom income.**

Revenue Rule 2009-9 adopted by IRS allows us to carry back our loss on the Madoff Ponzi scheme as an itemized deduction for five years and carry forward any remaining loss for 20 years. Under the IRS procedure the amount of Federal taxes that we can recover during the five-year carry back period of 2003 – 2007 is $273,000. During the 14 years from 1994 – 2007 the Federal taxes we paid on the fictitious Madoff income amounted to $536,000. Consequently, by limiting the carry-back period to five years the Federal government will keep $263.000 that we should have refunded without delay. It is inequitable and very costly to us to limit the Federal taxes that we can recover as

March 30, 2009

prescribed in IRS Revenue Rule 2009-9. The procedure should be changed to provide for refunding all the taxes paid on the phantom Madoff income immediately.

Had the Securities and Exchange Commission (SEC) been doing its job the fraud perpetrated by Madoff would not have continued for such a long time. Under the Madoff circumstances a five–year carry–back is totally inadequate for people like us who have paid taxes on phantom income for 14 years.

The IRS rule permits stretching the loss recovery over the next 20 years. However, I am a 73 years old retiree and my wife is a 70-year-old retiree who were counting on the money in the Madoff account for our retirement income as well as a self-insurance fund for any long-term care expenses. At our age, odds are that we won't be alive for 20 years. We need to recover all the taxes we paid on the phantom income as soon as possible in order to cover our actual living expenses in retirement as well as any future long-term care expenses.

IRS Commissioner Shulman's testimony states:

> *Some taxpayers have argued that they should be permitted to amend tax returns for years prior to the discovery of the theft to exclude the phantom income and receive a refund of tax in those years. The revenue ruling does not address this argument, and safe-harbor revenue procedure is conditioned on not amending prior year returns.*

The Congress needs to address the issue of filing amended returns. Allowing taxpayers to file amended returns is the most equitable way to enable all the Madoff victims to recover the taxes that they overpaid. Amended tax returns allow each victim to recover no more or no less than what they are entitled to receive. We urge the committee to introduce and the Congress to pass legislation as soon as possible that would permit the Madoff victims to file amended tax returns for each year in which they suffered losses to recover all Federal income taxes paid on the phantom Madoff income without delay. The safe-harbor procedures IRS adopted should apply to amended tax returns and any recovery of funds in a later years should be reported as income.

In order to claim a loss under Revenue Procedure 2009-20 issued by the IRS (Section 6 .02) taxpayers must execute a statement agreeing —

> *(2) Not to file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year;*

The prohibition on filing amended tax returns creates an issue regarding Medicare premiums. For 2007, 2008 & 2009 the monthly Medicare premium that we

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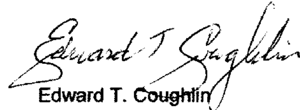
each pay includes a surcharge based on our Federal Adjusted Gross Income (AGI) that IRS provided to the Social Security Administration. Going back and filing amended tax returns to exclude the fictitious Madoff income would lower our AGI below the level that resulted in a surcharge. Hence, the Medicare monthly premium surcharges of $49.50 in 2007; $103.30 in 2008; and, $96.30 in 2009 that we both pay were overpayments and should be refunded.

We informed the Social Security Administration (SSA) that our AGI was overstated due to the Madoff fraud and asked that our 2009 Medicare premiums be reduced and overpayments in 2007, 2008 and 2009 be refunded. We met with a SSA claims representative on March 12, 2009 and were told that we would have to submit amended tax returns to SSA to get the premium surcharges refunded. Consequently, filing a loss claim using the IRS procedure whereby itemized deduction are increased but income is not reduced, we're can't get a refund of our Medicare premium overcharges.

We urge Chairman Baucus and the Committee members to adopt legislation to correct the inequities that the IRS Rules and Procedures inflict.

Thank you for considering our comments.

Sincerely,



Edward T. Coughlin

Kathleen M. Coughlin

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