

**FINANCIAL SERVICES AND GENERAL
GOVERNMENT APPROPRIATIONS FOR 2009**

HEARINGS
BEFORE A
SUBCOMMITTEE OF THE
COMMITTEE ON APPROPRIATIONS
HOUSE OF REPRESENTATIVES
ONE HUNDRED TENTH CONGRESS
SECOND SESSION

SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT
APPROPRIATIONS

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(II)

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR 2009

WEDNESDAY, MARCH 5, 2008.

DEPARTMENT OF THE TREASURY

WITNESS

HON. HENRY M. PAULSON, JR., SECRETARY OF THE TREASURY

CHAIRMAN SERRANO'S OPENING STATEMENT

Mr. SERRANO. Good morning. The subcommittee will now come to order. Today the subcommittee is pleased to welcome Henry Paulson, Secretary of the Treasury, for his annual appearance before our subcommittee. We all know that the Secretary of the Treasury occupies an important position in the Federal Government, serving as a policy advisor to the President on a broad range of domestic and international economic issues.

In addition, the Secretary's responsibilities as Department head cover a range of important functions: administering the U.S. public debt, issuing Federal Government payments, collecting the vast majority of the Federal Government's revenue, working to prevent money laundering and many other important responsibilities.

Some examples of the Secretary's recent work include helping to formulate and administer the economic stimulus package and working to counter the rise of foreclosures associated with the subprime mortgages. I look forward to discussing these issues today.

The issue of subprime mortgages, which this subcommittee addressed at a hearing last week, is a huge concern not only in my particular district, but throughout the country. While subprime loans have in many cases allowed low- to moderate-income families to experience home ownership for the first time, it is also apparent that in a great many cases, borrowers were not fully informed about the terms of the loans.

All consumers are at risk of being victimized by financial predators. However, it is often our most vulnerable populations who bear the brunt of these crimes. Each year, countless working-class parents who are struggling to achieve the American dream tragically have their hopes of upward mobility crushed by the practices of dishonest businesses. While their plight often goes unrecognized, the enduring housing crisis has opened the eyes of many Americans to their struggles and made us all aware of the devastating effects such exploitation can have on the strength of our economy. Hundreds of thousands of subprime loans have already reset to

much higher interest rates, and approximately 2 million subprime loans will reset over the next 2 years.

Foreclosures and late payments rose in January to the highest level on record and the medium price of a single family home fell in 2007 for the first time in at least 4 decades. The rise in foreclosures has had an impact not just on families who have lost their homes. Whole neighborhoods across the country have seen declines in property values and tax bases as a result of being near foreclosed homes.

In New York City, my city, as I noted last week, 400,000 homes are experiencing or will experience devaluation as a result of being located near foreclosed homes. In addition, minority communities have been and will continue to be the hardest hit by the foreclosure crisis, since these communities receive a disproportionate share of subprime loans.

In 2006, 52 percent of the home loans that went to African American families and 41 percent of the home loans that went to Latino families were subprime loans. As I expressed also last week, I am deeply concerned that many borrowers in these communities were steered specifically towards subprime loans even though the borrowers in many cases were fully qualified to receive conventional loans.

The Treasury Department has begun to address the issue of foreclosures, most notably in the Hope Now Initiative. Under this voluntary initiative, participating mortgage loan companies are agreeing to institute a 5-year delay in interest rate resets for certain families faced with the prospect of foreclosure.

While I truly appreciate the efforts, Mr. Secretary, that you and others in the Department have put into this initiative, I still have significant concerns, as I have pointed out before. Specifically I am concerned that, one, the proposal is still a voluntary initiative and, two, a great many borrowers who are facing foreclosure are not eligible.

While any progress in preventing foreclosures is to be welcomed, I have concerns about just how many people will be helped compared to the number of families who will face the loss of their homes. Indeed, the Secretary himself has stated recently that we have not yet seen the worst of the foreclosure crisis. I hope that we can continue to work together to explore ways to minimize the number of foreclosures.

We thank you, Mr. Secretary, for being here today. We assure you that this committee stands ready to support you in all the work that you do and we know that we probably will take a little more time than usual at this hearing with the issue of the mortgage issue, but it is the number one situation in this country which is really concerning and scaring a lot of folks very seriously.

Mr. SERRANO. So we welcome you, and I also welcome my partner and my friend, Congressman Regula. From Ohio, right?

Mr. REGULA. From Ohio. A rather significant State today.

Mr. SERRANO. Especially last night, yes.

Mr. REGULA. Even more so than Texas, which is not easy.

Mr. SERRANO. At least you had just one election. They had an election and a caucus.

Mr. REGULA. Yes. It takes them two times to do as much as we do in one.

Mr. SERRANO. Be nice to the Ranking Member.

MR. REGULA'S OPENING STATEMENT

Mr. REGULA. Well, Mr. Chairman, you have done an excellent job of outlining the challenges that confront the Secretary and I want to say, Mr. Secretary, that as a citizen of the United States, I appreciate the fact that you are willing to come to this city and accept the challenge of leading the Treasury Department. It is an extremely important responsibility in terms of the economic development of the country. I think sometimes we don't fully understand the role of Treasury.

But when you look back in history, it was Alexander Hamilton who pushed the development of the Treasury Department. It is so vital to a nation's success to have a good financial system. And you are the leader of that and we thank you for taking on that responsibility. I look forward to your testimony.

As the Chairman has said, we want to help in any way possible. You have some requested funding increase because of the IRS. You have a multiplicity of responsibilities: coinage, managing the Federal debt, which is a challenge. We appreciate what you have done by way of leadership in these responsibilities. So we welcome you here this morning.

Mr. SERRANO. Yes. And before we hear your testimony, Mr. Secretary, once again I want to thank you very much on your work on the stimulus package. I particularly want to thank you on your work to include the territories in the stimulus package, which we thought was something that was great.

And last but not least, we thank you for the fact that you helped us so much in getting five more quarters, starting with the District of Columbia, which will be added to the program. Mr. Secretary, please.

SECRETARY PAULSON'S TESTIMONY

Secretary PAULSON. Is this on now? Okay.

First of all, thank you for your gracious comments and thank you for all your leadership on the stimulus, and particularly as it relates to Puerto Rico and the territories where you were a real leader, and they should be very grateful.

Now, let me say to you and to Congressman Regula and members of the committee, I very much appreciate the opportunity to discuss the Treasury Department's proposed 2009 budget. Our budget request reflects the Department's continued commitment to promoting a healthy U.S. economy, fiscal discipline and national security. The Department has broad responsibility in Federal cash management, tax administration, and plays an integral role in combating terrorist financing and advocating the integrity of the U.S. and global financial systems.

Our spending priorities for the 2009 fiscal year fall into six main categories. I will briefly describe the priorities and then will have plenty of time for your questions.

Treasury has an important role to play as steward of the U.S. economy, and our office provides technical analysis, economic forecasting and policy guidance on issues ranging from Federal financing to domestic and global financing systems. Those functions are especially critical now as the U.S. economy, through a combination of a significant housing correction, high energy prices, and capital market turmoil has slowed appreciably.

Our long-term economic fundamentals are solid and I believe our economy will continue to grow this year, although not nearly as rapidly as in recent years.

In response to economic signals early this year, the administration and Congress worked together to quickly pass on a bipartisan basis the Economic Stimulus Act of 2008, and I would like to thank this subcommittee for approving funds for the IRS and FMS to administer the stimulus check rebate program under that act, thank you.

As you know, the stimulus payments to households and incentives to businesses in the act together are estimated to lead to the creation of half a million jobs by year end. This will provide timely and effective support for families and the economy, and it wouldn't be possible without your leadership.

Treasury's Office of Terrorism and Financial Intelligence, TFI, uses financial intelligence, sanctions and regulatory authority to track and combat threats to our national security and safeguard the U.S. Government financial system from abuse by terrorists, proliferators of weapons of mass destruction, and other illicit actors.

To continue to build on our efforts to combat these threats, we are requesting an \$11 million increase for TFI, including \$5½ million for the Financial Crimes Enforcement Network to ensure effective management of the Bank Secrecy Act.

The budget request emphasizes infrastructure and technology investments to modernize business processes and improve efficiency throughout the Treasury Department. We will continue to make information technology management a priority and have taken several significant steps to strengthen our systems and oversight.

Treasury is committed to managing the Nation's finances effectively, ensuring the most efficient use of taxpayer dollars in collecting the revenue due to the Federal Government. The Internal Revenue Service, of course, plays an integral role in this. The budget requests a 4.3 percent increase in IRS funding to expand IRS enforcement activities, improve compliance, enforce the tax gap, and continue improvements in taxpayer service.

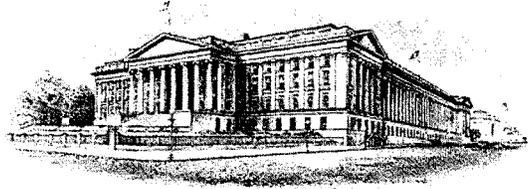
In addition, we are asking your colleagues on the State Foreign Operations Subcommittee to support funding for the multilateral development banks, noticeably new replenishment for the World Bank's International Development Association, IDA, and African Development Fund and a \$400 million request for the first installment of a \$2 billion clean technology fund that, with additional funding from other donors around the world, will help to finance clean energy products in the developing world and make strides towards addressing a global climate change.

Overall, the budget request reflects a prudent and forward-leaning approach to fulfilling the Treasury Department's core respon-

sibilities to support our economy, managing the government's finances and ensuring the financial system's security.

I thank you for your past support and consideration of our work and look forward to working with you during your deliberations. Thank you and I welcome your questions.

[The information follows:]



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10 a.m. (EST), March 5, 2008
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OPENING STATEMENT BY SECRETARY HENRY M. PAULSON, JR. ON THE DEPARTMENT OF THE TREASURY FY 2009 BUDGET REQUEST BEFORE THE HOUSE COMMITTEE ON APPROPRIATIONS SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT

Washington, DC— Chairman Serrano, Representative Regula, Members of the Committee: Thank you for the opportunity to discuss the Treasury Department's proposed fiscal year 2009 budget. Our budget request reflects the Department's continued commitment to promoting a healthy U.S. economy, fiscal discipline and national security. The Department has broad responsibility in federal cash management, tax administration and plays an integral role in combating terrorist financing and advocating the integrity of the U.S. and global financial systems.

Our spending priorities for the 2009 fiscal year fall into six main categories. I will briefly describe the priorities and then take your questions.

U.S. Economic Steward

Treasury has an important role to play as steward of the U.S. economy, and our offices provide technical analysis, economic forecasting and policy guidance on issues ranging from federal financing to domestic and global financial systems.

Those functions are especially critical now as the U.S. economy, through a combination of a significant housing correction, high energy prices and capital market turmoil has slowed appreciably. Our long term economic fundamentals are solid, and I believe our economy will continue to grow this year, although not as rapidly as in recent years.

In response to economic signals, early this year the Administration and the Congress worked together to quickly pass, on a bipartisan basis, the Economic Stimulus Act of 2008. And I would like to thank this subcommittee for approving funds for the IRS and the FMS to administer the stimulus check rebate program under that Act.

As you know, the stimulus payments to households and the incentives to businesses in the Act, together, are estimated to lead to the creation of half a million jobs by year-end. This will provide timely and effective support for families and our economy, and it wouldn't be possible without your leadership.

Strengthening National Security

Treasury's Office of Terrorism and Financial Intelligence (TFI) uses financial intelligence, sanctions, and regulatory authorities to track and combat threats to our security and safeguard the U.S. financial system from abuse by terrorists, proliferators of weapons of mass destruction and other illicit actors.

To continue and build on our efforts to combat these threats, we are requesting an \$11 million increase for TFI, including \$5.5 million for the Financial Crimes Enforcement Network to ensure effective management of the Bank Secrecy Act.

Efficient Management of the Treasury Department

The budget request emphasizes infrastructure and technology investments to modernize business processes and improve efficiency throughout the Treasury Department. We will continue to make information technology management a priority, and have taken several significant steps to strengthen our systems and oversight.

Fiscal Discipline

Treasury is committed to managing the nation's finances effectively, ensuring the most efficient use of taxpayer dollars and collecting the revenue due to the federal government.

Enforcing the Nation's Tax Laws Fairly and Efficiently

The Internal Revenue Service, of course, plays an integral role in this. The budget requests a 4.3 percent increase in IRS funding.

As in the past three budget requests, we are proposing to increase IRS enforcement funding as a Budget Enforcement Act program integrity cap adjustment. IRS enforcement efforts have yielded record revenue collections. With the requested funding, the IRS will collect an estimated \$55 billion in direct enforcement revenue in 2009.

The budget also includes a number of legislative proposals intended to target the tax gap and improve tax compliance, with an appropriate balance between enforcement and taxpayer service. These proposals are estimated to generate \$36 billion over the next ten years.

International Programs

We will continue to focus efforts on supporting a stable and growing global economy, through on-going dialogue and initiatives with developing economies throughout Asia, Latin America and Africa.

In addition we are asking your colleagues on the Foreign Operations Subcommittee to support key objectives of the President's international assistance agenda. This includes funding for the multilateral development banks – notably new replenishments for the World Bank's International Development Association and the African Development Fund.

Also included as a Foreign Operations priority is \$400 million request for the first installment of a \$2 billion clean technology fund that, with additional funding from the United Kingdom, Japan and other donors, will help finance clean energy projects in the developing world and make strides towards addressing global climate change.

Conclusion

Overall, the budget request reflects a prudent and forward-leaning approach to fulfilling the Treasury Department's core responsibilities to support our economy, managing the government's finances and

ensuring financial system security. I thank you for your past support and consideration of our work, and look forward to working with you during your deliberations.

Thank you and I welcome your questions.

Mr. SERRANO. Thank you, Mr. Secretary.

STIMULUS CHECKS AND THE TERRITORIES

I want to ask you first a question on the issue of the territories because as you well said, we worked long hours, the leadership of both parties and your office and my office, to make sure that territories were included. As you know, there is one difference. In the 50 States, checks will go directly to individuals. In the territories, a dollar amount is going to go to the central government, the territorial government, in the case of Puerto Rico the commonwealth government, which then will distribute dollars based on their tax rolls to the folks who will qualify, which is all the folks, a lot of the folks in the territories.

The concern, the fear by some folks as expressed to me and expressed in the press is that the local government in the territories, because the money is coming in a lump sum, could either use the money to sit there for a while and look like they are balancing their local budgets and/or would take local tax liabilities.

Let's say Mr. Rodriguez in San Juan owes \$300 to the local tax department. From the \$600 that he was supposed to get, he will only get \$300 because \$300 will be taken out for that.

Two problems with that. First of all, that is not really the intent. The intent was to get dollars into people's pockets so they could spend it and stimulate the economy. And secondly, unlike if you do it here, where you take from the stimulus check, from the rebate check to pay for a tax liability, over there you would be taking Federal dollars to pay for a State debt, if you will, or a debt to the State that hasn't been approved by Congress.

So what are the negotiations going like to make sure that the intent of this committee and this Congress for those dollars to go directly do take place?

Secretary PAULSON. Mr. Chairman, first of all, I appreciate your strong interest and your familiarity with the details and your concern here. I had a briefing on this earlier this week as I am getting continual briefings on the implementation of the stimulus package. And you are right to indicate that there is a significant difference, that we are working with the local authorities and through their tax system. And we are in the middle of these negotiations right now and there are a lot of technical issues and difficult issues we are working through. I am optimistic we are going to work through them.

And I guess what I would say to you, you flagged an important issue and one we are sensitive to. So we are just going to keep working on it and we will work with you and your staff on this, and come out with the best outcome possible.

Mr. SERRANO. I appreciate that. And let me just say on the record that it was our intent when we put this together in a bipartisan fashion that the dollars go directly to the folks and not be used for any local options or needs.

Lastly, as you know, just for the record, some folks commented about dollars going to the territories and said why would that money be going—some folks said overseas. We remind everybody that those folks would take that money and go spend it, and they would spend it in places called Kmart, Wal-Mart, J.C. Penney,

Costco and Sam's and other places. In other words, it is the same economy, it is the same retailers who operate in the territories that operate in the 50 States.

Secretary PAULSON. Thank you for continually reminding us of that because, again, the people in the territories owe a debt of gratitude to you.

Mr. SERRANO. Thank you.

SUBPRIME LOANS

Mr. Secretary, one of the organizations that testified before the subcommittee last week, the Center for Responsible Lending, has argued that the subprime situation escalated because Wall Street, as a purchaser of subprime loans on the secondary market, encouraged subprime lenders to abandon reasonable, qualifying standards and ignore whether their customers could actually afford the loan.

In addition, the Federal Reserve Chairman was quoted last August as saying that the failure of investors to provide adequate oversight of originations and to ensure that originators' incentives were properly aligned was a major cause of the problems that we see today in the subprime mortgage market.

Mr. Secretary, do you agree with these comments that are being made and how should this particular problem be addressed?

Secretary PAULSON. Yes. Again, thank you for that question because it is very timely. And as I have thought about this problem, I see two major focuses. The first was the one you mentioned in your initial remarks which is, let us figure out how to get help to the people who need it right now and get through this problem with as little individual stress and stress to the overall economy as possible. In other words, so that is—that is number one.

And then, second, is what is the right policy response to this? How do we respond to minimize the likelihood that something like this will happen again? And part of this is law enforcement and that doesn't fall under my responsibility. But again, we are seeing aggressive law enforcement activities at the Federal and the State level to go after people who committed crimes.

And then there is the question of the right policy response. And there I am really working on a daily basis on helping to formulate the policy response for the President's Working Group on Financial Markets. I chair that group. It has the chairman of the Fed, the chairman of the SEC, CFTC, and other regulators. There are efforts going on globally. And here, when we come up with this response, we are going to be looking at the mortgage origination process, the writing issues and issues surrounding the writing agency, the issues you mentioned on securitization and all of those issues, disclosure, valuation issues, so there are a good number of ones.

And then, separately, Treasury has been working now for almost a year on a regulatory blueprint, because we have a good regulatory system in the U.S. But it is not perfect and it is a patchwork quilt that has developed over many years, and it can be improved upon, and there are some gaping holes in it.

So you are right and both of the issues you have raised are the right ones: How do we mitigate the harm and then how do we reduce the likelihood we will have this problem again?

SPECULATORS

Mr. SERRANO. Something that I brought up last week and maybe you would like to comment on it. And very few times do we have an opportunity to look to both sides of a committee room and say we are all interested in making sure that this crisis doesn't get any deeper and that we help Americans keep their homes. But I suspect that we are talking about two sets of folks here, the vast majority, people who bought a house and now find themselves in a very difficult situation. But then there is the possibility that some were speculating on a very good market opportunity, and others who bought a second home perhaps that they knew they couldn't fully afford.

In preparing a response, how do we protect those that we need to and not necessarily bail out folks we don't need to bail out?

Secretary PAULSON. Again, Mr. Chairman, you and I are thinking about this very similarly. First of all, let's talk about the people we really need to help, because you rightfully singled out subprime mortgages where there is going to be a reset. There have been resets and there is a wave of them coming.

And if we look at foreclosures in the third quarter, there are 55 million mortgages held in the U.S.; 93 percent of those, 51 million, are making their payments every month on time. Then when you look at that pool, 13 percent are subprime. That was 40 percent of the foreclosures in the third quarter. Then if you look at the adjustable rate mortgages those where there was a product problem, you had 6½ percent of the mortgages and 40 percent of those that entered the foreclosure process. So we have a huge effort in getting to those people and coming up with programs to deal with the mortgage reset and to deal with the issues that they are going to face.

Then as you have said, I have seen these news reports about Moody's put out numbers, 8.8 million mortgages are under water that have zero to negative equity. Well, many of those are people who can afford their mortgage payment. And a good number of those are ones that put no money down on a home, speculated on a housing market and the idea that other taxpayers of the government should pay for their losses. If they can make their mortgage payments, my view is they should honor their mortgage payment. If they can not, they are speculators and they shouldn't be the focus of what we are doing and we should be concentrating our efforts on those who want to stay in their house, willing to talk to someone about it, and have a real problem, either an income problem or a product problem. We try to get at the income problem with the stimulus program. And the product problem, we are working on that very hard with the Hope Now Alliance. And there is always more that can be done.

Mr. SERRANO. Well, we thank you for your response and you are right, we are on the same track. On that, we don't bail people out who make bad investments. In other areas of the economy, we have to be careful that we balance that properly.

Secretary PAULSON. Yeah.

Mr. SERRANO. I will now recognize Mr. Regula. I remind Members that I will alternate, obviously, between two sides based on

what time you showed up, you came to the hearing. And once Mr. Regula is finished, this gavel is pretty strict on the 5-minute rule. Mr. Regula.

Mr. REGULA. Thank you, Mr. Chairman.

SOVEREIGN WEALTH FUNDS

Mr. Secretary, I would like to discuss the role of sovereign wealth funds in the United States financial markets. Do you think that the prevalence of these funds will change U.S. equity markets in the long term? Some commentators are saying that governments in the Middle East and Asia are now the largest net investors in the U.S. equity and bond market. Is this true and should we be concerned? We go back to the Dubai thing which got everybody alarmed some years ago. And do you think that sovereign wealth funds could come to substitute for central banks?

Secretary PAULSON. First of all, Congressman, thank you for the question because this is very topical now, and let me also say that we benefit and have for a long time in this country greatly from foreign investment. The greatest compliment another government can pay to the U.S. economy is to make a direct investment. Foreign governments, a wide variety of them invest in our Treasury securities. And as you have also said, there are sovereign wealth funds from around the world, including the Middle East. And they have been around the world for a long time.

Now, I would say that the absolute size of sovereign wealth funds has gone up dramatically. But as a percentage of global wealth, it hasn't really increased that dramatically. The projections are—and I am always a bit skeptical of projections because they always assume that a trend is just going to continue ad infinitum. But again, I think we need to assume that they are going to be bigger and more important.

And the way we think about these investors at Treasury is, first of all, it is important that no one would question their investment if there was a belief and an understanding and some assurance that their investments were going to be driven by commercial or economic means by those objectives, as opposed to strategic objectives, political objectives, whatever. And as far as we know, the vast majority of these investments, and maybe all, are driven by economic objectives. But what our role at Treasury has been is to say we welcome the investment, but then to have an active dialogue at Treasury, an active dialogue with a good number of these sovereign wealth funds. And we are encouraging them to develop a code of best practices as it relates to governance, as it relates to transparency, to work with the IMF and others, and to be more clear and more transparent about what their objectives are, so those countries that will be the recipients of those investments will be more comfortable.

Then we are also working with OECD countries, the developing countries that will be recipients of so many of these investments, to again come up with some practices so they won't use sovereign wealth funds as an excuse to be protectionists and to try to screen out investment.

SANCTIONS AGAINST IRAN

Mr. REGULA. As a follow-up to that, is the ability of the Treasury to freeze funds—and I think in particular I read somewhere that if we were to freeze economic activity of the Government of Iran, that this would be some measure of leverage in getting favorable foreign policy initiatives with them. Is that ability an important element in our foreign policy as a Nation?

Secretary PAULSON. Yes, Congressman. What you are referring to is the fact that now the responsibility of the Treasury Secretary is not just the safety and soundness of the financial system, it is the safety, soundness and security of the financial system. And Treasury is on the cutting edge of looking at financial abuse anywhere in the financial system. And one of the countries that we are monitoring and taking action against in the financial system is Iran, because they use Iranian banks, state-owned banks to engage in their weapons proliferation and acquisition of missile systems. They are continuing to enrich nuclear fuel. We see all kinds of deceptive practices by Iranian banks.

So we have been quite aggressive in terms of singling out different Iranian banks for sanctions on the part of the U.S. Government and encouraging organizations like the U.N. The U.N. just took action where a very recent resolution called upon the world to carefully scrutinize Iranian banks, be very careful of their dealings with them, and singled out a couple of banks specifically. So again this is a very important role of Treasury.

THE TREASURY ANNEX

Mr. REGULA. Last question. The Treasury Annex was constructed in 1918 and 1919 and I understand it is in need of some modernization. The fiscal year 2009 budget requests \$11.8 million for repair and renovations of the Treasury Annex. I assume this will be a multiyear project, most things in this town are, and require additional funds in future years. Would you tell the Committee why the renovation is needed and do you have any idea how long this will take?

Secretary PAULSON. Well, I would say if you walk through the building, you would recognize it is more than a renovation; that these are repairs and they are critical repairs to the infrastructure and all of the basic infrastructure in the building. It goes way beyond renovation. And this part of the building houses 320 people. And by coincidence, you know, you just asked about the Office of Terrorism and Financial Intelligence at Treasury. Those people are housed there. So it is a very critical, and as you said, that our budget request is \$11½ million and this will go on, obviously, for a number of years. Thank you.

Mr. REGULA. Thank you, Mr. Chairman.

Mr. SERRANO. Thank you, Mr. Regula.

Mr. Secretary, when Mr. Hinchey and I were first sworn into the New York State Assembly in 1975, we were immediately hit with the possibility of New York City going bankrupt, then New York State going bankrupt, then the infamous Financial Control Board, then the running out of the bond market. So we quickly learned

about some of the work you do. Not at your level, but we were quickly indoctrinated. Mr. Hinchey, what an introduction.

Mr. HINCHEY. Yeah. It is quite an introduction. Thank you very much, Mr. Chairman, for reminding us of that. That was quite an event.

RECESSION

Mr. Secretary, thank you very much for joining us and I very much appreciate your being here. As you mentioned in your testimony, the Treasury has a very important role to play as a steward of the United States economy, and I appreciate the work that you do in that regard. Last week, President Bush said that the economy was not in recession. But all the indicators are that we are in recession. I believe fully that we are in recession. It is only a matter of how deep this recession is going to be and how long it is going to last. If you look at all the indicators, you see that I think very, very clearly. The value of the dollar, for example, is now at a very low rate compared to the rate of the euro and it is falling with regard to virtually every other essential currency around the world, including the yen and others.

The price of oil has now more than doubled, in fact much more than doubled. But the price at the pump has more than doubled. The price of food has gone up dramatically. The cost of living for the American people is now at a higher and more difficult rate than it has been in a long, long time. Some people say not since 1929.

The disparity of income, the concentration of wealth in the hands of the wealthiest 1 percent of Americans, is now at the highest rate since 1929. In January, we saw an increase of more than 1 million Americans who are without work for a lengthy work period, and a whole host of other issues that are facing the American families across the country.

We have now essentially doubled the nonmortgage debt. It has gone from \$1¼ trillion to up above \$2½ trillion. The credit card debt in November rose at an annual rate of 8.5 percent—rather in October, at an annual rate of 8.5 percent. And then one month later it was up to 11.3 percent.

Americans are now paying double the price at the pump that they paid. U.S. manufacturing has shrunk at its fastest rate in almost 5 years while construction spending is down below where it was in 1994. We have lost now over the course of the last 6 years about 1.3 million manufacturing jobs.

You mentioned the proliferation of weapons of mass destruction in your testimony. I think that these are the examples of the proliferation of weapons of mass destruction against the economy.

So although we have passed the stimulus package, and I think it is a good stimulus package, it is going to be marginally effective only for a short period of time. There are so many other things that we should be doing. We should be reinvesting in our country, reinvesting in the infrastructure, putting more money into health care, for example, opposing what the President did in vetoing that health care program for children. What are we going to do to eliminate the proliferation of these weapons of mass destruction against our economy?

For corporations, and even in individuals, the bankruptcy rate has gone up to record levels. You had another hedge fund this morning, a big \$1 billion hedge fund just go into bankruptcy. What are we going to do, Mr. Secretary, to deal with this dire situation that we are confronting? Because if we don't deal with it effectively, this recession is going to get worse and last longer.

Secretary PAULSON. Congressman, I am very, very focused on the economy. Let me begin by saying to you that we had an economy that has grown for 6 years. I have said that I believe it is going to continue to grow this year. Okay? But whether I am right or whether you are right about whether it is going to grow this year, we recognize that the risks are to the downside. And that is why we moved as quickly as we did, with the help of Congress, to put a stimulus package in place. And that is why I get a briefing every day from the IRS or someone at Treasury in terms of what we are doing to get those checks out quickly and get them out in early May.

Now, in terms of the employment situation, I would just remind you that there are some positives here—unemployment, the last number was 4.9 percent. By any historical standards—I will just remind you that in 1929 it was 25 percent or whatever. So we have an economy that has grown for a long time. The underlying structure is very healthy. The long-term fundamentals of our economy are healthy.

We are facing the head winds that you cited. We are facing high oil prices. We have got this housing downturn. And we have the capital markets turmoil. And I think we are working our way through that with regard to the capital markets and what is going on with our major institutions. I believe all of our major institutions are fundamentally healthy.

But, again, whether it is the GSEs who are going to need to continue to play their countercyclical role or we need GSE reform and need them to raise capital, I am urging all financial institutions that think they are going to need capital, to raise capital so they can keep lending and playing an active role in the U.S. economy.

Mr. HINCHEY. I appreciate what you are saying and I respect everything that you just said. But if I may just take another second, Mr. Chairman.

The things that you mentioned are very vague. It is true that the economy has grown to some extent over the course of the last several years, but the number of jobs increase have been averaging about 95,000 when the normal necessary increase in jobs is 150,000 a year. Now we have just seen a reduction of 17,000. In other words, we haven't increased jobs, we have lost 17,000 in the last month. So the consequences are very dire for working people, working families, cost of living going up, the value of their income—now the average value of the American family's income has dropped by almost \$1,000. They are not able to deal with the situation. That is why their debt has gone up so much. Particularly credit card debt. People are borrowing 10 percent more than they are taking in every day.

So I would just ask deeply if you as a Secretary of the Treasury would consult with this administration more closely and help us in the Congress get legislation signed by the President that is going

to effectively stimulate this economy and get people back on the right economic track, because these are the proliferation of economic weapons of mass destruction that we are confronting.

Mr. SERRANO. Mr. Kirk.

NEGATIVE EQUITY

Mr. KIRK. Thank you, Mr. Chairman. And, Mr. Secretary, when you came out of Barrington and accepted this job, I thought maybe the Secretary of Defense seat was the hot seat in the Cabinet, but I now think you are it as far as big jobs. I just would note Chairman Bernanke yesterday before the Independent Banker's Association talked about the negative equity position of many mortgage holders, and I think the quote was principal reductions would be a more effective means, he felt of preventing widespread foreclosures. The back of the envelope numbers I have is the value of homes in America, 20 trillion, value of mortgages in America, 10. What we thought was subprime under stress was 1 trillion, but today's "Wall Street Journal" has that \$2.6 trillion number, meaning the problem would be 2½ times worse than estimates in December.

In America we have about 650,000 foreclosures a year in a good year. Now I think at the current rate we are at around 1.2 million per year. And so I don't know if you ever worked with Alex Pollack, the former president of the Chicago Home Loan Bank Board before. But at AEI, he is talking about restarting the Homeowners Loan Corporation, which is a different concept than Chairman Frank's concept of boosting up the FHA, because the hulk, by definition, is a 3-year institution only and then it gets out; whereas a permanent expansion of the bureaucracy I think might be—so I hope you would be looking—I know your team is working with Alex and talking to him and—

Secretary PAULSON. Well, I would say we—just to be very straightforward, Congressman, we are looking at a lot of ideas. I don't think that is a good idea. I think that idea does a lot more harm than good because, you know, something like that was done at the time of the Depression. Then foreclosures were 50 percent. Today they are 2 percent. Unemployment was 25 percent. Today it is at 4.9 percent. We now have the GSEs, Fannie and Freddie. We have the FHA. We have the Federal Home Loan Banks. And so we have—and even when you look at these—and I do agree that foreclosures are very expensive for everyone. And one of the things that—one of the tools that banks have when looking to work with homeowners that are facing difficulty making a mortgage payment is in addition to modifying other terms, another thing to be, you know, considered is reducing the principal on the mortgage.

But again, as I look at this, and I very much agree with what Chairman Serrano said, there are a fair number of people in this country, I mean even last year 30 percent of those who bought homes put no money down. And I think investors are going to be demanding in lenders' different practices in tightening up their standards. But I really don't think if somebody can afford to make a mortgage payment on their own and they choose not to—and I think the vast majority will, because I think the vast majority will say, "I may have negative equity in my home, but I put my roots down here, I am going to continue to live here." But if they say,

“I am just going to walk away from it and not honor my obligations unless somebody else pays for my losses,” I certainly don’t think other taxpayers should pay for their losses.

So, again, we are really focused on this. We have a program to deal with it—which some people have criticized and said it is not perfect. And it isn’t perfect. But it is a tangible idea that has been translated into action. There have been a million people since inception that have received a workout or a modification. So we are going to keep driving that. We are going to keep pushing for GSE reform so that the GSEs can get out there and raise the capital they need to play a countercyclical role. We need FHA modernization. We need the tax-exempt financing—

Mr. KIRK. Let me just hope that if it gets worse, you are still open-minded.

WORLD BANK FUNDING FOR IRAN

I want to raise one other issue which is World Bank funding for Iran. You have a request for \$1.2 billion to the Appropriations Committee. World Bank funding for Iran is totaling about 1.3 billion. You said that the IRGC is so deeply entrenched in Iran’s economy in commercial enterprises, that it is increasingly likely that if you are doing business with Iran, you are doing business with the Iranian Revolutionary Guard Corps. And the Treasury did designate the largest foreign bank of Iran, Bank Melli, as a terrorist financing institution. Problem: That was the conduit that the World Bank was using to provide U.S. taxpayer dollars to Iran through the World Bank. And so they then had to find a new financial intermediary—I am not exactly sure that the President of the United States knows that three blocks from the White House an institution is providing funding directly to the Government of Iran. But if that policy is maintained, as it appears it has, my office asked the U.S. executive director, Who is the new financial intermediary that the World Bank is paying to give money to the Government of Iran? And they said, We don’t know and you don’t have a right to that information. And I would hope that you would be able to tell us who that financial intermediary is.

Secondly, yesterday, the world—sorry—the U.N. passed a new sanctions resolution in section 10 calls upon States to exercise vigilance over the activities of financial institutions and their territories with all banks domiciled in Iran. So in conjunction with section 10 of the U.N. resolution which just passed unanimously in the Security Council, we ought to know who is the intermediary that U.S. taxpayer dollars are flowing through to Iran. And I would just ask you if you—it didn’t make a lot of sense to me that the World Bank is funding the Iranian Government. But if that is the administration’s policy, then who is the intermediary that we are using?

You just I think received a letter from half of the Senate calling for us to sanction the Central Bank of Iran. And so if we follow that policy, the question further becomes: What financial institution is the World Bank using to pay the Iranian Finance Ministry?

Secretary PAULSON. Congressman, let me first of all address your concerns, and I appreciate them because I think we at the Treas-

ury have been as aggressive as anyone could be in terms of going—

Mr. KIRK. And Stuart Levey did an outstanding job.

Secretary PAULSON. In terms of the central bank, I have cited them myself on remarks, and what we are doing is very contact based. Now, in terms of—

Mr. SERRANO. Secretary, is your mike off?

Secretary PAULSON. Is it?

Mr. SERRANO. Now it is on.

Secretary PAULSON. Now in terms—

Mr. SERRANO. I can hear you but the camera wanted—

Secretary PAULSON. In terms of the World Bank, again these votes predated my arrival at Treasury. But I understand the Treasury voted against every one of these—the U.S. Government voted against every one of these loans and these guarantees.

So we clearly voted against them. There haven't been any new programs that have been put in place since I have been down here. I know this is something that Bob Zoellick is very much focused on and he has got his own governance and his own rules to deal with.

I do believe actions like those that the U.N. took, in terms of that sanction, are only helpful to him and others as we carry this on, and I appreciate you being the strong advocate you are for being tough there.

Mr. KIRK. I have to support the appropriations request. I just hope with regard to Iran, we know who we are dealing with. Thank you.

Mr. SERRANO. Thank you. Mr. Schiff.

Mr. SCHIFF. Thank you, Mr. Chairman.

IRAN'S CENTRAL BANK

I want to follow up on the Iran situation because while we have taken action to deal with some of these private banks in Iran, it is now very clear, I think, that the central bank has become the new conduit for some of these private banks to funnel money through and evade the sanctions.

The Governor of the Bank Markazi, the central bank, Tahmaseb Mazaheri, admitted on February 5th that the central bank, quote, assists Iranian private and state-owned banks to do their commitments regardless of the pressure on them. And I think he is referring to the sanctions regime. So here the central bank pretty much acknowledges that they have stepped in to help these private banks that we have been trying to shut down in funneling money to Hezbollah and other terrorist activities.

As Mr. Kirk mentioned, Mr. Levey is doing a good job, identified banks like Bank Saderat that facilitated hundreds of millions of dollars going to Hezbollah. But now the central bank is accomplishing the same function. And I guess very similar to the sentiment expressed in the Senate letter, what are we doing to shut down the central bank's ability to launder this money?

And a further question is, in light of the U.N. sanctions, what efforts are we making to deal with banks in countries like Austria that have picked up some of the slack where other European banks have stopped doing business with Iran in ways that facilitate their terrorist financing. It appears Austrian banks have stepped into

the lurch. What kind of communications have we had with Austria to try to curb that practice?

So those are two questions I would like to ask you vis-a-vis Iran, and then I have one domestic question.

Secretary PAULSON. Okay. In terms of Iran, you are focused on the right issue, that almost a year ago, I singled out a number of remarks, Markazi for the work they have been doing with some of the other state-owned banks. We are focused on the issue. As we are working, we work to bring others along with us, because one of the things we have learned that when we have these conduct-based and we very much are a Treasury, we look very carefully at the law. We look at conduct. We look at having very good intelligence and we look at bringing others along with us, because I think these make the actions we take much more effective. But I hear you, I appreciate the letter. This is an issue and an issue we are focused on.

Now, in terms of banks around the world, one of the things that I did upon arrival at Treasury is work very closely with Stuart Levey and others to go not just to the governments, but to go directly to the heads of many banks around the world. Because I knew that if they saw what was going on, they would be even more proactive than their governments. They weren't going to want to be unwittingly abusing the system, helping to finance terrorists, helping to finance weapons acquisitions and so on. And we have done that pretty successfully.

So as we have done that, what we found is that the Iranians have been forced to open up new relationships with new banks in other parts of the world. And one of the things we do is we just—Stuart Levey just got back from a trip. So we are continuing to work and work in every country where there are banks that have business. But remember, it isn't—all business with Iran is not illegal under these sanctions. It is business with the sanctioned entities. So we are pointing out the risks. But we are all over this.

UNDERLYING STRUCTURE OF THE ECONOMY

Mr. SCHIFF. I am going to follow-up with you and Mr. Levey if I could on the central bank issue, as well as on Austria. But I do want to get to the one domestic question before I run out of time. And that is, you mentioned in your testimony that the underlying structure of the economy was still sound in your view. The question that I get asked most by my constituents in town halls or telephone conversations, it always comes out in slightly different fashion, but it raises a question about that very presumption about the underlying structure of our economy. And what people in my district say to me is they say, I am working harder than ever, my spouse is working harder than ever, and we are finding it more and more difficult every year to get by, to pay our bills, to pay our mortgage, to pay our rent, to pay our gas prices, what have you. They look at their parents' generation where the model was one head-of-household income earner. They seemed to have an easier standard of life, less worry about being able to pay for health care, losing their home because of a catastrophic illness.

What do we tell these families about what the administration is doing? What do we tell them about the underlying structure of our

economy? Because they look at it and they wonder whether the underlying structure of the economy is such that they are going to get squeezed and squeezed every year until something gives. And what do we tell those folks?

Secretary PAULSON. First of all, I get a chance to talk to a fair number of them, too, and I do understand there are a number of families that are working hard and struggling, and you raised a number of important issues.

To begin with, I always begin with telling them that the most important thing—first of all, we have to keep this economy growing because whatever their issues and problems are, they will be more significant if we weren't growing and if we weren't open to foreign investment and if we weren't active world traders, and right now exports are driving a lot of our growth.

And then on health care, I really do agree with you when you cited that. I think that is—if we weren't going through this current downturn and mortgage problem, by far the overwhelming issue in our economy would be health care. And there I really do believe we are going to need some dramatic solutions and entitlement reform is going to be a big part of it. Medicaid and Medicare reform is going to be a very big part of it, and work to make private insurance more affordable and more available. And I don't think we have time right here. But I will talk to you off line. We have made some proposals at Treasury. And this isn't right in the middle of our lane at Treasury but we have had some proposals that deal with the Tax Code that would help—at least help jump-start the creation of a stronger and broader private health care insurance market.

Mr. SCHIFF. Thank you, Mr. Chairman.

Mr. SERRANO. Thank you.

I thank Mr. Goode for allowing us to break the order here. It is his turn to allow Ms. Kilpatrick to make a few comments before she returns to a hearing across the hallway.

Ms. KILPATRICK. Thank you, Mr. Chairman. First let me thank my gentleman friend from Virginia. Thank you very much. Mr. Secretary, let me apologize for my absence. And the Chair understands we have Homeland Security at the same time across the hall and Admiral Allen is testifying. So I wanted to make sure first I came to say hello.

Secretary PAULSON. Why, thank you very much for coming.

Ms. KILPATRICK. Thank you very much. And for your call during the stimulus package discussion and I hope we can continue that as well.

CDFI FUND

I want to just bring up, just briefly, community development in financial institutions. This committee worked real hard last year to put some of the money back in to kind of help our communities who are struggling to get back. In the President's recommendation, he is recommending that we cut that appropriation some 70 percent. It is 69.6 to be exact, which means there will still be another deepening hit for the communities across America. And I won't begin to ask you in terms of will you support an increase in that. That is our job to do that.

How did you arrive at that? Is it something that you can help us with? I am going to be pushing hard to have it—

Secretary PAULSON. First of all, Congresswoman, that is a very good program, it is an effective program. We have good leadership. I was in Chicago last year at NeighborWorks which is a housing counseling, making a CDFI award. We have got good leadership in the program. We put funding in at the same level that we had requested last year. You funded it at a higher level. We have executed the program I think well. There are just tough trade-offs. And we had some very tough trade-offs to make in putting together any budget. But I just want to assure you that we are doing everything we can to execute that program well and it has got strong leadership and I am committed to the program.

Ms. KILPATRICK. That will be one of my requests, that we work together to try do what we can.

Secretary PAULSON. We look forward to working with you on this.

SUMMER JOBS PROGRAM

Ms. KILPATRICK. My only other question was summer job programs. That is one of the things that we proposed in the first stimulus package that we did not get.

Secretary PAULSON. Right.

Ms. KILPATRICK. We always try do a youth program, but we are now looking for a summer jobs program for the parents of the youth who find themselves unemployed or now laid off. We lost 350,000 jobs in Michigan over the last decade or so. It is really important to us that we try to put a summer jobs program in place.

There are mechanisms already set up. We just need the money to be put in. I am advocating a billion or 2 that would put tens of thousands of people back to work during this time. It is not a long, full-term, forever job but something so that the children can feel more secure in their homes. I hope we can work and talk to you on that.

Secretary PAULSON. Well, I would say thank you, and you have been a real leader in that area. I know how important summer jobs are for everyone, and particularly our youth. Thank you for your comment, and I will look forward to talking with you and others about that.

Ms. KILPATRICK. Thank you, sir.

Thank you, Mr. Chairman.

Mr. SERRANO. Thank you.

The distinguished gentleman from the Bronx, New York, Mr. Goode. That is not a Bronx accent?

Mr. GOODE. It is Bronx just south of Martinsville.

Mr. SERRANO. Thank you.

Mr. GOODE. Thank you, Mr. Chairman.

HEALTH CARE

I heard a previous question comment on our health care system and how many changes it has needed and really how bad it is. I have listened to the debates on the Presidential candidates and heard the candidates comment on how bad it is. I have got a letter here from somebody who is in this country that came either from

Pakistan or India, and they want their sister to come over here, and now they want their niece to come over because they claim the health care system—and I don't know whether it is Pakistan or India—can't handle what they have got. They want to come over to this country.

Secretary PAULSON. Yeah.

Mr. GOODE. And that is repeated about every week in my office, of people who want to come here from other countries to get the health care.

What I am going to do—and maybe you can correct me if I am wrong. You need to listen to the Presidential debates. I won't be able to help you because you are in a socialized medicine country and you ought to stay there. Because, you know, everybody in this country—not everyone but a lot of the candidates are saying how bad our system is. So you have gotten wrong information. You need to stay in the socialized medicine system. That is how I am going to respond to that.

But, Mr. Secretary, you have to stay where the candidates say it is the best. Stay in India and Pakistan and don't come over here. I don't know which country they were from. I can't tell by the name.

But let us go on to another question I have got here.

TAXING CARRIED INTEREST

Carried interest, I know there have been proposals in bills to say that that should be taxed at ordinary income rate instead of capital gain rate. We had that as an offset I believe in H.R. 2834. Can you explain how that, not for the hedge fund managers but say for real estate partners, what the impact would be if that change were made?

Secretary PAULSON. Well, it would—I think it would have a negative impact. Because—let me just tell you how I think about this. Because in our Tax Code we tax businesses in different forms. We tax corporations, partnerships, sole proprietorships and so on. And the way we tax partnerships with, you know, the carried interest or mechanisms similar to carried interest, impacts—we have energy partnerships, we have real estate partnerships, and we have a variety of industries, not just finance and asset management. And this has been a big driver of entrepreneurial behavior and activity. So, again, I think it is difficult to just pick one industry out.

Part of the problem we have in our Tax Code is we have so much complexity as it is, and we get where we are by sort of singling out one industry or something for special treatment. So, again, I think we need to look at it more broadly and look at it and say, what is going on here? And we have benefited for a long time for the way in which we have encouraged entrepreneurial activity and partnerships.

Mr. GOODE. So then would it be fair to say then that you think this would discourage, if you changed it from capital gains rate to ordinary income rate, real estate investment, energy investment?

Secretary PAULSON. Yeah, I'd be very careful before I did that. I just think I wouldn't single that out, and that has been part of a tax code that has worked well for sometime.

Mr. GOODE. All right.

U.S. MINT

Last thing, I know the Mint is under your jurisdiction.

Secretary PAULSON. What did you say?

Mr. GOODE. The U.S. Mint. Are you all melting down the Gold First Spouse Coins if they don't sell out or have you melted them down? Because I know the price of gold is right much higher now than it was when you first started the program.

Secretary PAULSON. That is a successful program, and it is a profitable operation, and we are working hard to sell those coins.

Mr. GOODE. So you—it is 40,000, I believe. It is 20,000 for the proof, 20,000 uncirculated. You are not melting any of them down? You are going to try to sell them all?

Secretary PAULSON. Not that I know of.

Mr. GOODE. But you are going to sell—if you had one, say, from James Madison, Dolly Madison, that you didn't sell, but the price of gold is up, you are going to sell it at the cost for James Monroe First Spouse and not—as the price goes up, you raise the price? Or can you?

Secretary PAULSON. I don't believe we do. If I am wrong on this, I will get back to you.

You know, there are a number of things that we are focused on where we would like to make a difference in the cost and save money for the taxpayers. I have been really focused on legislation we have which would let us change the metal content of pennies and nickels to make those more cost efficient.

Mr. GOODE. Thank you, Mr. Chairman.

Mr. SERRANO. So you want to get rid of the penny, hey?

Secretary PAULSON. No, I have got no intent to—

Mr. SERRANO. Are you familiar with the program in New York where they collect pennies and they turn it over to charity? It is amazing.

Secretary PAULSON. Yeah, it is a great program, great program.

Mr. SERRANO. Speaking of greatness, Mr. Ruppertsberger.

Mr. RUPPERSBERGER. Well, thank you. That was a very nice introduction.

First thing, thank you for being here.

As we are talking about the U.S. Mint I am going through a process now to try to direct the Mint to create a commemorative coin in 2012 to celebrate the Star Spangled Banner. The war of 1812, the 200th anniversary, is in 2 years. I never realized the process where you have to get 290 co-sponsors. I have been working the floor for a while. We have 251. We then go to the next step. There are two commemorative coins produced by the Mint a year. The good news, it is budget neutral.

So it is not a question, just a statement.

Secretary PAULSON. Okay.

OFFICE OF TERRORISM AND FINANCIAL INTELLIGENCE

Mr. RUPPERSBERGER. I am on the House Select Intelligence Committee, so a lot of what we do is in the area of intelligence. I just want to talk to you about your role in helping us with respect to fighting global terrorism.

The Office of Terrorism and Financial Intelligence was created I believe in 2005. We call it TFI, yes?

Secretary PAULSON. TFI.

Mr. RUPPERSBERGER. TFI, okay. So many acronyms in the field. It basically provides intelligence analysts, combats money laundering, which is very important, and it enforces U.S. Government sanctions.

Now you have asked for an \$11 million increase for the TFI in fiscal year '09. This is on top of the 29 percent from fiscal year '07 and '08. I am asking a question—I am probably going to be in favor of this, based on my role. It is so important that we have this component and this resource of fighting global terrorism. Could you explain why the increase and why it is needed?

Secretary PAULSON. Yeah. Well, I would say, first of all, you need to understand that we are the only office in the U.S. Government with TFI solely devoted to using financial means to track, degrade and disrupt our enemies; and so our budget is the smallest really of any of the U.S. intelligence agencies; and it is less than 1 percent of the overall U.S. intelligence budget. And I guess the way I would describe it to you, Congressman, is, in today's world, the global financial system is so prevalent that it is very difficult for terrorists to operate without using the financial system in some way. And so that is a weakness, but it is a strength, because it gives us a way to track what the terrorists are doing, and it gives us a way to disrupt what they are doing and to—so it helps us from that perspective.

Then, as has been pointed out, those countries that are global renegades, as it were, those countries that are pursuing their weapons of mass destruction, the weapons proliferation, Iranians, for instance, are—again attempt to use the financial system to help them pursue their objectives, abuse the system. And we at Treasury are able to have an impact and—have an impact and drive behavior. So, again, I would argue that this is money very well spent and very necessary.

Mr. RUPPERSBERGER. You know, fighting terrorism is a team effort. That is why the Office of Director of National Intelligence came together so all agencies can work together to connect the dots. I do know in my role on the Intelligence Committee dealing with the CIA and NSA and FBI and all those groups that they very much feel very strongly about what you just said.

Now following the money is clearly a big priority as it relates to terrorists. At some point they have to bring their heads up into the open to get the money; and we have been very effective in catching them. Some of our allied countries, some of our quasi-allied countries, they are still working with us on the money laundering phase.

I also know that the sanctions—we talked about Iran, but, as an example, in North Korea, we have been very effective. That bank was Banco Delta Asia. We have put them out of business.

Secretary PAULSON. Correct.

Mr. RUPPERSBERGER. Sometimes they work; sometimes they don't. I think that is one of the main reasons why the North Koreans came back to the table, because we really put them in a posi-

tion where they could not really do much as it related to money. Could you comment on the success there?

Secretary PAULSON. Yeah, I would just simply say you are right, that I think when Treasury and the U.S. Government sanctions banks, it has a big impact, and I think that it can change behavior. And I do think the world states that want to, if they understand they need to change their behavior to become part of the world financial system, I think that is a big inducement. And so we—

I think the other thing that makes a big difference is we base our sanctions on evidence, strong intelligence. It is conduct based, and we seek to enlist others to work along with us.

Mr. RUPPERSBERGER. They have just imposed sanctions on Burma now—

Secretary PAULSON. Yes, right. And, again, bad actors in Burma, right.

Mr. RUPPERSBERGER [continuing]. Appropriations process.

And I do want—Mr. Chairman, this is important. Because sometimes when you ask for an increase of over 30 percent, our staff and our people will look at that and say, why the increase? I would really hope that this committee look very strongly at the need for what we do on money laundering. It is a really effective tool.

Do you also have the resources to continue to do what you are doing in the money laundering phase? Do you have the expertise and the ability to train the people that are following the money working with the other intelligence agencies?

Secretary PAULSON. I think we do. I think we have got really excellent people. And even more important than how many, it is the quality of the people, as you have pointed out.

Mr. RUPPERSBERGER. And these people have to go all over the world, too.

Secretary PAULSON. We have excellent people. They work hard. Their leader just got back. Stuart Levey just returned from a trip to the Middle East, gone for a whole week, got back on a Saturday. And so we are going wherever we need to go and doing what we need to do.

INTEREST RATE REDUCTIONS

Mr. RUPPERSBERGER. Switching domestically, just a couple of issues. I think if you look in the past, until we have had this crisis now, a lot of what has helped our economy was the lower interest rates, which allowed people to refinance, use the equity in their homes to have money that we use for spending. It seems that some of the moves that we have made now through the Federal Reserve just haven't really done a lot to bring the actual residential mortgage rates down. Do you have an opinion of where you think that—what we need to do to let the banks understand—I mean, I think the banks want to keep taking the profit in, but sooner or later we will need to—are you hitting the—I think you can answer it, but I can't ask any more.

Secretary PAULSON. Should I answer it?

Mr. SERRANO. Sure, go ahead.

Secretary PAULSON. I would say that, as helpful as the Fed's interest rate reductions have been, and they have been quite helpful to the overall economy, they alone won't be sufficient to work

through some of the excesses that have taken place in the credit market and in the housing markets. So we are making progress, but there is still stress in a number of these markets; and it is going to take a while for some of them to perform as normal.

But one thing I will say that has been a help is, when you look at the adjustable rate subprime market, that those mortgages were facing resets. If you take an average mortgage before the recent Fed cuts, the reset would have gone from 8.5 to maybe 10.8 percent. On a \$200,000 mortgage, that is more than \$300 a month. After the Fed cut, the reset goes from 8.5 to 9 percent, which is about \$70 a month. So there is definitely help, and it is very tangible help for those people facing resets. But you are right. In and of itself, it will take more time and more—

Mr. RUPPERSBERGER. Do you anticipate the rates to go down?

Secretary PAULSON. It is not my job to anticipate what the chairman of the Fed is going to do. Thanks.

Mr. SERRANO. Thank you.

IRS PRIVATE DEBT COLLECTION PROGRAM

Mr. Secretary, at this time last year—first of all, you know of the opposition of many Members of Congress to the IRS, to private debt collectors. We feel that, as scary as it has been in the past to see an IRS agent at your door, you would rather have that than a private company, I believe, getting paid \$0.25 on the dollar to collect. Because, eventually, we will start hearing more horror stories about tactics used to collect those debts.

At this time last year, there was talk of expanding the program to include, at the minimum— To include ten more private debt collection companies. Now it seems like you are going keep the same two. Now does this indicate that the department is losing confidence in the private debt collection program or you are just trying to make the chairman of this committee somewhat happy? Notwithstanding the last—

Secretary PAULSON. Mr. Chairman, listen, your views are well-known; and I would say we are very focused on making this program work and work whereby protecting taxpayer rights. And so we have been careful in the implementation. We have, as you say, two contractors we are working with; and so we are really focused on enforcing the law and making this program work and work properly.

Mr. SERRANO. So it is basically not that you want to expand it as you are being careful about how to expand it?

Secretary PAULSON. We are maintaining the activities but being very careful here and implementing it, and these are the contractors that have measured up, and we are proceeding with this in I think a responsible, careful way.

RESPONSE OF LENDERS

Mr. SERRANO. Thank you.

Going back to the mortgage issue, it would seem to so many of us that it is in the best interest of the lenders to make sure that things work out properly. Yet it also appears to us that the lenders themselves did very little to try to deal with this problem when it became a problem, that it took you personally, your agency, your

department, government to be involved. Why did it take them so long to rule? Why did they not want to move when it was in their best interest? It is not just the folks who own the home that run the risk of losing it, but they are losing money, too.

Secretary PAULSON. Mr. Chairman, a very good point. I would say a number of them did and were moving, but what we needed to do was get the whole industry to come together and let me tell you why.

Because, if you go back many years ago, a homeowner would have a mortgage from a bank. If there was a problem, the homeowner would go to the bank. And if the homeowner was able to afford to stay in the home, the bank would make some modification, and they would work something out. Because foreclosures are very expensive for lenders.

But now, as a result of a securitization process, we have investors spread all over the world. It is highly complex. There are various tranches of the same loan with different interests.

So what it took to get this program up and going was to have, first of all—to get through a number of technical issues, technological issues, to get guidance from the SEC on accounting. So we got that guidance in early January, support from the investors, legal support. And so what has happened here, I think that there have been certain lenders, I think, that would have done something here without the government getting involved, but the beauty of this is we now have servicers covering 90 percent of the subprime market. And some firms have been doing the right things very quickly. Others have been slower to follow.

But, again, I think there are different levels of sophistication, different levels of resources. And there were some huge technical issues, legal issues, accounting issues that we have worked through; and now I think we are in a position where we have got this up and going at a time when we are going to be having the biggest wave of resets coming.

Mr. SERRANO. Thank you.

Let me ask you one last question, because we need to finish up so that you can go resolve all these problems; and we also have to give up this wonderful room in a little while.

TRAVEL TO CUBA

One of my favorite subjects that we always discuss in private and public, travel to Cuba. I know that Treasury is bound by certain White House regulations, orders that are put in place and law. But within the law and within regulations there are also decisions made on what travel is allowed and what travel is not allowed.

And it would seem to many that lately, the last year or so, travel to Cuba has tightened to the point where even people like Jose Basulto, a veteran of the Bay of Pigs and founder of the Brothers to the Rescue and the gentleman who was involved in the shooting down of the two airplanes by the Cuban government, even he has done a total turnaround and said the current type of tightening hurts individual victims more than it damages the government of Cuba.

Why the feeling by most folks that Treasury has actually tightened the ability of people to travel to Cuba?

Secretary PAULSON. Mr. Chairman, I don't believe at least the facts I look at bear that out when I look at the huge number, you know, of over 50,000 licenses that are being processed for travelers to Cuba. So, again, we clearly are going to enforce the law until the behavior changes there, which is odious behavior. But in terms of the way that—there are licenses being processed all the time for people with legitimate reasons to go to the country. So, again, I'd be happy to talk to you about that off-line.

Mr. SERRANO. Okay. I would like to do that. Because one week doesn't pass when our office, either here or in the Bronx, gets calls from what we would consider legitimate groups—you know, church groups, people involved with technology, educators, Little League baseball teams—who are having such a hard time traveling to Cuba.

Secretary PAULSON. There are a lot of church groups going to Cuba. There have been some groups that have gone and it looks like they use the church as a bit of a shield to pave the way for other forms of travel. But you probably don't hear from all those that are able to get their licenses approved quickly.

But, again, I think the data that I look at looks like we are not tightening it up, but we are administering an important program.

Mr. SERRANO. Well, that may be true. I am open to that discussion about not knowing about the other groups. In fact, Mr. Regula and I off-line, as you would say, were discussing immigration a moment ago. He says we get a lot of calls about people who want to bring relatives into the country. We don't remember a call about somebody who wants to get out of the country.

Mr. Regula.

FINANCIAL LITERACY PROGRAM

Mr. REGULA. How is the financial education program working? Are you having some degree of success? The fact that so many people got into financial instruments that they didn't fully understand the implication of, illustrates the need to improve financial education for young people.

Secretary PAULSON. Oh, you are so right; and we have a quite active financial literacy program where we outreach to not just schools but to communities and to workplaces. We have—our Treasurer, Anna Cabral, who provides great leadership there. There is much going on, but it is a huge need and will be a need in this country for a long time, including having disclosure that is simple and easy to understand, for consumers to understand, rather than consumer disclosure written by some lawyer that no one can understand. And so there is—you are very right to highlight the need for more work there.

BANKRUPTCY COURT REFORM

Mr. REGULA. I know that the Senate has kicked around the proposal that bankruptcy judges could alter the terms of the contracts. It seems to me it is getting into treacherous ground when you begin to allow a third party to order what is an agreed set of conditions on a mortgage or any financial instrument.

Secretary PAULSON. Right. Congressman, I think you are right.

First of all, a lot of people are focused on this and a lot of people who are working with the same objective we have, which is to keep people in their home that have—some of whom have been abused by being put into financings they don't understand.

But, as I thought about it, it is a slippery slope. First of all, property rights are key to our country; and changing a contract retroactively is something you shouldn't do without an awful lot of thought. And it can also dry up financing in the future for those you want to help.

And then, secondly, our focus is on getting to people who want to stay in their home and we want them to pick up the phone and call a lender and do a workout, as opposed to slowing up the process and bogging down the court system. That is how I have thought about it.

Mr. SERRANO. Thank you.

Mr. Hinchey.

THE ECONOMY

Mr. HINCHEY. Thank you very much, Mr. Chairman.

I don't mean to press you on this, Mr. Secretary, but your role as steward of the economy is very important to all of us; and the situation that we are confronting nationally is getting worse and worse.

A few moments ago, we talked about the situation of unemployment; and you rightly said it wasn't nearly as high as it was in the 1930s.

Secretary PAULSON. It is way below—it is 4.9 percent. The average has been 6 percent. Forget about the '30s. This is about as good as it gets in terms of unemployment.

Mr. HINCHEY. Not really, because what we have seen over the course of the last few years is a dramatic increase in the number of people experiencing long-term unemployment, more than 26 weeks. It has gone from a little—just under 1.4 million to now more than 2.5 million people who are experiencing long-term unemployment, more than 26 weeks.

As a result of that, they are not included in the unemployment list. They and other people who are struggling and looking for jobs, may be working a day or two a week, they are not included, either. When you bring all of those people in, the unemployment rate in our country now is about 9 percent. That is the real unemployment rate, the real number of unemployed people looking for work.

So I am deeply concerned about this recession that we are experiencing and what appears to be the way in which important people who have the responsibility to deal with the economy are avoiding it.

Let me just read you a couple of in things that showed up in the newspaper headlines today. One says, productivity growth slows sharply; and another says, unexpected drop in private sector jobs reported. We are seeing this kind of thing every single day. More and more, the experts are telling us that there is a recession. We had individuals from two major Wall Street firms, Merrill Lynch and your old company Goldman Sachs, indicate we are in a recession. Now Warren Buffett echoed that same statement.

So I just think that we have got to do more. I don't think it—I think it is very clear. Talk to anybody across the country. They will say the same thing. They are struggling.

What are we going to do? When are we going to face up to the fact that the economy is in recession? What are we going to do it prevent it from getting worse?

Secretary PAULSON. Congressman, I don't mean to sound defensive, but I think this administration and I have been really focused on the economy, and as soon as we saw it slowing down in December we began work on a stimulus package.

Whether I turn out to be right when I say I think the economy is going to grow this year or others that say we are in a recession are right, we both agree the economy is slowing down significantly. We agree that's the resurgence of the downside, and we are focused on them.

And, as I said, my focus has been right now sort of a three-part focus. It is getting the stimulus package out. Obviously, we don't want to raise taxes, so I would just urge Members of Congress let us get the AMT patch done early this year and reduce that uncertainty. But that is one focus.

Another focus is on minimizing the impact of the housing decline, and we have got a variety of programs, and we really—I would like to see FHA modernization. You know, the House has passed it. The Senate has passed it. I would like to get it out of Congress and get it signed into law.

I would like to see GSE reforms. The GSEs can play their countercyclical role in housing. I think that is the second part.

And the third part is I am concerned that the financial institutions who are so key to keeping our economy going and needing to lend and make money available to consumers and businesses that they are able to continue to do that, so I am pressing them to raise capital.

But those are my big focuses.

Mr. HINCHEY. I think they are appropriate focuses, but I don't think they will do the job that really needs to be done.

You mentioned the idea of no taxes, but the fact of the matter is that one of the ways in which people have pretended that the economy is doing well is borrowing and spending, borrowing more and more and spending more and more. The national debt now has gotten close to double over the course of the last 7 years. We are now well above \$9 trillion. And so much money is being spent in ways that border on corruption, particularly in the situation in Iraq, if you look at the hundreds of billions of dollars that have been spent there.

IRS PRIVATE DEBT COLLECTION PROGRAM

One of the issues that is much more smaller than that I would like to ask you as my last question has to do with the IRS and the way in which the privatization of collection has been instituted by this administration, in other words, bringing in private companies to collect money owed to the Internal Revenue Service in taxes.

The way in which that has been done has been so terribly ineffective. In fact, the analysis indicates that we have lost more than \$50 million over the course of the last couple of years by investing

in these private companies to go out and collect taxes. They are spending more than they are taking in. It just doesn't make any sense. Is there any way that we are going to deal with this ineffective, inefficient, bordering on corruption privatization of the responsibilities of our government?

Secretary PAULSON. Well, in terms of the PCA as a private collection agency—your chairman asked me about that earlier—that was a program that I inherited. I think as I have looked at it we have got two contractors, and the money that they are raising is money we wouldn't get if we didn't have the program, and so it is more than paying for itself now.

In terms of what happened in the past, as you look at now that is pretty much a sunk cost; and right now they are operating efficiently and are raising money that wouldn't be raised if they weren't there. Thank you.

Mr. HINCHEY. Thank you.

Secretary PAULSON. Saved by the bell.

Mr. HINCHEY. I can hear the tap.

Mr. SERRANO. You guys are never through.

Mr. Goode.

Mr. GOODE. Just a couple quick questions, Mr. Chairman.

Mr. Hinchey mentioned the debt. How much is the national debt right now?

Secretary PAULSON. It is around \$9 trillion.

Mr. GOODE. All right. And your deficit in the budget you submitted is what, \$400 billion?

Secretary PAULSON. Yeah, it was 162 at the end of last year, and it will be a bit over \$400 billion in the coming year because—to a large extent because of the stimulus program.

Mr. GOODE. The stimulus, is that a—this year, it is 125.

Secretary PAULSON. This year, it is 125; next year, 20, roughly.

Mr. GOODE. That will go down, because some of the tax things will bring money in.

Secretary PAULSON. You are correct.

EX POST FACTO LAWS

Mr. GOODE. All right. On the issue raised by Mr. Regula, some States in their constitutions have provisions against ex post facto laws. Would those provisions—I am not sure whether this one there is one in the U.S. Constitution or not. Would those provisions come into play if you empowered the bankruptcy judge in his example to go in and reform an existing contract?

Secretary PAULSON. Congressman, you would have to ask a very good lawyer or the Justice Department that question. I just looked at it, and the way I answered the question, I said I don't like to change contracts retroactively.

Mr. GOODE. So you are not going to say yes and you are not going to say no?

Secretary PAULSON. No, I am just going to say—

Mr. GOODE. Possibility?

Secretary PAULSON. I am not even saying a possibility, I am just saying someone else is going to answer it. I don't even need to answer it, because I think it is the wrong policy.

Mr. GOODE. Okay, thank you.

That is it, Mr. Chairman.

Mr. SERRANO. Wow, I am recommending you for baseball commissioner.

Secretary PAULSON. Thank you. Thank you. But take care of this steroid scandal before I get there.

Mr. SERRANO. Yeah, that is tougher than anything you inherited here.

Mr. Secretary, we are going to thank you for your testimony, for spending time with us today, for the work that you do. We don't always agree on some of the policies, but we respect the work that you are doing and the fact that you want the best for our country and economy, and we respect that and appreciate that.

Secretary PAULSON. Well, Mr. Chairman, thank you for all the support your committee gives Treasury in supporting our initiatives with the funding. It is very important, and it is very important to our country.

Mr. SERRANO. So, remember, get the Puerto Rico quarter out as soon as possible, solve the territory's dollars directly, ease travel to Cuba and make Mr. Hinchey happy. If you do all of that——

Thank you so much, and the meeting is adjourned.

Secretary PAULSON. Thank you.

**Questions for the Record
Department of the Treasury**

Questions from Chairman José E. Serrano

Serrano – 1: With regard to the rebate checks that will be issued as part of the stimulus package, the Department announced earlier that the rebate checks would begin going out in early May. Is that still the schedule?

RESPONSE:

Economic stimulus payments made by direct deposit to the taxpayer's bank account will begin to be sent by May 2, 2008. Payments made by paper check will begin to be mailed by May 16, 2008. Please see the below schedule:

For tax returns processed by April 15, 2008, stimulus payments by direct deposit will be made over a three week period from May 2 to May 16. Stimulus payments made by paper check will be made over a nine week period from May 16 to July 11.

For tax returns processed after April 15, taxpayers can expect to receive their economic stimulus payments about two weeks after receiving their tax refunds, but not before the date they would have received their stimulus payments if their returns had been processed by April 15.

On March 17, the IRS issued a press release including a detailed schedule of stimulus payments. A copy of that press release is attached.

IRS Announces Economic Stimulus Payment Schedules, Provides Online Payment Calculator

IR-2008-44, Mar. 17, 2008

WASHINGTON — The Internal Revenue Service announced today that it will begin sending more than 130 million economic stimulus payments starting May 2. The initial round of weekly payments will be completed by early July.

The IRS also announced the availability of a new online calculator on IRS.gov to help people determine the amount of their stimulus payments.

Stimulus payments will be made by direct deposit to people who choose to receive their 2007 income tax refunds through direct deposit. All others will receive their economic stimulus payments in the form of a paper check.

“To receive an economic stimulus payment, people just need to file their tax returns as they usually do,” said IRS Acting Commissioner Linda E. Stiff. “The payments will be automatic for the vast majority of taxpayers. Some lower-income workers and recipients of certain Social Security and veterans benefits who don’t normally need to file a tax return will need to do so in order to receive a stimulus payment. IRS.gov has all the information people need to help them obtain a stimulus payment.”

Stimulus payments will be sent out in the order of the last two digits of the Social Security number used on the tax return.

Because the IRS will use the Social Security number to determine when checks are mailed, taxpayers may receive their checks at different times than their neighbors or other family members. On a jointly filed return, the first Social Security number listed will determine the mail-out time.

The IRS expects to make about 34 million payments within the first three weeks after the payment schedule begins May 2. With more than 130 million households expected to receive stimulus payments, more than 25 percent of the payments will be made in the first three weeks.

Taxpayers who choose direct deposit on their federal income tax returns can expect to receive their economic stimulus payments between May 2 and May 16 provided their returns were received and processed by April 15, 2008. For taxpayers who did not choose direct deposit on their tax return but whose returns were processed by April 15, the paper checks will be in the mail starting May 16, with the initial mailings completed by around July 11.

The IRS is also announcing today the availability of an [on-line calculator](#) on IRS.gov to help taxpayers determine if they are eligible to receive an

economic stimulus payment and if they are, how much they can expect. Anyone who has prepared a 2007 income tax return can use the calculator. It will ask taxpayers a series of questions, so they should have their 2007 tax returns handy. After answering the questions, the calculator will provide the projected dollar value of the payment.

Below are the schedules for economic stimulus payments related to tax returns processed by April 15, 2008.

**Stimulus Payment Schedule for Tax Returns
Received and Processed by April 15**

Direct Deposit Payments	
If the last two digits of your Social Security number are:	Your economic stimulus payment deposit should be sent to your bank account by:
00 – 20	May 2
21 – 75	May 9
76 – 99	May 16
Paper Check	
If the last two digits of your Social Security number are:	Your check should be in the mail by:
00 – 09	May 16
10 – 18	May 23
19 – 25	May 30
26 – 38	June 6
39 – 51	June 13
52 – 63	June 20
64 – 75	June 27
76 – 87	July 4
88 – 99	July 11

A small percentage of tax returns will require additional time to process and to compute a stimulus payment amount. For these returns, stimulus payments may not be issued in accordance with the schedule above, even if the tax return was processed by April 15.

Serrano – 2: The Center for Responsible Lending, in written testimony, argued that, “for years the mortgage industry has lobbied against subprime lending regulation and legislation, arguing that credit markets would shrink as a result of such regulation. Ironically, we have seen the credit markets become more restrictive in response to the lack of adequate regulation and the reckless lending that followed...” Does the Treasury Department agree this sentiment?

RESPONSE:

Credit markets are going through a period of market stress. While the current credit market stresses were certainly at least in part triggered by the subprime mortgage lending crisis that

resulted from weaker subprime mortgage credit underwriting standards, we are seeing the results of a much broader erosion of standards throughout corporate and consumer credit markets. This weakening of standards occurred during a long period of benign economic conditions and abundant liquidity, which resulted in market participants and regulators becoming too complacent about all types of financial risks. Now, in general, risk is being re-priced across the board and many institutions are deleveraging.

Serrano – 3: In a February 5th interview with National Journal magazine, Secretary Paulson stated that his definition of success, with regard to the HOPE NOW program, is “if you hold a subprime mortgage and you are able to make your initial payments, and you are unable to make the higher payment, and you want to stay in your house, are you able to stay in your house?” But at the same time many categories of subprime borrowers are not eligible for the five-year interest rate freeze. These include: all borrowers whose mortgage rates began to reset in 2007 or earlier, borrowers who are more than 60 days delinquent on more than one payment over the past year, and others. In looking at troubled subprime mortgages in which the borrower resides in the house---how many of these mortgages are not eligible for the interest rate freeze? Of those, how many are likely to face foreclosure, and what can be done to help these homeowners?

RESPONSE:

In drafting the American Securitization Forum’s Framework (ASF Framework) for streamlined refinancing and loan modifications, the industry aimed to develop a plan to address the majority of upcoming subprime adjustable-rate mortgage resets. With the ASF Framework now in place, servicers are able to evaluate and treat borrowers with rates resetting between January 1, 2008 and July 31, 2010 in a much more streamlined process.

Industry estimates place the total number of subprime ARMs at 3.4 million, with another 3.3 million fixed rate mortgages. For subprime borrowers that have already had their rate reset or are in a fixed rate mortgage, a rate freeze isn’t an appropriate solution. The time saved by the streamlined process will allow servicers to devote more of their time and resources to other borrowers who may already be delinquent or do not meet other characteristics of the ASF Framework. That means that many additional subprime ARM borrowers may see their rates dialed back to or below their original rate prior to reset, but these modifications will be done by their servicer on a case-by-case basis to ensure that each solution is right for the borrower and the investor.

Members of the HOPE NOW Alliance have estimated that of the 1.8 million subprime adjustable-rate mortgage borrowers with rates resetting in 2008 and 2009, 600,000 or so will not be able to stay current with their payments prior to the rate-reset. Our goal is to ensure all of those who are current at the time of reset are able to stay in their home, whether through a modification, a refinancing, or the ability to afford the reset. Of the estimated 600,000 who are delinquent at the time of reset, a more in-depth analysis of their situation will be necessary – many of these borrowers may go back to being renters again. However, those delinquent borrowers who have the basic financial ability to afford their home may still receive help through a custom modification or a fixed-rate loan through the FHA Secure program, which was launched to allow some delinquent borrowers to qualify for FHA refinancing.

It is difficult to estimate how many delinquent borrowers will go all the way through the foreclosure process. While the goal of HOPE NOW is home retention for all able borrowers, servicers and counselors in the Alliance are also working hard to help borrowers who cannot afford their home avoid foreclosure – whether it be through a loan modification which helps the borrower keep their home, or another option like a short sale or deed-in-lieu of foreclosure which allows the borrower to mitigate the impact on their credit.

Serrano – 4: A Washington Post article on March 4, 2008 included an observation by Bill Longbrake, a senior policy adviser for the Financial Services Roundtable, a member of the HOPE NOW coalition. Mr. Longbrake noted that financial firms have been reluctant to offer generous loan modifications because they have to consider the returns of the investors who buy mortgages. Are financial firms perhaps misreading the situation by offering too few loan modifications, and as a result, ending up with losses from foreclosures--losses that the firms could have avoided if only they were more willing to do more loan modifications?

RESPONSE:

Reviewing industry progress – as published by HOPE NOW – shows a dramatic increase in the number of loan modifications since the Alliance’s formation. Industry estimates show that approximately 25,000 loan modifications were being completed every month in the three months leading up to the formation of HOPE NOW. Recent data released shows that 55,000 modifications were completed in February 2008 alone. That said, it is imperative that HOPE NOW continue to improve upon these results, and Treasury will be sure to consistently convey that message to the Alliance.

Borrowers, servicers, and investors all lose in the foreclosure process. However, it is important to acknowledge that borrowers entered into a contract they were expected to honor when they took out a mortgage. Servicers have an obligation to evaluate a borrower’s ability to afford a mortgage when performing a loan modification – different borrowers will be able to afford different payments. Hence, the terms of loan modifications will differ for many borrowers.

Clearly it is difficult to alter the behavior of an entire industry; however, the dramatic increase in modifications since the launch of the HOPE NOW Alliance exemplifies the extraordinary efforts being lent to this endeavor

Serrano – 5: The Treasury Department, in the fiscal year 2009 budget justification, appears to point to the CDFI Fund as playing a role in dealing with the mortgage crisis. If so, why is the Department proposing to slash funding (compared to the fiscal year 2008 enacted level) for the CDFI Fund program?

RESPONSE:

Under the President’s FY 2009 budget request, the CDFI Fund will continue to provide grants, loans and equity investments through the CDFI Program, provide allocations of tax credits through the New Markets Tax Credit Program, and manage the CDFI Fund’s existing portfolio of awards from FY 2008 and before.

While the CDFI Fund plays an important role in providing capacity-building funding to organizations that serve low-income home owners (among others), the situation in the mortgage market requires a larger response from mortgage servicers, lenders, and brokers. CDFIs are not the originators of many of the subprime loans held in the larger mortgage market.

The Department of Housing and Urban Development (HUD) and Department of the Treasury have facilitated the creation of the HOPE NOW Alliance. The Alliance is a private sector coalition that brings an array of parties together and facilitates private sector solutions. We feel that this alliance will have a much broader impact in the mortgage market, of which CDFIs are a smaller subset.

To boost housing counseling efforts, the Neighborhood Reinvestment Corporation (also known as NeighborWorks America) was designated by Congress to develop and implement a new program to minimize the impact on homeowners who face or are at-risk of foreclosure. Created by your Transportation-HUD Appropriations Subcommittee colleagues, NeighborWorks is administering a new foreclosure mitigation program, with an appropriation of \$180 million. NeighborWorks has awarded \$130 million to applicants who plan to provide 89 percent of their services in areas of greatest need.

Due to the CDFI Fund's experience working with CDFIs that serve distressed communities and low-income homeowners, the CDFI Fund Director is serving on the NeighborWorks's advisory committee to provide input and guidance to NeighborWorks regarding this important new program.

Serrano – 6: In December 2007, the Congressional Budget Office released its updated data on household incomes, and it shows that the increase in income inequality in the U.S. was greater from 2003 to 2005 than over any other two-year period since CBO began these measurements in 1979. Overall, in just that two year period, \$400 billion dollars in pre-tax income effectively shifted from the bottom 95% of households to the top 5% of households. The Treasury Department's fiscal year 2009 budget submission includes a statement indicating that the Department is working toward an economic system that strives to decrease the gap in the global standard of living. Is the Department troubled by the growing gap between rich and poor within the United States as well, and doesn't the greater inequality in income indicate a failure of policy?

RESPONSE:

The Secretary has long indicated that the distribution of income in the United States is a key challenge. Many Americans aren't seeing significant increases in their take-home pay and nominal increases in wages are being eaten up by high energy prices and rising health-care costs, among others.

The underlying trend in rising inequality dates back many years, and was evident in the recovery of the 1990s. It stems from a number of factors, including technology, the rise of new industries, and U.S. integration with the global economy, all of which raise demand for skilled workers. The yearly earnings gap between workers with a bachelor's degree and workers with a high school degree has grown more than 60 percent since 1975.

The 2003 to 2005 increase in inequality is not a failure of recent policy. The economy grew about 3¼ percent a year in 2004 and 2005 – a substantial improvement over the less than 2 percent annual growth from 2001 to 2003. Stronger economic growth creates new and better opportunities for all Americans. As the economy grows, however, market forces work to provide the greatest rewards to those with the skills needed in the growth areas. This means that those workers with less education and fewer skills will realize fewer rewards and have fewer opportunities to advance.

The first priority must be to maintain strong economic growth that leads to better opportunities for all Americans. We also need to continue our focus on helping people of all ages pursue first-rate education and retraining opportunities, so they can acquire the skills needed to advance in a competitive worldwide environment.

Serrano – 7: What is the estimated total cost of the Electronic Content Management pilot program? How many years will it take to complete?

RESPONSE:

Treasury will design, develop and deploy an enterprise content management (ECM) solution that integrates document management, case management and records management capabilities at its pilot organizations estimated to cost \$53 million for full functionality. Of this amount, approximately \$40 million will be used in the development and configuration of an ECM software suite and the purchase of foundational hardware. The remaining funds would be necessary to deploy the software suite to the three pilot organizations.

The Treasury ECM solution will provide document management, records management, and case management functionality. Document management provides the capabilities to manage, track and store electronic documents or images of paper documents. Records management provides capabilities of identifying, classifying, archiving, and preserving records in accordance with organization-specific and federal compliance specifications. Case management capabilities include workflow, reporting, and lifecycle management of business processes associated with end-to-end case management.

With an implemented ECM solution, Treasury will improve its ability to electronically “file and find” massive volumes of data (e.g. documents, records, images, and case files), much of which are subject to statutory/regulatory handling and storage requirements. While initial efforts will focus on delivering an ECM system that meets the immediate business priorities of the pilot organizations, the solution will provide the technology foundation and core capabilities to support future ECM needs of other Treasury organizations.

The three Treasury pilot organizations scheduled to receive the ECM solution are:

Treasury Office of Foreign Assets Control
Internal Revenue Service Criminal Investigation
Financial Crimes Enforcement Network

Development and deployment of the integrated ECM solution will take five to seven years to complete depending on available funding. Treasury will begin delivering ECM functionality in FY2009.

Serrano – 8: GAO has reported that tax expenditures in some years exceed discretionary spending, and yet they are not in the financial statements, nor are they part of the budget process. GAO has recommended that OMB work with the Secretary of the Treasury on reporting better information on tax expenditure performance and including tax expenditures under budget review processes. What actions has the Treasury Department taken to: (1) present tax expenditures in the budget together with related spending to show a truer picture of federal support? and (2) develop a framework for evaluating tax expenditures?

RESPONSE:

The Treasury Department prepares tax expenditure estimates for approximately 120 income tax provisions (see: Tax Expenditures, Analytical Perspectives, Fiscal Year 2009 Budget of the U.S. Government, pages 287-328). These estimates are disaggregated by budget function, which should enable the comparison between tax expenditures and outlays category. Direct comparisons require some caution, however, because tax expenditure estimates do not incorporate behavioral effects nor do they account for the interaction among tax provisions.

The Treasury Department prepares tax expenditure estimates by organizational form (corporate vs. individual) and by budget function, mimicking the outlay side of the budget. It also provides present value estimates when benefits accrue over time and ranks provisions by the magnitude of the revenue loss.

The staff of the Treasury Department continues to work on and conduct research on the effects of tax expenditures. These studies are publicly released, for example, through presentations at conferences and publication in academic publications to solicit feedback and improve the analyses. Like most research on economic issues, the results frequently are uncertain and subject to different interpretations. Often the findings from such studies, as well as those in the broader academic literature, are in conflict with one another. In one example, two studies on the incentive effects of the deduction for charitable contributions by Treasury staff members arrived at different answers on whether the deduction from the income tax for charitable contributions stimulates additional charitable giving. Published in two prestigious economics journals, the American Economic Review and the Journal of Political Economy, these two analyses and findings were subject to peer review and made available to the public.

Serrano – 9: How much did the Treasury Department spend on outside contracts in fiscal year 2007?

RESPONSE:

The Department spent \$4.2 billion in FY2007 on contracts, including approximately \$259 million in FY2007 in support of other agencies' requirements.

Serrano – 10: For fiscal year 2007, how much did the Treasury Department rely on contracts that were not fully and openly competed?

RESPONSE:

The Department relied on competition for 76% of its dollars obligated in FY2007. This number is based on a competition report generated based on data from the federal-wide Federal Procurement Data System-Next Generation (FPDS-NG).

Serrano – 11: Please provide a listing of all fiscal year 2007 outside contracts of \$50,000 or more, along with the purpose of each contract. In the listing, please indicate which contracts were not fully and openly competed.

RESPONSE:

The attached list of contracts over \$50,000 awarded by Treasury during FY2007 was generated using an ad hoc report from FPDS-NG on April 3, 2008.

NOTE: A detailed listing is available at the office of the Financial Services subcommittee.

Serrano - 12: How many contract employees now work in space with the regular civil service employees of the Treasury Department?

RESPONSE:

Treasury bureaus report a total of 9,306 contractor employees performing work in space with civil service employees. Contracts vary greatly by purpose, scope and duration, and bureau systems vary in the way they track contractor employee data. For example, these numbers reflect employees who perform work full-time on site all year as well as employees of contractors on site only intermittently or for short duration

Serrano - 13: Please provide a list of how many contract and civil service employees now work in each major location (more than 100 total employees) maintained by the Treasury Department.

RESPONSE:

The Treasury Department currently has 126 geographic locations with more than 100 employees. Please see the attached excel file for the listing of contractor and civil service employees in each of these locations.

Serrano - 13: Please provide a list of how many contract and civil service employees now work in each major location (more than 100 total employees) maintained by the Treasury Department.

State	City	TOTAL CIVIL SERVICE	TOTAL CONTRACTOR	Bureaus
AL	BIRMINGHAM	372	50	IRS, FMS, TIGTA, OCC
AL	HOMEWOOD	195	0	FMS
AR	LITTLE ROCK	151	1	IRS, TIGTA, OCC, TTB
AZ	PHOENIX	474	8	IRS, TIGTA, OCC, TTB
AZ	TEMPE	101	0	IRS
CA	EL MONTE	284	0	IRS
CA	EL SEGUNDO	167	0	IRS
CA	EMERYVILLE	112	0	FMS
CA	FRESNO	5,891	413	IRS, TIGTA
CA	GLENDALE	283	1	IRS, OCC
CA	LAGUNA NIGUEL	595	3	IRS, TIGTA
CA	LONG BEACH	134	0	IRS
CA	LOS ANGELES	679	2	IRS, FinCEN, TTB
CA	OAKLAND	897	6	IRS, TIGTA
CA	SACRAMENTO	320	0	IRS, TTB
CA	SAN BERNARDINO	200	5	IRS
CA	SAN DIEGO	301	1	IRS, TIGTA
CA	SAN FRANCISCO	1,058	30	IRS, FMS, FinCEN, MINT, OCC, TTB
CA	SAN JOSE	423	3	IRS
CA	SANTA ANA	214	1	IRS
CA	TULARE	217	0	IRS
CA	VAN NUYS	115	0	IRS
CA	WALNUT CREEK	109	0	IRS, TTB
CO	DENVER	1,400	13	IRS, MINT, TIGTA, OCC
CO	ENGLEWOOD	129	0	IRS
CT	HARTFORD	206	0	IRS, TIGTA
CT	NEW HAVEN	120	1	IRS
DC	WASHINGTON	8,442	1,606	IRS, BPU, FMS, FinCEN, DD, OIG, BEP, MINT, TIGTA, OCC, TTB, OTS
FL	JACKSONVILLE	1,384	2	IRS, TIGTA, OCC
FL	MAITLAND	179	3	IRS
FL	MIAMI	279	0	IRS, DO, OCC, TTB
FL	PLANTATION	515	1	IRS
FL	ST PETERSBURG	112	8	IRS
FL	TAMPA	203	1	IRS, TIGTA, OCC, TTB, DO
FL	WEST PALM BEACH	106	0	IRS
GA	ATLANTA	2,002	382	IRS, TIGTA, OCC, DO
GA	CHAMBLEE	4,498	114	IRS, TIGTA
GA	GLYNCO	110	0	IRS, FinCEN, MINT, TIGTA, BEP
HI	HONOLULU	139	0	IRS, TIGTA
IA	DES MOINES	105	0	IRS
ID	BOISE	108	1	IRS
IL	BLOOMINGTON	500	2	IRS
IL	CHICAGO	1,088	6	IRS, TIGTA, OCC, FinCEN, TTB
IL	DOWNERS GROVE	301	2	IRS
IL	SCHAUMBURG	114	0	IRS
IN	INDIANAPOLIS	639	4	IRS, TIGTA, OCC
KS	WICHITA	117	0	IRS, OCC
KY	COVINGTON	4,421	255	IRS, TIGTA
KY	FLORENCE	492	103	IRS
KY	LOUISVILLE	202	0	IRS, TIGTA, OCC
LA	NEW ORLEANS	281	2	IRS, TIGTA, OCC
MA	ANDOVER	1,958	168	IRS, TIGTA
MA	BOSTON	529	17	IRS, OIG, TIGTA, OCC
MA	FITCHBURG	300	0	IRS
MA	LOWELL	617	0	IRS
MA	METHUEN	369	0	IRS
MA	STONEHAM	208	0	IRS, TIGTA

State	City	TOTAL CIVIL SERVICE	TOTAL CONTRACTOR	Bureaus
MD	BALTIMORE	765	1	IRS, BPD, TIGTA
MD	HYATTSVILLE	981	287	FMS
MD	NEW CARROLLTON/LANDOVER	3,354	1,973	IRS, FMS, TIGTA, OCC
MD	OXON HILL	392	66	IRS
MD	WHEATON/SILVER SPRING	107	0	IRS, TIGTA
MI	DETROIT	1,400	132	IRS, TIGTA
MI	GRAND RAPIDS	124	1	IRS, TIGTA
MN	BLOOMINGTON	139	0	IRS
MN	BROOKLYN CENTER	122	0	IRS
MN	MINNEAPOLIS	120	0	IRS, OCC
MN	ST PAUL	299	4	IRS, TIGTA, TTB
MO	KANSAS CITY	4,998	893	IRS, FMS, TIGTA
MO	ST LOUIS	981	7	IRS, TIGTA, OIG
MO	TOWN AND COUNTRY	206	0	IRS
MS	JACKSON	117	2	IRS
NC	CHARLOTTE	359	10	IRS, OCC, TTB, FMS
NC	GREENSBORO	268	3	IRS, TIGTA, TTB
NE	OMAHA	170	0	IRS, OCC
NJ	CHERRY HILL	110	1	IRS
NJ	EDISON	160	0	IRS, OCC
NJ	MOUNTAINSIDE	174	0	IRS
NJ	NEWARK	102	0	IRS
NJ	SPRINGFIELD	184	8	IRS
NM	ALBUQUERQUE	120	0	IRS, OCC
NV	LAS VEGAS	310	2	IRS, TIGTA
NY	ALBANY	142	1	IRS
NY	BUFFALO	279	0	IRS, TIGTA
NY	CHEEKTOWAGA	780	3	IRS
NY	GARDEN CITY	243	6	IRS, TIGTA
NY	HAUPPAUGE	124	0	IRS
NY	HOLTSVILLE	3,392	126	IRS, TIGTA
NY	NEW YORK-INCL QUEENS/KINGS/RICHMOND	2,215	5	IRS, TIGTA, OCC
NY	SYRACUSE	108	0	IRS, TIGTA, OCC, TTB
NY	WESTPOINT	193	5	MINT
OH	CINCINNATI	1,132	224	IRS, TIGTA, TTB
OH	CLEVELAND	545	3	IRS, TIGTA, OCC
OH	COLUMBUS	177	4	IRS, OCC, TTB
OH	INDEPENDENCE	243	0	IRS, OCC
OK	OKLAHOMA CITY	349	0	IRS, TIGTA, OCC
OK	TULSA	126	0	IRS, OCC
OR	PORTLAND	572	0	IRS, TIGTA, OCC, TTB
PA	KING OF PRUSSIA	120	3	IRS
PA	PHILADELPHIA	5,608	245	IRS, FMS, MINT, TIGTA, TTB
PA	PITTSBURGH	735	2	IRS, TIGTA, OCC
PR	GUAYNABO	518	0	IRS, TTB
PR	HATO REY	102	0	IRS, TIGTA
SC	COLUMBIA	127	0	IRS, TIGTA
TN	MEMPHIS	2,833	198	IRS, TIGTA, OCC
TN	NASHVILLE	939	3	IRS, TIGTA
TX	AUSTIN	6,369	556	IRS, FMS, DO, TIGTA, OCC
TX	DALLAS	1,381	19	IRS, TIGTA, OCC, TTB
TX	FARMERS BRANCH	902	139	IRS, TIGTA
TX	FORT WORTH	825	130	IRS, BEP
TX	HOUSTON	1,185	13	IRS, TIGTA, OCC
TX	SAN ANTONIO	527	17	IRS, BPD, TIGTA, TTB
UT	OGDEN	5,926	611	IRS, TIGTA
UT	SALT LAKE CITY	227	1	IRS, OCC
VA	NORTHERN VIRGINIA	812	2	IRS, FinCEN, DO, OIG, TIGTA, OCC, TTB
VA	RICHMOND	652	2	IRS, TIGTA, TTB
WA	SEATTLE	1,067	1	IRS, BPD, TIGTA, OCC, TTB
WI	MILWAUKEE	248	0	IRS, TIGTA

State	City	TOTAL CIVIL SERVICE	TOTAL CONTRACTOR	Bureaus
WV	BECKLEY	243	21	IRS
WV	MARTINSBURG/KEARNEYSVILLE	946	65	IRS, TIGTA
WV	PARKERSBURG	1,945	87	IRS, BPD
Total		105,188	9,097	

Questions from Ranking Member Regula:**Regula – 1:**

Stimulus

The stimulus bill provides IRS with funding for 940 full time equivalents to implement the tax rebate program. The IRS used 743 staff years to implement the 2001 rebates. This is an increase of 197 staff years. I would have expected the IRS to become more efficient over the past 7 years. Why are more staff required to implement this rebate than in 2001?

RESPONSE:

There are several differences between the 2001 rebate and the 2008 economic stimulus payments that contribute to the increase in costs. More than 130 million individuals are expected to receive a payment in 2008. This includes more than 15 million who are Social Security and Veteran beneficiaries who would not otherwise file a tax return, but are required to in order to receive an economic stimulus payment. In 2001, approximately 90 million individuals received an advance refund that did not include this population that normally are not required to file an income tax return.

As the result of this expanded population, the IRS anticipates that these individuals will seek additional help through toll-free assistors and Taxpayer Assistance Centers during the peak of the normal filing season. The complexity of the 2008 economic stimulus eligibility requirements may also have an affect on the number of individuals seeking assistance.

The complexity, increase in tax return filings, additional telephone calls and walk-in taxpayers seeking return assistance all contribute to the 2008 cost to successfully administer the payments.

Regula – 2:

China

In fiscal year 2008, the Committee supported your request for a \$618,000 increase and 6 positions to enhance Treasury's international economic policy coordination. Treasury is leading the Administration's efforts in the US-China Strategic Economic Dialogue, which is intended to address issues such as the value of Chinese currency, human rights, energy, intellectual property rights and other topics.

As you know, I am very concerned that China's currency is significantly undervalued as compared to the U.S. dollar (some say by as much as 40 percent) because the Chinese government pegs the yuan to the dollar, thereby not allowing market forces to determine the true exchange rate between the two currencies. An undervalued Chinese currency makes Chinese exports to the U.S. cheaper and U.S. exports to China more expensive. Many argue that this under valuation of the yuan has caused job dislocation in several sectors of the economy and has added to the growing U.S. trade deficit. I know that the Chinese have increased the value of their currency by small amounts recently but I think you agree that more change is needed.

Can you describe the effects of Chinese currency manipulation on the US? What can the Congress do to help you on this issue?

RESPONSE:

A healthy Chinese economy that is capable of sustaining strong economic growth without generating large external imbalances is of vital interest to the people of the United States, to the people of China, and to the global economy as a whole. Currency adjustment must play an important role in helping China make the transition into this model of economic growth.

Initially, after moving away from a pegged exchange rate in July 2005, China's actions were cautious, with the RMB appreciating slowly. The pace of renminbi appreciation accelerated significantly in 2007, and has further accelerated in 2008. The renminbi has appreciated by a total of about 18.2 percent against the dollar since the end of the peg. This progress is welcome, but it must continue.

The focus of our engagement policy is to encourage China to let the renminbi better reflect underlying market forces. We have met with some success but we will continue to push the Chinese government on this issue.

Regula – 3:

Foreign Debt

I understand that approximately 54 percent of the US government's public debt is held by foreign investors. What happens if these sources choose not to invest in the U.S. in the future?

RESPONSE:

U.S. government securities are highly sought after as a result of their unique characteristics. Our debt and securities markets are the deepest and most liquid in the world with over \$500 billion in volume each day. Foreign investors are attracted to investing in the U.S. market because of the depth and liquidity of the Treasury market, the strong long-term economic prospects of the United States, our strong macroeconomic performance, and the stability offered by our financial system. Over time, we have seen buyers diversify away from Treasuries as well as the emergence of new buyers such as Brazil, India, and Mexico without adverse implications to the market. If international investors choose to not invest in Treasury securities in the future, the consequences could include higher interest rates which in turn impact individuals, for example, through higher mortgage rates and credit card rates. Nonetheless, no other debt market in the world can offer the liquidity of the US Treasury market.

Regula – 4:

Law Enforcement and Intelligence

According to the Final Report of the 9/11 Commission, "the government has made significant strides in using terrorism finance as an intelligence tool". The budget request proposes a \$4.3 million increase to your National Security efforts.

- Can you describe how Treasury works with FBI, CIA and other Intelligence Community agencies to combat terrorism and the spread of weapons of mass destruction?

RESPONSE:

Treasury's Office of Intelligence and Analysis (OIA) works very closely with FBI, CIA, and the other members of the Intelligence Community (IC) to combat terrorism and the spread of WMD. Intelligence provided to Treasury by the IC agencies is essential to OIA efforts to identify and track the financiers and supporters of terrorists and WMD proliferation networks. In addition, OIA routinely provides support to FBI counterterrorism investigations, and frequently offers input to counterterrorism and counter-proliferation analytic products drafted by FBI, CIA, and other IC agencies. On numerous occasions, OIA analysts have drafted intelligence reports jointly with their counterparts at FBI and CIA. In order to strengthen cooperation with these agencies, OIA has detailed officers to FBI's Terrorist Finance Operations Section (TFOS) and to CIA. OIA also has officers forward-deployed to US Central Command, US Pacific Command, US European Command, and the joint Treasury-DoD Iraq Threat Finance Cell (ITFC) in Baghdad. The Defense Intelligence Agency (DIA) and the National Security Agency (NSA) have assigned officers to OIA to facilitate cooperation and information sharing.

OIA's FY 2009 Global Finance Initiative (GFI) would give Treasury the resources it needs to successfully leverage its status as a fully-integrated member of the IC. GFI would provide \$2 million, including a realignment of \$1 million in Department base resources, and 10 positions to establish a capability in OIA to advance global finance intelligence issues within the IC. Resources would be targeted to aligning IC collection requirements on finance-related issues more closely with policymaker needs; developing and taking advantage of new sources of information; enhancing analysis on finance-related issues in coordination with the IC; and expanding OIA's role and relationships within the IC. This initiative is aligned with key tasks and objectives of the National Security Strategy, the National Intelligence Strategy, the National Implementation Plan for the War on Terror, and the Treasury Strategic Plan.

- To the extent that you can in this public forum, can you describe how your sanctions against Iran have impacted their development of weapons of mass destruction?

RESPONSE:

Some of the world's leading financial institutions have essentially stopped dealing with Iranian banks, some of which Treasury has designated, in any currency. This is a situation that many of Iran's elite have found painful and, combined with the Iranian regime's mismanagement of their country's economy, is generating a debate about the current regime's policies.

- Can you describe how US sanctions have impacted the genocide in Sudan?

RESPONSE:

Treasury will be providing an assessment of the effectiveness of its Sudan sanctions program in the near future, pursuant to section 10(b) of the Sudan Accountability and Divestment Act of 2007.

Questions from Chairman David Obey:

Obey – 1: Since 1925, the Wisconsin Alumni Research Foundation (WARF) has commercialized the inventions and discoveries of the University of Wisconsin's faculty in order to support the University in its many endeavors. I understand that WARF served as the model for the Bayh-Dole Act of 1980 which codified the patent-transfer process that WARF had developed to the benefit of the University and that WARF was awarded the National Medal of Technology by President Bush in a White House ceremony for its efforts.

I understand, further, that when Congress enacted the Pension Protection Act of 2006 (PPA), it included provisions to make sure that WARF could continue to serve the University and the public as before. Several members of the Wisconsin delegation worked with the House Ways and Means Committee to ensure that WARF was appropriately classified as a "functionally integrated" type III supporting organization. Among other things, this distinguished WARF from grant-making organizations; whereas grant-making organizations are subject to a pay-out requirement, WARF and similar type III supporting organizations are absolved from any pay-out requirement because of its functional integration. I understand that such organizations were distinguished in this manner both before and after enactment of the Pension Protection Act.

Last year, Treasury issued an Advanced Notice of Proposed Rulemaking (ANPR) which, I understand, was intended to develop a measure of what it means to be functionally integrated in order to combat abuses by some type III organizations. Further, it is my understanding that it did so by proposing adoption of an asset test under which 65 percent of an organization's assets would need to be directed to the integrated activity.

This proposed asset test creates an enormous problem for WARF and would appear to run counter to congressional intent under the PPA. Specifically, the proposed regulation would require that WARF spend 65% of its roughly \$2 billion endowment, an endowment which it has built up since 1925, on its patent-transfer function or suffer the loss of the status it has been accorded as a functionally integrated organization. That would undermine the ability of WARF to carry out the functions it currently performs in support of research and other activities of the University of Wisconsin.

Under the ANPR, then, it appears that WARF is being penalized for its own success, and I do not believe that was the intent of the PPA, nor of the ANPR. It would mean that WARF could meet this asset-test if it had little or no assets in its endowment but, because it has been successful in building up a large endowment dedicated to the University, it is punished.

Am I correct in my understanding that it was not the intention of the Department of the Treasury or the ANPR to punish WARF for its success?

If that was not the intent, will the Department amend the ANPR when it publishes the Notice of Proposed Rulemaking in the months to come to ensure that it follows the will of Congress, as laid out in the Pension Protection Act and preserve WARF's status as a functionally integrated type III supporting organization?

RESPONSE:

“Supporting organizations” that provide support to certain exempt organizations under section 501(c)(3) of the Internal Revenue Code are classified for Federal tax purposes as public charities, rather than as private foundations. Private foundations are subject to more stringent rules than public charities, including a payout requirement. In the Pension Protection Act of 2006 (the “Act”), Congress directed the Treasury Department to promulgate new regulations that set forth a payout requirement for so-called “non-functionally integrated” Type III supporting organizations and strengthen the “functional integration” standard. The legislative history to the Act states further that the Treasury has discretion, in revising the regulations, to determine whether it is appropriate to impose a payout requirement on any or all organizations not currently required to pay out.

On August 2, 2007, the Treasury Department and the Internal Revenue Service (IRS) issued an Advance Notice of Proposed Rulemaking relating to Type III supporting organizations (the Advance Notice). The payout requirement described in the Advance Notice would require a non-functionally integrated Type III supporting organization to distribute annually to its supported organizations an amount equal to 5 percent of the fair market value of the organization’s assets, similar to the payout requirement for private foundations. The Advance Notice also includes a test (the “asset test”) for functional integration that would require a Type III supporting organization to make direct charitable expenditures equal to substantially all of the lesser of its adjusted net income or 5 percent of the fair market value of its non-charitable-use assets, and to devote at least 65 percent of its assets to the active conduct of its exempt activities.

The Advance Notice requested comments on the payout requirement and the test for functional integration, as well as the transition rules for existing organizations. The Treasury Department and the IRS received a number of public comments in response to the Advance Notice, including comments from the Wisconsin Alumni Research Foundation. These comments address a number of issues, including the negative impact of the asset test on supporting organizations that have significant endowment assets. While it would not be appropriate to comment on application of the Advance Notice to any particular organization, the Treasury Department and the IRS are evaluating the comments received in response to the Advance Notice and will take them into consideration as proposed regulations are developed. In particular, the Treasury Department and the IRS will work to ensure that the proposed asset test for functional integration appropriately reflects the Congressional intent to strengthen the standard for functional integration and also takes into account the potential impact of the proposed asset test on organizations with endowments.

Questions from Mr. Ruppertsberger:

Ruppertsberger – 1: According to PL 110-161, the side edging on the dollar coin, including the Presidential dollar coin series, stating ‘In God We Trust’, must be moved from the edge to the face of the coin. What is the cost estimate for this change? Could you please detail the schedule for these changes to occur and indicate if this affects previously designed coins?

RESPONSE:

The cost estimate for the change is negligible. These changes will not occur until coins are issued in calendar year 2009 and do not affect previously designed coins.

Background:

Public Law 110-161, Title VII, section 623, amended section 5512(n)(2) of Title 31 of the United States Code by requiring that the inscription “In God We Trust” be moved from the edge of the Presidential \$1 Coins to “the obverse or the reverse” of the coins.

The Congressional Budget Office and the United States Mint determined that the cost of implementing this provision, which requires that the inscription “In God We Trust” be returned to either the obverse or reverse of the Presidential \$1 Coins, was not significant because the effective date of the amendment was “as soon as practicable.” The Secretary of the Treasury determined the change would be made for all future Presidential \$1 Coins beginning in 2009, which enabled the United States Mint to incorporate the change into its normal design and production schedule.

The same legislation also amended P.L. 110-82, codified at 31 U.S.C. 5112(r)(2), the Native American \$1 Coin Program, which directed the United States Mint to edge-incuse certain inscriptions, including “In God We Trust,” onto the redesigned “Sacagawea” Native American \$1 Coin beginning in 2009. The amendment required that the inscription “In God We Trust” appear on the obverse or reverse of the Native American \$1 Coin instead.

Therefore, in 2009 and beyond, both of the circulating dollar coins, the Presidential \$1 Coin and the Native American \$1 Coin, will feature edge-incused inscriptions. However, the obverse or the reverse of the coins will bear the inscription of the national motto “In God We Trust.”

Questions from Mr. Visclosky**Visclosky – 1:*****Relaxing the Dumping Rules for Chinese Companies Accused of Dumping***

Recently the Commerce Department requested comments regarding whether it should treat individual Chinese companies accused of dumping as “market oriented enterprises.” This would mean Commerce would use actual Chinese prices and costs in calculating a dumping margin, despite the continued importance of state control and direction throughout the Chinese economy. As a result, it would be much easier for Chinese companies to avoid paying antidumping duties. I believe adopting such a practice would seriously weaken our trade laws and would harm U.S. companies and workers who are competing with dumped Chinese imports.

Is Treasury supporting this proposal? At a time when our trade deficit with China is growing, when Chinese products are being imported in violation of basic safety standards, and when imports from China have cost tens of thousands of Americans their jobs, why should the U.S. government make it *easier* for Chinese producers to dump their products in the United States? Wouldn't such a proposal further encourage U.S. companies to outsource production to China?

RESPONSE:

By statute, U.S. antidumping and countervailing duty laws are administered solely by the Department of Commerce and the International Trade Commission. Commerce has asked for public comment on the question of granting “market enterprise” status to certain companies in China, and will carefully review the comments it receives.

As part of Treasury's continuous dialogue with China, which focuses on economic issues, we have consistently encouraged China to have less government involvement in the Chinese economy.

Visclosky – 2:***Chinese Currency Harming U.S. Manufacturers' Competitiveness***

Although China has permitted some revaluation of the yuan against the dollar, China continues to intervene in foreign exchange markets to meet an excess demand for yuan and the size of that intervention grows. As measured by its accumulation of official reserves, net intervention was \$462 billion in 2007 and was much greater than the \$247 billion in 2006. In 2007, accumulation of official reserves came to about one-third of the value of China's exports of goods.

What implications does that magnitude of intervention have for the fundamental misalignment between the dollar and the yuan, and stability of the global financial system? How large is that misalignment and has there been any significant change in that misalignment in the past year?

What are the implications of an undervalued yuan for U.S. manufacturers locked in price

competition with products from mainland China? If there was a major revaluation of the yuan, what would be the fundamental impact on the cost competitiveness of U.S. manufacturers?

RESPONSE:

China's rapid accumulation of foreign exchange reserves places a heavy burden on China's central bank, The People's Bank of China (PBOC), and plays a role in limiting the PBOC's ability to undertake the types of monetary policy measures that are needed to help maintain a stable macroeconomic and financial environment in China.

Secretary Paulson has stated that he believes that the renminbi is currently undervalued. However, determining the precise difference between a given currency's exchange rate and the rate that would be determined in markets is very difficult. Economists have devised various methods to estimate what a market-determined rate would be for currencies that are managed. In most cases, and in the case of China, these estimates produce a broad range of estimates and have little statistical reliability. Ultimately, China needs to get a point where the market determines the RMB value. To do this, China will need to strengthen and deepen its financial system. They are working on this, but the process will take some time.

It should be noted that renminbi appreciation holds a mixture of implications for the cost competitiveness of U.S. firms. While renminbi appreciation raises the cost of Chinese exports relative to U.S. goods and services, it also raises the production costs of U.S. firms that import intermediate goods and other inputs from China.

Questions from Mr. Cramer:

Cramer – 1: With evidence that our economy is sluggish, can you discuss different options the Treasury is proposing to aide families hurting by this economic crisis, in addition to the recently passed stimulus package?

RESPONSE:

We have a two-pronged policy approach to address the challenges facing our economy today. First, we worked with Congress to enact a broad stimulus package that will provide about \$150 billion in tax relief for individuals and businesses in 2008, leading to the creation of over half a million new jobs this year. We expect to deliver stimulus payments to over 130 million households starting in May, with the bulk of those dollars distributed by the first week in July. The boost from consumer spending and business investment will support our economy while the housing and credit market adjustments proceed.

Second, we have implemented a number of measures aimed at minimizing the effect of the housing downturn on the overall economy. Treasury helped facilitate the development of a private sector alliance—HOPE NOW—that is using a broad set of tools to assist struggling borrowers who want to keep their homes. Since July, about 1.2 million struggling homeowners received a work-out—either a loan modification or a repayment plan—that helped them avoid foreclosure. Of those, 717,000 were for subprime borrowers. This data does not include refinancings, which also provide borrowers with affordable, long-term

mortgages. Lower payments and loan modifications directly help those households most affected by the housing downturn. The Administration also launched FHA Secure, a temporary program designed to allow struggling homeowners to refinance into fixed-rate, low cost loans. Since FHA Secure was announced, FHA has refinanced over 150 thousand homeowners into FHA loans, and expects to refinance 500 thousand total borrowers by the end of 2008, including approximately 100 thousand that will qualify under additional program flexibility recently announced by FHA. The President also signed into law a temporary provision to eliminate taxes on forgiven mortgage debt.

We will also continue to pursue other policy options that are currently awaiting Congressional action in order to help ease the strain of the housing downturn. These include FHA modernization, GSE reform, and permitting state and local governments to issue tax-exempt bonds to refinance existing loans.

Cramer – 2: Can you discuss your proposal for the permanent extension of the 2001/2003 tax cuts and what your offsets are so that they are pay-go compliant? What is the Treasury's position regarding offsets for this proposed legislation?

RESPONSE:

The tax relief and incentives to work, save, and invest provided by the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003, and expanded by the Small Business and Work Opportunity Tax Act of 2007, are essential to the long-run performance of the economy. All taxpayers should have the certainty of knowing that these provisions will extend beyond 2010, when they are scheduled to expire under current law. Taxpayers plan for periods far beyond the scheduled sunset dates of the EGTRRA and JGTRRA provisions when saving for their children's education, undertaking new business ventures, planning for retirement, and undertaking estate planning. Permanent extension of the provisions is essential for promoting growth and higher levels of income in the future. Consequently, the Administration's FY 2009 Budget incorporates permanent extension within an overall budget that reaches balance by 2012. The Administration's Budget is prepared in compliance with rules applicable to the Executive Branch, such as those set forth in OMB Circular A-11. On the other hand, the implications of the Congressional "pay-go" rules for any particular legislative proposal would be properly considered by the Legislative Branch.

Questions from Mr. Bonner:

Bonner – 1: Secretary Paulson, you have discussed in your testimony the importance of a “stable and growing economy” and on numerous occasions you have recognized that foreign-owned companies provide 5 million *direct* US jobs and roughly the same number of *indirect* US jobs. In a presidential election year, while it is popular for candidates to criticize the “outsourcing” of jobs, it is important that we recognize the value of foreign corporations “insourcing” jobs and employing American workers right here in the United States. How and to what extent is “insourcing” an important component of our domestic economy – even in a time when our economy is slowing? A few have said that, by allowing foreign corporations to invest in the US and employ US workers, we are providing an economic stimulus plan for that foreign country – what role does foreign investment play to support the President’s economic stimulus plan?

RESPONSE:

“Insourcing” is an important dimension of the world economy. It is the expansion into the United States by foreign-headquartered multinational firms. In 2006, U.S. affiliates of foreign multinationals employed 5.3 million U.S. workers, providing 4.5 percent of all private sector employment. Over one-third of those jobs were in manufacturing (39 percent in 2005 – latest available), a sector which accounts for just 12 percent of overall private sector employment.

U.S. affiliates of foreign companies support an annual payroll of \$335.9 billion here in the U.S. – with average compensation per worker of \$66,042, over 25 percent higher than compensation at all other U.S. companies. Also, these U.S. affiliates of foreign companies account for 14 percent of R&D, 10 percent of private-sector capital investment, and around 20 percent of U.S. exports. Insourcing is far from negligible in its impact.

The bottom line is that insourcing companies improve the performance of the U.S. economy. It is important that we understand the contributions of insourcing companies, and that we work together to formulate policy accordingly.

THURSDAY, MARCH 6, 2008.

OFFICE OF MANAGEMENT AND BUDGET

WITNESS

HON. JIM NUSSLE, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

CHAIRMAN SERRANO'S OPENING STATEMENT

Mr. SERRANO. The Subcommittee will come to order. Welcome to this hearing of the Financial Services and General Government Subcommittee. Today, the Subcommittee will hear from an old friend and former colleague, director of the Office of Management and Budget, the Honorable Jim Nussle, my locker mate. We will explain that later. The locker is still there.

Mr. NUSSLE. Does this all have to be on the record, Mr. Chairman?

Mr. SERRANO. Well, before the fireworks start, we should let people know that we actually like each other. Remember, it is all about the meanness.

Mr. NUSSLE. It is. It is.

Mr. SERRANO. Good morning, Mr. Director. We do welcome you. This is your first appearance before the Appropriations Committee as OMB director, and we are pleased to have you.

Today's hearing has a dual purpose. Our Subcommittee has jurisdiction over OMB's budget, and we will be interested in your presentation on that budget.

The hearing will also delve into government-wide budget and management issues at OMB overseas.

With respect to OMB's budget, the Fiscal Year 2009 request is about \$5 million below the enacted Fiscal Year 2008 level, but that decrease is due to a proposed shift of rent costs from OMB's budget to the White House Office of Administration. The actual proposed change from the current year is an increase of nearly \$2 million, or about 2.5 percent. This will allow you to maintain your current staffing levels. The Subcommittee will continue to take a close look at your budget proposals, and we look forward to working with you on that.

I would also like to make a few comments regarding the bigger budget picture.

The president's Fiscal Year 2009 budget proposes \$991.6 billion in nonemergency discretionary spending, according to the Congressional Budget Office. While this is a substantial increase over Fiscal Year 2008, the increase is for defense and other security spending. Nondefense, nonsecurity spending for the basic operations of government would actually decline by 1.6 percent, even before accounting for inflation, based on CBO estimates.

This budget continues to squeeze on the programs that provide essential government services to the people who need them most. These include programs to protect the environment, educate our children, provide medical research and health care, retrain jobless, support law enforcement, revitalize communities, and offer social services to the most needy. Cuts to these programs hurt the most disadvantaged of the population, and they concern me deeply.

The total proposed cut to domestic discretionary programs, according to nonpartisan Center on Budget and Policy Priorities, is around \$15 billion. As a share of the economy, nondefense, discretionary programs have declined from 5.2 percent of gross domestic product in 1980 to 3.7 percent today, and further declines in coming years are anticipated under this budget.

But talking about these raw numbers does not do justice to the millions of Americans who are affected by these cuts. Take, for example, the proposed cuts to the Community Services Block Grant and the Social Services Block Grant, a combined \$1.2 billion cut from the current funding level. This will affect services for low-income seniors, children, the unemployed, and disabled. The Social Services Block Grant touches the lives of nearly 17 million people, most of whom are children.

The Community Services Block Grant supported services to about 21 percent of people living under poverty in 2005, or about five million people. There is a significant human cost to making the kind of cuts to these programs that are envisioned.

It is my hope that, over the next several months, the Appropriations Committee will play a key part in restoring balance and fairness to the budget, and while we may not see eye to eye on all matters, I am hoping to work closely with Director Nussle on the issues relating to the Subcommittee, and I want to reiterate what I said before.

We have this wonderful, two-party system, and the times that you were in the House, we disagreed on many issues. We did not disagree, however, on being friends, and it is always exciting to see a former Member come back.

I will say that Mr. Regula will say wonderful things. But it is always nice to see a former Member and a friend. Mr. Regula?

MR. REGULA'S OPENING STATEMENT

Mr. REGULA. Well, I think the best thing about the Director is he comes from a state where they make John Deere tractors, so that is my likely slight prejudice here.

We are happy to welcome Director Nussle. It must be kind of a new experience because you chaired the Budget Committee, and you proposed a budget, which we kind of tended to ignore in the appropriations process. Now you have got a little more clout as Director than you did as chairman of the Budget Committee.

I really think that we do not realize the important role that OMB plays in our governmental structure, because in effect your budget sets forth the priorities of the administration, which is a partner with the Congress in ultimately setting national priorities and the way in which we commit our resources and priorities as a nation. I have often said that Appropriations is a great committee because policy follows the money, and you, as director of OMB, at least, out-

lined where the administration wants to go, and we, in turn, have to react as appropriators on behalf of the people that we represent, and we have different sets of priorities, depending on the makeup of our districts.

This is a wonderful system we live in. I said to somebody the other day, and I was eight years in the state legislature and 36 years here, and if somebody gave me a clean sheet of paper and said, "Design a governmental system," I would not change a whole lot. I think the genius of the Founding Fathers is remarkable in how they put together the Constitution. Well, so much for my sermon.

I notice you want to eliminate the deficit by 2012. I have been here 36 years, and every administration wants to eliminate the deficit. It is a standard refrain, and Members do the same thing. We go out and give speeches about how terrible it is that we do not balance the budget.

I am pleased that you believe that the economy will not fall into recession. Yesterday, I was with the Secretary of Treasury, who takes the same position that we are not that bad off. I notice, out in my area, the traffic is as heavy as it has ever been, and we are an area tied to heavy industry. So if we had this huge recession, there would not be a lot of people on the road, but they are out there, going to the marketplace or wherever. I do not know if you have the same experience up your way, but there are a lot of cars on the road.

Mr. SERRANO. Up my way, there are always a lot of people on the road.

Mr. REGULA. Well, I think that perhaps things were going a little too much boom town, and we needed to take a deep breath.

I noticed that you take a little whack at congressional earmarks, which is a very popular topic at the moment, but it is less than one percent of the overall budget. My feeling is that transparency is the way. I have never had an earmark that I would not be happy to have an interview by the press as to what happened to it because, in many cases, the local people call them the "Good Housekeeping Seal of Approval." I have one university that got a million dollars, raised five, and has one of the top science classrooms in our area in a small school.

So there can be positive things, and I noticed that, while you do not call it "earmarks," you have put in a number of things like West Wing construction projects, new port-of-entry facilities, federal courthouse renovations, science labs, veterans' hospitals, dams, and levees. Now, they are a form of earmark, maybe not classified as such.

One last comment: You devote about the same amount of space to earmarks in your testimony as you do to the funding requests that involve the mandatories. There is a world of difference. I think the mandatories are going to be an enormous challenge down the road, when the baby boomers hit. We had testimony from the Office of Personnel Management the other day that, in 10 years, 60 percent of the federal workforce will retire, and probably the same thing applies to the private sector. That is going to put a huge challenge on the mandatories, and I think perhaps it deserves a lit-

tle more attention than earmarks, in terms of your long-term thinking.

So I will have a few questions, but I think OMB, the role it has in government is not given the visibility it should have because you set, at OMB, the priorities for the administration, which is half of this equation, and that is a pretty important challenge.

Mr. SERRANO. Thank you, Mr. Regula.

Let me, before you begin your testimony, Mr. Director, just make a quick observation. Mr. Regula did bring up the issue of earmarks, and that is an issue that is not going to go away.

As we have discussed on many occasions, you and I, on a very friendly basis, I am in a unique situation. I represent the poorest congressional district in our country, which is located within the richest city on earth, which is within walking distance of the wealthiest congressional district in the United States: the south Bronx to the east side of Manhattan.

Earmarks, to me, is simply a way to tell a federal agency that they should pay attention to some of the needs of my district. Traditionally, it did not happen. The people did not vote. The people were poorer. Therefore, as part of that behavior, they did not vote. They were not a political force. Now, we have even more folks who are not citizens, whereas, before, it was just folks that did not get involved.

So I am a big believer that the issue is, as Mr. Regula has said, to make sure that that system is tightened up properly so that the waste factor does not become the overriding factor. But the idea that only an agency head knows how to spend money in any congressional district is really absurd to me.

Lastly, no one ever really complains about an agency head sending grants to a district that may not be working, but everybody complains about a Member of Congress sending an earmark to a district if it runs into any kinds of problems, so just that point.

My last point to you is there are 10 subcommittee hearings going on right now on appropriations, so do not look at the attendance here today as a sign of how we feel about you or OMB. Everybody is running on to different hearings.

Thank you so much. We are glad to hear your testimony. All of your testimony, as you know, will go into the record. We hope you stay within five minutes so that we can ask you 1,375 questions.

DIRECTOR NUSSLE'S TESTIMONY

Mr. NUSSLE. I am happy to, Mr. Chairman, and I am probably the least that you have to explain to when it comes to being pulled in many directions here on the Hill. I am aware of that, and I appreciate it.

First of all, thank you. It is nice to be back. It is a real honor to be before you, as a friend and a former colleague and still a colleague, as well as my friend, Ralph Regula, who has been chair, as well as a colleague of mine for many years. Just while I have the microphone and the opportunity, let me thank you both for your service, but particularly you, Ralph, because you made a decision to retire, and that is a tough decision, but you have served your communities so well, and you have been a good friend and a great colleague, so thank you for your service.

I guess, a couple of things. First, you are right. On the testimony, because you are before this Subcommittee, the testimony is focused on appropriations, on OMB and on appropriations, and those things that would be important, I thought, for the Appropriations Committee to be mindful of, or that I was hoping you would be mindful of.

But I take it very seriously your admonition, and I have, in my testimony, in a more macro way to the Budget Committees, as well as speeches that I have given, as well as my tenure here in the Congress, to quickly point out that now 62 percent of the budget is on automatic pilot and has nothing to do with the appropriations process, and that is where most of the big bucks and the highest rates of growth and the most uncontrollable, unsustainable spending occurs.

So all I can say is, "amen, you are right." We, unfortunately, get wrapped around the axle over, you are right, one percent, whether it is earmarks. We get wrapped around the axle of discretionary spending very often. That does not mean that those dollars are not important, so I am not here to suggest that we do not care about the nickels and the dimes because they do add up to dollars, but you are correct, and it has always been something that I thought I, at least, had some standing. Even though there is a natural tension between Budget Committees and Appropriation Committees, I always felt I had, at least, some standing with your chairs and ranking members because I did take on the issue of mandatory spending.

To focus first on what I wanted to make sure I touched on, because this is the reason for the hearing, is to talk a little bit about the funding request for OMB. Our request this year, and the Chairman rightfully stated it, is \$72.8 million, and if you compare that, because we now are excluding rent that goes over to GSA through the Office of Administration, if you compare that to recent amounts, we are asking for a 2.60 percent increase. That is a requested increase in order to deal with and fund 489 staff people and FTEs. The 489 for 2009 is a slight increase to cover GSA rental costs.

The requested funding also includes budget savings, including reductions and information technology support and transfer of GSA rent to OA. For the last seven years, we believe that OMB has submitted a disciplined budget. It is a small agency. It is an important agency, as you have suggested, or, at least, I think it is. I think you do, too. We have got some great people who work there. But over the seven years of those requests, our request has only grown by 13 percent. We believe that is a very disciplined approach toward management of the agency and fiscal management of the agency.

It is a great team, and there is a lot of cross-pollination, I am told, both from the Appropriations Committee and OMB, and a few alumni are here in the room today.

It is a great team. They work with professionalism and dedication. They do not work in a partisan way. They work for the public good and for the public service, and I am proud of the job that they do.

Before I began as Director, I had a healthy respect for them, but I can tell you, having had a chance to get to know them on that kind of professional basis, it has only grown.

I would like to, if I can, just touch on a couple of things with regard to the President's Budget overall, and then I am pleased to take your questions and comments.

First of all, the President asked me to do five things when he asked me to write the budget. He wanted me to make sure that we addressed the initial economic concerns that the country was facing, and we have done that in a bipartisan way, and that is included in the budget. The fiscal stimulus and growth package that we have already passed was included in the budget as we prepared that, at \$150 billion, one percent of GDP, but, nonetheless, we included that in the projections.

Second, we wanted to ensure sustained prosperity, which the President believes is not only important but is required if, in fact, we are going to tackle so many challenges that are laid before us. Economic growth is very important, and he believes that is best done by keeping taxes low and by making sure that the tax relief is permanent and that the tax code is predictable. So tax relief continues in this budget.

He wanted to make sure we kept the country safe. That was obviously a very high priority because, as the Chairman knows, if the country is not safe, the rest of this conversation does not matter. It is so important, both from the standpoint of national security and homeland security, that that is accomplished.

He wanted to get the balance, as the Ranking Member said, by 2012. I view that not as the destination, however, which brings me to my last point, and that is he also wanted us to tackle the long-term spending challenges, which are, what I would suggest, out-of-control, mandatory, fiscal obligations that we are creating and continue to create, and we begin to address that in this budget, too.

So, if I may, let me just cover a couple of things and do so. We believe spending continues to be the challenge, and we have done a number of things here in order to address that. Revenue, to our mind, is not the challenge. Even when we cut taxes, more revenue came into the federal government. It is our view that getting more revenue to come, except through economic growth, is really not what we ought to be working on.

We ought to be working on the spending challenge, and we see it, certainly, as two parts.

The first part is on the discretionary side. We have sent up another package of programs, totaling about \$18 billion, that we believe either should be eliminated or significantly reduced, and I commend the Appropriations Committee for looking through that list very seriously and, over the years, has taken that list very seriously and has reduced or eliminated programs from that list.

I can understand how there will be some who say, "That list is getting too long," or "something is appearing on the list that we have not approached in the past. Why is it still on the list?" But I will tell you that I think we have worked together in a good fashion to cull through many of those programs and try and either improve them or eliminate them where they are duplicative, or they are not meeting the objectives.

As far as earmarks, having been a Member of Congress and understanding that process, I would again agree with you both that transparency, I think, is probably the biggest issue that concerns the Administration and the American people. Certainly, that is why the President wanted them to be reduced in half and to be put in bill text, as opposed to having report language earmarks, which are often difficult for the Administration to define or understand without more follow up from the Committee or from staff or, for that matter, earmarks that are phoned in that are done later on in some fashion.

Having more transparency in this process, as the Ranking Member has suggested, for those that we are proud and for those that you are proud of, there should not be a problem, and we are not suggesting that the Article 1 responsibility of determining that spending is wrong at all. It is exactly the way it should go, but it should be done in the open, and the Administration, where it has designated funding, has done so in the open, and those dollars and requests are put in the budget a year in advance.

We put the justifications with them. We assume that you are going the work through them and not take them all, eliminate some, complain about others. But they are our requests, and most of them, if not all, are done in a competitive way that, we believe, is a better way of approaching it than in the past.

Finally, on the mandatory spending, as I said, 62 percent now is on autopilot, and, in the next 35 years alone, there will be no money left for discretionary spending, given the rate of growth in revenues. There just will not be anything for national defense, homeland security, any of the other priorities that are within discretionary spending with the automatic spending trends that we find.

So the President has said, Look, let us try and deal with this long-term problem in bite-sized pieces, and we look back at some of the ways this has been done before.

In 1997, in a bipartisan way, the Administration and the Congress, Clinton and a Republican Congress, in this instance, worked together on a package that is actually larger than the package that we are putting up. The package that we are putting up is a smaller package than the one we were able to agree on in 1997, where we dipped the growth curve of mandatory spending for one of the first times, and we propose that again here.

We are saying, instead of, for instance, Medicare growing at 7.2 percent, let us allow it to grow. It should grow. There is natural inflation that is in there, but it should grow at five percent, not at 7.2 percent, and we find savings in that as a way of accomplishing a bending of the growth curve and dealing with one-third of the mandatory challenge that is out there. It does not address all of it. It does not solve the problem, but, as true in any situation, you have got to take this in steps.

We know that. Congress, I think, recognizes that as well. Hopefully, we are not going to come to a situation where it has to be dealt with all in one big bite. So we are saying, let us take it in bite-sized pieces. We are proposing that first bite to be one-third of the problem, and we do put that in there, and we are asking Congress to consider it.

But, as this Committee, as the Appropriations Committee, well knows, the fights, unfortunately, will be about the discretionary package, and it appears thus far, at least from what we have seen from the Budget Committees, that they will not consider mandatory savings, and I think that is a missed opportunity, given the fact that we have this looming challenge and that if we do not begin to address it in bite-sized pieces, it will come up to bite us.

So that is what I wanted to come and present to you. I am pleased to try and answer your questions, and if you stump me in an area, I have got some good people from OMB behind me who might have the answer, and if we cannot do it, we will get it to you in writing. Mr. Chairman, thank you.

[The information follows:]

Testimony of OMB Director Nussle**OMB's FY 2009 Budget
Financial Services Subcommittee
United States House of Representatives****March 6, 2008**

Chairman Serrano, Ranking Member Regula, and distinguished members of the Subcommittee, I am pleased to be here today regarding the President's FY 2009 Budget request for the Office of Management and Budget.

OMB's Budget

For the FY 2009 Budget OMB has requested funding level at \$72,800,000. When comparing total FY 2009 OMB resources (including GSA rent) to the FY 2008 enacted appropriation level, OMB's budgeted increase is \$1,972,000, or 2.53 percent. The requested increase provides resources that will allow OMB to fund 489 staff in FY 2009 and a slight increase in GSA rental costs. The requested funding level also includes budget savings, including reductions in information technology support and the transfer of GSA rent to the Office of Administration. For the last seven years OMB has submitted disciplined budget requests for our small Agency. Over those seven years, OMB's total budget has grown by just 13 percent.

As was true when I was in Congress, I would not be here without the hard work and dedication of staff. Before I began my tenure as Director of OMB, I had respect and admiration for the OMB staff. This perspective has only grown stronger as I lead this team of talented, intelligent and dedicated professionals. It is truly a pleasure to come to work each day and roll up my sleeves next to them. I thank each and every one of them for their devotion to public service.

I am confident that OMB can continue to do our important work if provided our requested level of funding.

Total Fiscal Year 2009 Budget

Let me turn to the budget itself. The President's FY09 Budget focuses our resources on our nation's highest priorities: the security of the American people and the prosperity of our economy.

The Budget invests substantial resources to protect the United States from those who would do us harm. Continuing our Nation's efforts to combat terrorism around the globe, the Budget provides our men and women in uniform the tools they need to succeed in Afghanistan and Iraq, and it furnishes the resources needed for our civilians to help those nations achieve economic and political stabilization. The Budget proposal also strengthens our overseas diplomatic capabilities and development efforts, advances our

political and economic interests abroad, and improves the lives of people around the world.

Over the past seven years, we see the economy has successfully responded to substantial challenges, including a recession that began in 2000, terrorist attacks, corporate scandals, wars, and devastating natural disasters. It is a measure of our economy's resilience and the effectiveness of pro-growth policies that our economy has absorbed these shocks, grown for six straight years, and had the longest period of uninterrupted job growth on record. Yet mixed indicators confirm that economic growth cannot be taken for granted.

Americans have real concerns about their ability to afford healthcare coverage, pay rising energy bills, and meet monthly mortgage payments. They expect their elected leaders in Washington to address these pressures on our economy. So this Budget puts forth proposals to make health care more affordable and accessible, reduce our dependence on foreign oil, and help Americans struggling to keep their homes.

Above all, the Budget proposal continues the pro-growth policies that have helped promote innovation and entrepreneurship. I join the President in his belief that higher taxes would only lead to more wasteful spending in Washington – putting at risk both economic growth and a balanced budget.

As we work to keep taxes low, we must do more to restrain spending to achieve balance by 2012. The Budget proposes to keep non-security discretionary spending growth below 1 percent for 2009 and then hold it at that level for the next 4 years. It also cuts spending on 151 projects totaling more than \$18 billion that are not achieving results – because good intentions alone do not justify a program that is not working.

There is also the matter of earmarks. Earmarks have tripled in number over the last decade and have increased spending by billions of dollars. Most earmarks are not even included in legislative text and are not subject to an up or down vote of Congress. Last year, the President has called on Congress to voluntarily reform the earmarking process. Unfortunately, limited progress was made. That's why the President announced during his State of the Union Address that he will veto any annual spending bill that does not meet his goal of cutting earmarks in half from FY08 levels on a bill by bill basis.

The President also issued an Executive Order instructing federal agencies to ignore earmarks unless included in bill text that has been reviewed and voted on by Members of Congress. This means earmarks will be subject to votes, which will better expose them to the light of day and help constrain excessive and unjustified spending. If Congress continues the process of earmarking in report language, those projects will have to compete for federal dollars before funding is provided based on merit. We believe these changes are necessary to reform the culture of earmarking that has led to wasteful and unjustified pork-barrel spending.

As we take these steps to address discretionary spending, we also need to confront the biggest challenge to the Federal budget: the unsustainable growth in entitlement spending. Many Americans depend on programs like Social Security, Medicare, and Medicaid, and we have an obligation to make sure they are sound for our children and grandchildren. I am the third Budget Director to come before you with this request. If we do not address this challenge, we will leave our children three bad options: huge tax increases, huge deficits, or huge cuts in benefits. And the longer we put off the problem, the more difficult, unfair, and expensive a solution becomes.

The Budget proposal works to slow the rate of growth of these programs in the short term, which will save \$208 billion over 5 years. This step alone would reduce Medicare's 75-year unfunded obligation by nearly one-third. This is one of the most serious challenges that faces our country. I want to work with the members of this committee to address reforms that can avert the oncoming fiscal train wreck. In doing so, we need to make sure that all tools at our disposal are used to put these vital programs on a sustainable path. Reconciliation is such a tool, but if it is only used to increase spending and the size of the Federal government, it will be a missed opportunity to achieve retirement and health security for the American people.

Before closing, I would like to take a minute to discuss funding for our troops. Last February, the President's Budget included a full-year estimate for FY08 GWOT funding. While some changes were made to the request in the fall, Congress has had more than three fourths of our request pending since February. This past December, Congress chose to only provide partial funding for our troops and they will soon need the remainder of the request to ensure that operations continue without interruption. I ask Members of Congress to quickly consider the remaining funding our military commanders have told us the troops need to do their jobs. The Budget includes an allocation of \$70 billion for the Global War on Terror. A detailed request will be submitted to the Congress once we have secured the resources for FY08 and have better information on the changing conditions in the field from General Petraeus and Ambassador Crocker.

In the Budget, the President has set clear priorities that will help us meet our Nation's most pressing needs while addressing the long-term challenges ahead. With pro-growth policies and spending discipline, we will balance the budget in 2012, keep the tax burden low, and provide for our national security. And that will help make our country safer and more prosperous. Mr. Chairman, thank you for the time, and I look forward to your questions.

Conclusion

I want to thank the Committee for giving me the opportunity to discuss OMB's budget today. I feel that we've submitted a disciplined budget request. We look forward to working with the Committee on the OMB Budget and the overall FY 2009 Budget.

Mr. SERRANO. Thank you so much. I know you have folks from OMB behind you, and we have folks formerly from OMB all around us.

Mr. NUSSLE. I know. So I cannot hide. I realize that.

Mr. SERRANO. In fact, I just came from a hearing of the Homeland Security Subcommittee, and when I said that I was coming here to spend time with you, half of the staff said, "We were there also."

Before I get to my first question, which has to do with that subject, let me just ask you a question, based on what you have said.

MEDICARE

So Medicare, for instance, is naturally going to grow to seven percent, and the Administration would want to see a growth of five percent. Is that understood to mean that the natural growth would cover people in need, and the reduced growth would then leave out some people who are in need? When we deal with numbers, we are also dealing with people, so how do we cut in those areas where we know we can cut and not hurt an individual's need but not cut in the areas where the person or a group of people will be served?

Mr. NUSSLE. We have tried to go through and take proposals from MEDPAC, which provides the proposals and alternatives, for ways that we can reform these programs, Medicare and Medicaid, and we have asked them, you know, what is the best way to approach this? We have tried to take proposals that they have come up with that go toward efficiencies, improving the system, and saving money, as opposed to, as you say, cutting into beneficiaries.

So, yes, we have tried, in those instances, to work on program changes for efficiencies and not to, as some might say, go after beneficiaries. In fact, we are trying to improve the program constantly. That is what Part D was for. That is what Medicare Advantage was for, was to try and expand the program in ways that can better serve the beneficiaries and provide them with access to quality health care.

Mr. SERRANO. I think that any time any administration—this one, the next one, a Democratic or Republican administration—talks about reductions, if they mean, or they are interpreted to mean, that they will leave people out, beneficiaries out, then you are going to run into that trouble. You know that, and that is what we have to deal with here.

OMB RECRUITMENT AND RETENTION

But you did mention folks from OMB. That is my first question, which is, last year, Director Portman told this Committee that OMB had a very aggressive recruitment program, but we also know that OMB loses a lot of very talented people to go elsewhere. How do you keep doing the job properly? How does the agency do what it is supposed to do when you are losing people, and what is the rate of turnover?

Mr. NUSSLE. We were just talking about this on the way over because we are in the middle of a recruiting period right now. We have been in a number of schools. We are reaching out to schools, in particular, where we have alumni that are at OMB, and we actually use them, ask them to go and talk to the people in their col-

leges and universities in order to try to accomplish that. We have already covered 27 schools during February, as an example, to try and build on that recruitment.

But you are right, and we talked about this in your office privately as well, that there is this concern, not only about recruitment but also retention. Once you get some good folks, you want to make sure you hold onto them because it is tough to train them. Obviously, we are talking about public service, and this is not the highest-paid jobs in the world on either side of Pennsylvania Avenue, but I think some recognition of that is something that we have tried to build into the budget, as well as recognizing that there are ways within the agency to improve the work.

One of the biggest complaints I had when I got in was about the trade-off. We do surveys within OMB, and they said it was one of the best places in the federal government to work but some of the heaviest workload. So we have been trying to work on workload. It is not just a matter of hiring more people, but it is also making sure that the work is distributed appropriately.

So we are working on a number of areas, but, specifically to recruitment, we have been in 27 schools in February, and we hope that that, as well as a number of other things, pays off.

Mr. SERRANO. You know, speaking on that issue, I have often said that when a person becomes chairman of a committee in Congress, you do X amount of what needs to be done by any chairman. And X amount is what you bring to it, and so part of my rallying cry is always to remind folks that we have American territories that are not states. So I hope that the 27 schools could include some schools in the territories.

In fact, I wish there was a way that OMB could help us in putting forth a notice throughout the federal government that when it comes to recruiting from schools, there are territories that prepare fine English-speaking folks. In fact, NASA started recruiting—we do not know how—20 years ago or so, at the University of Puerto Rico at Mayaguez campus, Mayaguez being the hometown—I will spell that later—my hometown in Puerto Rico. Now whenever NASA sends up a flight, you would be surprised at the number of people who graduated from that university who work at NASA.

So one way to score great points with this chairman is to either let me know that within the 27, there are some in the territories, and, if not, they will increase it to 35 or whatever.

Mr. NUSSLE. I will confess to you, Mr. Chairman, I cannot make you happy today, but I already have one volunteer who wants to go to Puerto Rico and do some recruiting, and I may go, too.

CUTS TO SERVICES

Mr. SERRANO. Good job. Now, let me ask you a question. The President's Budget request would make deep cuts in inflation-adjusted, domestic discretionary spending. As I said in my opening statement, this affects needed services for many Americans, including low-income seniors, children, the unemployed, and the disabled.

How can a budget that makes deep cuts to the domestic discretionary side of the budget provide essential services to those Americans who are most in need, especially at a time when, if indeed this economy is where many of us feel it is already, and where it may

head to, some of these folks will be even hit harder? Is this the time to make cuts there, which will affect them?

Mr. NUSSLE. Well, that is always a challenge, and it is particularly a challenge, given the fact that now 62 percent of our choices are basically off the table for discussion. We are only working with a certain pot of money that we can work from.

So you are right. Whenever there is a budget document that is put together, first and foremost, those choices typically come from discretionary spending. We have tried to balance that, but recognizing what Congress might be willing to do, that balance, most likely, will not occur this year.

Second, we also do a job to try and rate all of the programs and to do it as objectively as possible so that we can see whether or not the programs are actually meeting the goals that you and I and others have intended for the programs to meet and to address the needs of the people that they were intended to meet.

Some do an excellent job, some are duplicative, some need to be improved, and some need to be eliminated. So we have gone through and tried to rate them in that way and make choices between some that are doing a good job and some that are not doing as good a job or need to be reformed. So you will see those in the budget as well.

Then, finally, and I am not going to pretend I know your community. I know the communities that I served, and I can tell you that, at least in my instance, most of those communities were not waiting for the federal government, or most of the people there were not waiting for the federal government, in a program or in an earmark, in order to solve their problems.

Most Americans know that the problems are going to be solved around their kitchen table, around their neighborhood, around their community, first and foremost, before anybody from Washington is actually going to be able to help them, and I think so much of what we try and do in this is recognize that and to make sure that they have the resources to accomplish those solutions.

So that is the direction that we have when try and put together a budget.

Mr. SERRANO. Well, we do not disagree on that comment. I am glad to say, and I am impressed, that you have not changed your line of presentation for a long time. We have discussed this in the past. But there are services that, whether people are waiting for them or not, do come from Washington: educational services, services to the hospital, dollars that come to their local hospital, dollars that come for programs in their community.

They may not be waiting for them, but it is part of what happens to them on a daily basis, whether they mention it or not, called to their attention or not, it is there. When we cut that, we run into a problem.

VETO THREATS

One last question before I turn to Mr. Regula, as a follow up. You wrote recently, I think, last week, to the Chairman and Ranking Member of the House Budget Committee, saying that the President would veto any appropriations bill that exceeds his request. That

is fine. We understand that statement. We went through that last year. That is why we had one large bill in December.

But how could you be offering veto threats if you have not even seen a plan for what we hope to present to you? Is that kind of a declaration of some sort of government war before we even begin? We are still holding hearings here. I have no clue what this bill will look like, and you are already telling me that if it exceeds what the President asked for, not knowing where the amount may be that exceeds what he asked for, and you are listening to the Chairman, who, last year, started off under the President's request, did not get me a gold star or a nickname. I do not want a nickname. How do we offer so early veto threats?

Mr. NUSSLE. I think the challenge here, as the Chairman is well aware, is that we are, unfortunately, not just talking about the 302[b] allocations to the subcommittees and where you will be writing your bills; it was a signal that suggests that, at least from the discretionary top line, the President has set a number, realizing that Congress will have puts and takes, will add and subtract, will decide within its committees how to distribute those resources.

But we wanted to send a signal early on that we thought that it was a reasonable amount that the President was requesting and that that should be the number that we all work from because if we do not work from that number, if we do not start with that top-line number in mind, then we know from the beginning, as soon as those allocations are given, that there is going to be a fight, that there is going to be a problem.

Last year, that signal, in my view, was not given clear enough maybe as early as it could have been, and so we wanted to give that signal early this year, and we got a signal back from the leadership that said, maybe we will wait for the next administration.

So I think it sets up the discussion early on, and, hopefully, it gives some guidance, as you are looking through it, about what the Administration is interested in working together on.

Mr. SERRANO. Well, as I turn to Mr. Regula, it is nice to see that the President has become a fiscal conservative in the last year. Mr. Regula.

Mr. REGULA. That was a gratuitous comment.

Mr. SERRANO. It was off the record. It was just between you and I.

BUDGET PRIORITIZATION

Mr. REGULA. Right. Following up on that, how do you establish your priorities? Do you sit down and consult with Josh Bolten or the President? Because, without any question, the document you present here does clearly establish the priorities, as they are viewed by the Administration, for the expenditure of all of the discretionary money, and, as such, they obviously influence the way in which we have programmatic direction of the federal government. How do you go about this?

Mr. NUSSLE. It is an amazing process, I would say to you, having not been part of it until this year. It starts very early in the year. Usually, probably in the months coming up now, the agencies and the departments will begin formulating their requests, and it starts in that process, and then it goes through a review process at OMB

where we include not only the President's advisers but also recommendations from those department heads and agency heads and folks, and we go through a very rigorous process of trade-offs, of what is working and what is not, asking, hopefully, some very tough questions about the programs.

We do not just look at how much money is being spent. We look at whether the program is working and how effective it is. Certainly, everyone, including the President's chief of staff and former OMB director, as well as the President, is consulted for their views. But it starts with the President. That is why I outlined the goals that he wanted me to consider as I was trying to put a budget together for him.

So it starts with him, at the principal level. It flows through a very complicated process back up to the President for final recommendation and final approval, and it is a fascinating process to go through. But there are many trade-offs within there as you go through it, obviously.

DISTRICT OF COLUMBIA

Mr. REGULA. I was pleased to see that you increased the federal payment to the District of Columbia. I think Mayor Fenty and Chancellor Rhee are making a real effort to deal with the challenges of the education program in D.C., and I think that, by putting the amount you did in the budget on that, it gives a stamp of approval to their effort, and it certainly is well overdue for the city to become what President Reagan called the "shining city on the hill." We need to address the education challenges.

Mr. NUSSLE. Well, we see this as a package deal, too, and one that was worked on—it is very delicate—in order for improvement, not only in the public schools but education in general in D.C., so we hope that the Appropriations Committee will take a look at that.

Mr. REGULA. I hope so, too. Also, I had put language in on HIV/AIDS, which the Subcommittee did, and report language asking the Administration to help the city address this epidemic, and it is an epidemic in this city. I have been disappointed that you have not acted on the report language. Any reason? What do you propose to do in the future?

Mr. NUSSLE. As far as that goes, I certainly would take that into consideration and your concerns in mind at this point in time, but you are right. There is some controversy surrounding the proposals. We understand that and the policy, but I certainly would keep that concern in mind.

Mr. REGULA. Well, it is a real challenge in this city—

Mr. NUSSLE. Yes.

Mr. REGULA [continuing]. Because the incidence of cases is very high, and it has to be part of what you are trying to do with education and so on to make this a better place for everybody.

TREASURY DEPARTMENT FUNDING IN STIMULUS BILL

I noticed that you put \$250 million to the Treasury Department in the stimulus bill that was done at kind of the last minute, and it was a form of administration earmark to carry out the stimulus

bill. It seemed to me that maybe that should have had some scrutiny before it was made part of the package.

Mr. NUSSLE. Did you have an opportunity to ask Secretary of Treasury Paulson about that? I believe, if I am not mistaken, that is the amount to actually do the checks—

Mr. REGULA. I know.

Mr. NUSSLE [continuing]. Because it is outside the normal process for the IRS. I may be mistaken about it, but I think that is what it was.

Mr. REGULA. I think that is right. It was just an arbitrary figure that went in at the last minute, without any scrutiny on the part of the Congress.

Mr. NUSSLE. This may not be enough scrutiny for your liking, but we did scrutinize it at OMB before we approved it.

Mr. REGULA. So you thought it was a legitimate figure.

Mr. NUSSLE. Yes, we did. In order to accomplish it and get the checks out as quickly as possible, which, we believe, will be the first couple of weeks of May. We thought it was important, you know, to get those out the door, if, in fact, they were going to have the stimulative effect that was required.

[Discussion held off the record.]

Mr. SERRANO. Before we leave, we have a few minutes we can take.

Mr. VISCLOSKEY. Mr. Chairman, thank you, and I appreciate your courtesy, Mr. Regula's, and, particularly, Mr. Cramer's for coming in late. Mr. Nussle, very good to see you.

LAKE COUNTY HIDTA

I have a serious concern and dispute with the Office of National Drug Control Policy, and, given your testimony today, you are the closest administration official I can get on the record, so I appreciate your attendance.

Lake County, Indiana, was declared a HIDTA in 1997, High-Intensity Drug Trafficking Area.

In 2006, \$3,022,000 were appropriated. I would point out that, in August of last year, ONDCP approached me in my office and suggested that there are problems with the HIDTA in Lake County, Indiana, from their perspective.

I would point out for the record that, subsequent to last August, there was a change in the chairmanship of the executive board, and you now have an official from the Federal Bureau of Investigation who chairs that HIDTA. There was a change at the request by the agency of the fiduciary.

There were multiple changes in the budget process and also in elimination of what was declared unnecessary spending, all at the request of the Administration.

The HIDTA is also in the process of physically moving their operation to another location, again, at the request of the Administration.

When the Administration came in in August, they suggested that, given their concerns, they wanted to move the jurisdiction and the money and the resources to the Chicago HIDTA. I suggested that we were willing to work with the administration to make the necessary changes and, again, would point out for the

record that it is now headed by someone from the Federal Bureau of Investigation.

The Administration's budget this year cut the Lake County HIDTA by \$1,272,000. I find it very interesting that the Chicago HIDTA was increased by \$1,200,000. So, from my perspective, the administration, in a very cavalier fashion, did exactly what they threatened to do in August, despite what I think was significant cooperation in changes and reforms of the HIDTA.

In reading why there was a decrease, there was an indication of poor performance. I have acknowledged there that the changes were apparently necessary and were made subsequent to last August. There is a decrease due to small geographical area. I think that is subject to definition. Lake County is the size it is, and I cannot change that.

But, finally, I am particularly disturbed that the justification was there is a diminished threat compared to other areas of the country. The largest city in Lake County, Indiana, is Gary, Indiana. In 2006, there were 55 homicides in Gary. In 2007, as of December 18th, there were 71. Homicides in Gary, Indiana, went up 40 percent last year. It was, on a per capita basis for communities in excess of 100,000, declared the murder capital of the United States of America. The county in which Lake County resides had their homicide rate increase by 32 percent.

So I hate to see what the threats in some other communities are if that is a diminishment of the problem that we are facing. I certainly would ask for your intervention and investigation of this matter because, again, people went to great pains and much cooperation to make the necessary changes, and, from my perspective, most importantly, looking ahead to the people I represent, there is a huge threat, given the fact that homicides increased by 40 percent in Gary.

With that, Mr. Chairman, I just wanted to pour my heart out and suggest that I am very unhappy with that decision.

Mr. NUSSLE. May I get back to you? This is not something I have—

Mr. VISCLOSKEY. No. I understand that.

Mr. NUSSLE [continuing]. Personal familiarity with, so let me do some digging and checking and get you a response rather than trying to do it off the cuff.

Mr. VISCLOSKEY. I would appreciate that very much.

Mr. SERRANO. We have just a few minutes to vote, so we shall break right now. When we come back, Mr. Cramer will be our first speaker.

[Whereupon, at 10:50 a.m., a recess was taken.]

Mr. SERRANO. I do not know, Mr. Director, if you saw those power rankings that came out recently, these things called "power rankings" on Members of Congress. Mr. Cramer was way up there.

Mr. CRAMER. I was?

Mr. SERRANO. You were certainly ahead of me. You were in the top 20 or something, yes.

Mr. CRAMER. Really?

Mr. SERRANO. Right after Pelosi. It is incredible.

Mr. CRAMER. Twenty-six.

Mr. SERRANO. Twenty-six out of 435 is not bad. Mr. Cramer.

Mr. CRAMER. I am sure that makes you tremble there. Jim Nussle, I said to you before I left, welcome back.

FARM BILL

We know you, and we are glad you are here today, and you have got a tough job under tough circumstances. I wanted to talk to you about the Farm Bill, and you live and breathe farm issues just like we live and breathe farm issues, kind of where we are and why we are where we are.

With talks ongoing, the Administration recently released the parameters for a successful Farm Bill. It stated that a Farm Bill final product must not include any tax increases.

What I wanted to know is what would be acceptable as offsets to the Administration? I understand we need to get \$10 billion above the baseline that we now have. What do you see happening, or can you look down the road, with a March 15th expiration date or deadline for the bill?

Mr. NUSSLE. At this point in time, it is difficult to project what will happen because we are closing in on a deadline, and just the physical production of a Farm Bill during the next basically week before recess is going to be pretty difficult to do.

As far as what is acceptable, we have been—when I say “we,” I say the Administration, the royal “we”—have been in many conversations and negotiations and meetings about what that might entail. We have provided lists to USDA, as far as different things that might be acceptable. We draw from the budget, obviously, as a starting point of spending offsets that we think might be acceptable, that we have floated, if you will, as part of it.

But I think the offsets are probably just one of a number of challenges. There is separation still on how much money the Farm Bill should spend. There is separation still on how much reform could be entailed in the bill. So I think there is still a lot of separation that only coming to some agreement on offsets probably would not necessarily be the final resolution of.

I have been in a couple of the meetings. I have not been in all of them. Most of this is being led by our new Secretary of Agriculture and his deputy, and I have been invited to a few of the meetings but have not participated in all of them.

Mr. CRAMER. All right. Well, thank you for that insight, and, Mr. Chairman, that is what I wanted to bring up. Thank you.

Mr. SERRANO. Thank you. Boy, people are treating you well today.

Mr. NUSSLE. Bud and I came in—

Mr. CRAMER. We were classmates.

Mr. SERRANO. We were locker mates.

Mr. NUSSLE. It is old home week. Does that not mean anything? I have thought of a nickname, Mr. Chairman, but I will have to share it with you later.

Mr. SERRANO. Ahead. I think “commandate” would be a little too much for the President, do you not think?

OMB INPUT IN BUDGET

Let me ask you a question a little off the path here. Obviously, your office and you, personally, get involved in all of the fiscal

issues of presenting the budget, but the budget also carries language issues, visions that the administration has, and I single out, for instance, this whole issue with the needle exchange program in Washington, D.C., something that I worked hard to get rid of—the ban on using local funds.

Now it appears in the budget again. Does your office get involved in that kind of thing, or does OMB get involved in that kind of thing, at all, or is that other folks' input into the budget?

Mr. NUSSLE. Well, there are many other folks who have input into the budget. We have policy councils, as you know, that help make determinations of what should be and what should not be the official administration policy, and, obviously, the President has the final decision of what those policies should be. But there is an entirely separate, from just the budgetary aspect, an entirely separate policy process that different policy counsels control within the Administration.

Mr. SERRANO. That particular issue is one that is going to stir up some issues again around here, some feelings, because it was believed, strongly by many Members, that D.C. should be able to spend its own money on this particular program. We were able to accomplish this. They are very happy. They allocated dollars to it. They have a serious problem with the HIV virus issues in the city, in the District, and we would just hope that the Administration would have left that alone.

FEDERAL CONTRACTS

On this whole issue of the value of federal contracts, which have increased significantly during the Bush Administration to around \$400 billion, about 40 cents of every discretionary dollar is going into contracts. At the same time, the Administration has pressed for reduction in the federal workforce, with many responsibilities being shifted away from federal employees and toward contractors.

What is most troubling, however, is the increase in the amount of noncompetitive contracting under this Administration. Noncompetitive contracting doubled, to about \$145 billion in 2005.

So the question is, how does this Administration justify the enormous expansion of contracting and, in particular, noncompetitive contracting, over the past eight years? Do you think the federal government relies too much on contractors, and how should we define inherently governmental functions?

Mr. NUSSLE. First, on the contracting in general, we have gone through a process. I have not been here for much of it, but, as I understand it, a process of reviewing those contracts with an eye toward making them competitive in those instances where a sole-source contract is not either appropriate, or there are obviously more entities that could compete for them.

So there has been a process undergoing that has attempted to try and improve on that. Some very good improvements have been made. The amount of dollars, however, is probably not the only comparison. When you say it has doubled in 2005, doubling from when, that is?

Mr. SERRANO. From 2000 and 2001.

Mr. NUSSLE. Okay. I mean, I think there is some comparison here that is important. We have tried to scrutinize those sole-

source contracts in a new way to ensure that those situations where there are sole-source contracts are only in those situations where there is no competition available, that there is usually one entity that does the kind of work that we are looking for.

Within the agencies themselves, that kind of competitive process is one that, frankly, when you allow the workforce to compete for a contract that is put out for bid, we see that it not only improves the work that the agencies are doing in those entities that have been put out for bid, but, in many instances, the government workers themselves are the ones who win the contract.

So we think this has improved the system. More improvements certainly can be made. I think all of those contracts should be scrutinized. That is why we have gone through that process. We believe some improvements have been made in this area. It is not just a matter of looking at how much money is being spent in these areas as the only comparison.

Mr. SERRANO. One of the issues that comes up, Mr. Director, is the fact that, under contracting, you will have, or already have, situations where a person under a contract is working in the same workplace, sitting next to a person who is a federal employee covered, we understand, under different rules at times, ethics rules, and so on. One is covered by the people they work for, and one is covered by the rules that you and I are covered by. Does that not create a problem, and is that not a dangerous situation that you could have in the workplace?

Mr. NUSSLE. It may. It may be more circumstantial. Right off the cuff, this is not an issues that has been brought to my attention. I appreciate you doing that. So, I guess what I would like to do is explore those instances where you feel it would be a problem.

My gut reaction is that there may be some reason why those differences are there and that those differences may very well be appropriate, but you are obviously singling out some areas where they may not be.

I would be happy to work with you and investigate that a little bit further.

Mr. SERRANO. We would like you to look at that and see if there is a way of dealing with that.

Let me go to Mr. Regula now.

Mr. REGULA. I have no questions. I am okay.

Mr. SERRANO. Mr. Hinchey.

Mr. HINCHEY. Thank you, Mr. Chairman. Mr. Director, it is nice to see you.

Mr. NUSSLE. Good to see you.

FOOD SAFETY AND INSPECTION SERVICE

Mr. HINCHEY. It is reminiscent of old times. I wanted to ask you a question about the Agriculture Department.

Mr. NUSSLE. Yes.

Mr. HINCHEY. We were just at a hearing with the Food Safety and Inspection Services, and there is a very good man, a man by the name of Raymond, I think, who is very good. He heads that program up, and I think he does a very good job.

In the context of the discussion with him, we made the observation that the number of inspectors for food safety across the coun-

try has gone down by about 10 percent. It was unclear as to why that was happening. I would not expect you to be able to answer anything like this now, but I wonder if you would not mind taking a look at this and seeing why that number has dropped down.

The reason I asked that question about the Food Safety and Inspection Service is now, in the context of these lesser and lesser people out there doing inspections, is the fact that recently we saw, in fact, last month, the largest withdrawal of food from the market in the history of the country. It was beef products.

In the context of that withdrawal, the Agriculture Department, particularly the Food Safety and Services operation within the Agriculture Department, was not permitted to reveal the name of the companies or the stores from which this adverse product had been sold, and a lot of it had been sold. A lot of people had bought the stuff.

So that just does not make any sense to me. So I would like very much to try to figure out and be told, frankly, where those products are being sold from so that we could get a better idea as to what the consequences were, and if that information is put out, we are less likely to see something like this happening in the future.

So if your excellent staff here would not mind taking a look at that, and if you would not mind giving us that information, we would appreciate it.

Mr. NUSSLE. I am sorry to ask you the question, but you stated a number. Do you remember what they said? How many inspectors were less than the year before?

Mr. HINCHEY. Yes. The number of inspectors that is supposed to be out there is 8,000, and that number, I think, has been standard for quite a while, but the actual number that is out there now, I believe, is 7,310.

Mr. NUSSLE. Okay. The reason I am asking that—I do not mean to ask you the questions—the answer that I immediately go to is, well, let us see if there has been less money appropriated. You have increased our request, and we have increased your request every year.

I think there has been a steady increase here. In fact, this year, we are asking for a seven-percent increase in that area, so there may be a deeper issue here that I would be happy to look into and that you obviously are looking into as well. But it is probably not as a direct result of cuts as much as maybe something else that is going on. But I would be happy to look into it.

Mr. HINCHEY. Well, your conclusion is exactly the same as the one that I came to, based not upon all of the information but based upon the amount of information that we have. So I would appreciate it if you would.

Any more time, Mr. Chairman, or is my five minutes up?

Mr. SERRANO. For you?

Mr. HINCHEY. For me.

Mr. SERRANO. You can take a little more time. Do not push it, though.

Mr. HINCHEY. Absolutely not. If you are a guy originally from Manhattan, and you have to deal with a guy from the Bronx, you know, there is always that little bit of tension.

PRIVATE CONTRACTORS

I think the issues that were raised earlier, and I was not here, unfortunately, because of the other committee hearing, having to do with these contracts, the contractual situations that are out there, we know, for example, that with regard to the private contracts that have been engaged in Iraq, they have been very, very expensive. I think the largest one is something in the neighborhood of \$122 billion—that is Kellogg, Brown & Root—and there are others that are in the multiple billions of dollars, many of them in the tens of billions, some of them up close to 100 billions of dollars.

Huge amounts of money have been spent on these private contractors, and I think that this is something that really needs to be overseen much more carefully. I think a lot of that money, frankly, has been spent corruptly, corruptly in the sense that the reason for which that money was sent to these contractors did not result in the expectation that should be coming from it as a result of it.

This is something that is bad on two counts: It is costing us a lot of money and not giving us the results.

On a smaller scale, there is now a contracting operation engaged in security at West Point, and I am wondering why that is. Why is it that the Army, and I assume this is happening at Annapolis and the Air Force Academy—I do not know for sure, but I think it probably is—why is it that the military is not continuing to be allowed to provide the security for itself? Why are we bringing in private contractors? I do not like it. It makes me very uncomfortable.

So I would appreciate it if this is something that you would not mind taking a look at.

Mr. NUSSLE. This is an instance, again, where West Point is providing security to the campus using a private contractor, is what you discovered.

Mr. HINCHEY. Yes. Right.

Mr. NUSSLE. Okay.

Mr. HINCHEY. So when you come into the campus of West Point, you have to go through a security operation, of course. All of the cars are checked, et cetera, stopped. I am just wondering what the policy was. How did it get initiated? Why is it being carried out, so that the military does not provide their own security at these bases? Instead, we have a private corporation providing that security.

Mr. NUSSLE. Okay.

Mr. HINCHEY. I would appreciate it very much.

Mr. NUSSLE. Thank you.

Mr. HINCHEY. Thank you.

Mr. SERRANO. Mr. Regula.

AMERICAN COMPETITIVENESS INITIATIVE

Mr. REGULA. A couple of quick ones. I noticed you request \$12.2 billion for the American Competitiveness Initiative to support basic research in world-leading facilities. Tell me how you see this being achieved. How are we going to use that money, and how are we going to achieve competitiveness?

Mr. NUSSLE. Well, giving you this answer—I should ask you because you have been a leader in this area. Basic research is vitally important to our country.

Mr. REGULA. Well, do you see this money going out to schools, for example?

Mr. NUSSLE. Well, there are some instances, yes, where that is how it could be done. It should be awarded in a competitive way, and it should be done for basic research, and that is the basis surrounding this initiative.

Mr. REGULA. I like the idea. Do not misunderstand me. Are you telling me that a university that has a program that will enhance the competitiveness of the United States through the students that they educate would be able to apply for a grant or put a program in place? Would that be the way?

Mr. NUSSLE. Yes.

Mr. REGULA. Well, it will be interesting. Are there defined guidelines?

Mr. NUSSLE. Well, we assume, and we will be happy to work with the Congress on those kinds of guidelines. Our intent is to try and provide the incentive and the seed money for that basic research, and there are a number of ways that that could be handled, some of which have been tried before, and, certainly, Congress has experience in this area of setting up these kinds of initiatives, but this is one that the President felt was an important one.

Mr. REGULA. I think so. I agree.

Mr. NUSSLE. He mentioned this in his 2006 State of the Union, and it was set up for that purpose. But it was, as you say, a way to try and get ahead of the curve when it comes to some of the basic research that we need in order to make sure that we stay on a competitive edge with not only our partners but also our competitors around the world.

Mr. REGULA. Well, should Members be telling higher education facilities in their districts, you ought to look into this?

Mr. NUSSLE. Well, not until we get it up and funded and everything else.

Mr. REGULA. So you do not have guidelines.

Mr. NUSSLE. I will trust you on your communication with your universities, I am sure, but, at this point in time, most of those are going to be through the agencies that are already established that, I think, have become partners in this initiative, or could be partners in this initiative, including the National Science Foundation and the Department of Energy and the National Institutes of Standards and Technology Labs. Those are the ones that we see.

So there are ways that we can formulate this. That is the way we suggest it being done, and we also suggest that it should receive a pretty healthy amount. Congress did not see that last year and cut it back from the request, but we believe that this is a worthwhile priority that can give us the edge that we need.

EARMARKS

Mr. REGULA. One other question. How would you define a congressionally mandated earmark, euphemistically known as an “earmark”? How would you define it?

Mr. NUSSLE. How would I define it? Well, how I define it is I think it is any time the Congress designates dollars to a particular project or program in a noncompetitive way, and the ones, again, that we believe are the onerous ones are the ones that are not found in bill language but are in the report language or within funding that is then phoned in to the different agencies or departments. Those are the ones that we find concerning. So that is how I would define it.

Mr. REGULA. Would you concede that there are good, useful earmarks?

Mr. NUSSLE. Oh, sure, and that is why the President does not say, you know, get rid of all of them. But I think, too, what we have tried to do is to shine the light on the problem. Not only are there situations where they are not all good; they are not all bad. You are right. Both sides of that coin are true.

But any time that they are not transparent, when they are air dropped in at the last minute in a conference report, when it does not receive the scrutiny of this Committee or the Congress, that is when I think you start running into trouble, and that is the reason why I think we have the controversy set up the way we do right now.

Mr. REGULA. Thank you, Mr. Chairman.

Mr. SERRANO. Thank you. Mr. Director, our newest Member of the Committee, Mr. Bonner, who has got nine questions for you.

Mr. BONNER. Mr. Chairman, I am sorry I was absent yesterday.

Mr. SERRANO. It was noted.

Mr. BONNER. My perfect attendance has already been blemished, and I apologize.

Mr. SERRANO. That is okay.

Mr. BONNER. But, in fairness, the Director can probably appreciate more than some why we were not here. I hope you had a good, restful night's sleep last night, Mr. Director. Where were you at twelve-thirty in the morning?

Mr. NUSSLE. At twelve-thirty in the morning?

Mr. BONNER. Yes, sir.

Mr. NUSSLE. I hate to admit this. I was in bed.

Mr. BONNER. Well, your former colleagues on the Budget Committee were not.

Mr. NUSSLE. I did have an eye on the goings on and was amazed that it took them so long to get a budget out. We were always able to do it before midnight.

Mr. BONNER. And you gave us a blueprint that we could have just rubber stamped, if we had only taken your offer.

JOBS

Mr. Chairman, thank you. I do have one question because there has been a lot of conversation around the country. Some television celebrities who pretend to be journalists talk a lot about the outsourcing of jobs in our country. It is a legitimate question, and, in some parts of the country, we have seen tremendous job losses in states like Michigan, who have seen literally tens of thousands, if not hundreds of thousands, of people who have to leave because the economy in some states is not doing as well as it is in other states.

Let me give you quick example of where I am going with my question, and then I will get to the question.

Fifteen years ago, in my home state of Alabama, we did not make a single automobile. Despite the image that some might have about Alabama, we knew how to spell "automobile," but we did not make an automobile.

Then, about 15 years ago, our leadership in our state went out, borrowed money in a bond issue, and incentivized a company, Mercedes Benz, to come to the United States and to locate in Alabama. Today, that \$250 million investment has created 50,000 jobs in the state of Alabama alone, and Honda, who is in the Ranking Member's state, and Hyundai, the Korean company, and Toyota—many foreign companies have invested, have followed the lead that Mercedes had—BMW is in South Carolina.

So I know it gets to be a tricky question, especially when people like Lou Dobbs get on TV and talk about all of the outsourcing of jobs. In your position as director of the budget, how important is it, would you say, that we also consider in-sourcing of jobs, foreign investment coming into this country and creating job opportunities, many times making two or three times what previous job opportunities were in those districts and those communities and those states?

Mr. NUSSLE. That is a huge opportunity and factor in our growing economy, that we are attractive to capital and that we continue to promote that kind of investment, whether it is investment here in the United States or investment from abroad. All of that is very important to not only job creation and retention but to the future job growth and economic growth of our country.

As you know, you do not solve a lot of the budgetary problems and the fiscal problems with growth alone, but growth is extremely important, having people who have good-paying jobs that are able to pay their taxes and to deal with some of the challenges at the local, state, and federal level is an important part of how we deal with these things, from a fiscal standpoint.

So I would view that as a very important component in our continuing economic growth.

Mr. BONNER. And a positive one?

Mr. NUSSLE. Yes, sir.

FOREIGN INVESTMENT

Mr. BONNER. Just a quick follow up. Some have said, some of the critics, have said that, by allowing foreign corporations to invest in the United States and employ U.S. workers, we are, in fact, providing an economic stimulus plan to that foreign country. What role does foreign investment play in support of the President's economic stimulus plan and plans going forward?

We will have a new president next year, but what role, in your view, does it play going forward?

Mr. NUSSLE. Other than just generally answering that, that I believe it is an important role, and it is a vital part of our economic growth, I think those are probably questions that are better asked of the Secretary of the Treasury, who probably has a little bit more of a handle on all of those different component parts. But I view it, and I think the Administration continues to view that, as a very

important component of our continuing economic growth and our success in the future.

Mr. BONNER. Again, we missed you last night and yesterday in the budget, but we appreciate you coming to this Committee today.

Mr. NUSSLE. Congratulations on your committee assignment, too.

Mr. BONNER. Thank you very much. I not only got on a great committee, but a great chairman to work with. I said, last week, that he was handsome, debonair, smart, and he is not listening to anything I am saying now, but I stand by all of those comments. Thank you for being with us.

Mr. SERRANO. You must be referring to Ralph Regula.

Mr. BONNER. Thank you, Mr. Chairman.

Mr. SERRANO. Thank you. Should we read back the record?

Mr. NUSSLE. It was all good things.

Mr. SERRANO. Yes, I understand. I am going to just ask you a couple of more things. We do not want to keep you here much longer.

A-76 AND OMB DIRECTION

On this outsourcing issue, OMB has been very aggressive in telling agencies how and when to use the A-76 process. OMB's A-76 direction to agencies has taken the form of everything, from numerical quotas to quarterly PMA score cards. This has generated bipartisan congressional concern.

The 2008 Financial Services Bill from this Committee included a government-wide prohibition, 739[d], against, one, OMB directing or requiring agencies to prepare for, undertake, continue, or complete any A-76 activity; two, any agency following OMB's direction or requirements to prepare for, undertake, continue, or complete any A-76 activity.

On February 20th, OMB issued guidance to ensure compliance with several A-76 related provisions in the bill, but absent from the OMB guidance was any discussion of 739[d].

So the first question is, has OMB implemented 739[d]? If so, how has that happened? Has OMB issued guidance that makes it clear that OMB will not force agencies to meet privatization goals if the agencies determine that it is inconsistent with their missions?

Please provide the Subcommittee with copies of that direction to agencies and show me how agencies' A-76 schedules have changed, and, if not, is it reasonable to expect that the Congress will allow the Administration to pursue its A-76 agenda if OMB cannot follow the law? Should A-76 activity, as of the date of enactment of 739[d], be suspended administratively or legislatively until the prohibition is satisfactorily implemented?

Mr. NUSSLE. I guess, to start with, Mr. Chairman, I think it might be good for me to provide this answer in writing for you and be very direct to your very direct question.

Generally speaking, we believe we are following the law. We believe we are not giving direction to the agencies on any kind of specificity of how they should handle this, and we believe we have followed that directive. But I am sure there is a difference of opinion on that score, from what I understand, and so rather than to try and do it here verbally, I would recommend or suggest that I

take that question and give it a very serious answer, in writing, to the Committee so that you can review that.

Mr. SERRANO. Well, we would appreciate that, but I still would like to know, if you can tell me, why there was no mention of 739[d] in the directive.

Mr. NUSSLE. We thought it was covered within the directive. That is why I say, I think there may be a difference here in interpretation. We thought it was covered, would be my answer.

Mr. SERRANO. All right. Okay. So we will get that in writing from you.

PRESIDENTIAL EARMARKS

Last question: Does the President submit earmarks, and, if so, how much?

Mr. NUSSLE. The President does not submit earmarks. We believe that the difference here is that, and I understand there is a difference of opinion as to what is an administration earmark and what is not, I think the big difference here, if I may say, is that, first of all, anything we propose, as far as spending, was submitted in February and will be laying out there for the entire world to see, including justifications for the next however many months it takes for any of those to be considered before they may be put into possibly an appropriation bill as much as nine months to a year later, and they are based on what we think is a meritorious process.

Often, if they are directed spending, they are directed in order to complete a task that has been part of a bill for some time, or part of a spending measure for some time, and in those instances where they are not, where there are pools of money, they are meant to be done in a competitive way.

In fact, I went through the budget this year in a specific way to try and root out any of those that were not done, based on merit or based in a competitive process.

Mr. SERRANO. But here is where we may have the difference, and here is where you may want to answer later on.

If the president says, "I want X amount of billions for education," that is no different than if we say, "We are allocating, appropriating, X amount of billions to education." But if we say, within the bill, "and with that X amount of billions, \$2 million are going to go to Serrano's district to build a particular school," that is an earmark.

So when the President says, "I want this from Congress for a particular program," that is fine, but when the president says, "And within that, I am going to create a program in your district for so much," is that not an earmark?

Mr. NUSSLE. You will not find those in our budget. Let me go back to your—

Mr. SERRANO. You do not find in your budgets, for instance, on the HIDTA, certain amounts of money going directly to certain communities?

Mr. NUSSLE. But those are already competitively done as part of the process. They are based on merit and criteria that determine that. It is not a decision that was made arbitrarily, where I say, for instance, for Mr. Visclosky's district, that it goes specifically to

Lake County and Gary, Indiana, based on only my judgment, as the OMB Director.

Mr. SERRANO. Well, that is basically the whole argument about earmarks. Remember, I started off by saying that I do not think only someone at an agency level understands what my district needs. That is where I think the basic difference comes in.

Mr. NUSSLE. Sure.

Mr. SERRANO. I do not see a difference between me sending dollars to clean up the Bronx River because, otherwise, that agency would have never sent dollars to clean up the Bronx River, or the President, within an environmental dollar expenditure, sending dollars to clean up a particular river in California, Texas, Ohio, wherever. To me, that is an earmark, too. Anyway, to be continued.

Mr. HINCHEY. Mr. Chairman, one last question.

Mr. SERRANO. I was pointing to my right.

Mr. HINCHEY. I am usually to your left, Mr. Chairman.

Mr. SERRANO. Anyway, Mr. Hinchey will end our hearing.

Mr. HINCHEY. Thank you, Mr. Chairman.

Mr. SERRANO. All right.

TCE RISK ASSESSMENT PROGRAM

Mr. HINCHEY. I just wanted to ask you about one question involving the EPA, which is a critical question in a lot of communities across the country, and it involves a substance called trichloroethylene, TCE. TCE was used abundantly by a lot of manufacturing corporations up to a decade or two ago, and a lot of it is in ground water and is being absorbed by breathing into homes and businesses in various places. A lot of attention has been paid to it.

In July of 2006, the National Academy of Sciences, their National Research Council, came out with a report that said that the health impacts of TCE were severe in terms of things like kidney cancer, neurological problems, heart defects, and that they were particularly severe on women and children, particularly women with pregnancies.

The EPA went to work on that, and they began to develop a risk-assessment program. Actually, they revised what they had. That risk-assessment program now has been essentially completed, but I understand that putting it into effect, is now being held up by the information and regulatory affairs operation of OMB.

Now, if that can be overcome rapidly, it would be in the very direct and important interest of hundreds of thousands, maybe millions, of people across the country because there are thousands of these pollution sites all over the country.

So I would appreciate it, Mr. Director, if you—

Mr. NUSSLE. I will look into that.

Mr. HINCHEY. Thank you.

Mr. NUSSLE. I am not familiar with where that is in process, so let me look into that.

Mr. HINCHEY. Okay. Would you get back to me on that?

Mr. NUSSLE. I can, yes, sir.

Mr. HINCHEY. I would appreciate it.

Mr. NUSSLE. Okay.

Mr. HINCHEY. Thank you very much. Thank you very much, Mr. Chairman.

Mr. SERRANO. Thank you. Mr. Bonner, you have no further questions?

Mr. BONNER. No. Thank you.

Mr. SERRANO. Mr. Director, we thank you so much for your testimony and for being here with us today.

Mr. NUSSLE. Thank you, Mr. Chairman.

Mr. SERRANO. We thank you for agreeing with us on earmarks.

Mr. NUSSLE. That is the way I heard it.

Mr. SERRANO. We thank you for the fact that you will now start recruiting in Puerto Rico and the territories.

Mr. NUSSLE. I am leaving this afternoon.

Mr. SERRANO. We really do. We look forward to working with you for the benefit of the American people, and I thank you. And this meeting is adjourned.

**Questions for the Record
Submitted by Chairman José E. Serrano**

1. CBO estimates of the budget. On March 3rd, CBO released an analysis of the President's budget request. The CBO analysis shows that the President's proposals would increase the FY 2009 deficit above baseline levels by roughly 65 percent. While CBO's estimates show balance by 2012, the President's budget does not include the cost of operations in Iraq and Afghanistan and other overseas activities related to the global war on terror past FY 2009. The President's budget also assumes that relief from the Alternative Minimum Tax will be allowed to expire. If that were to happen, the AMT would hit 38 million households that year (compared to about 4 million households today).

- **How can the administration claim to balance the budget by 2012 if it does not include any Iraq or Afghanistan funds after 2009 and has not accounted for AMT reform?**

The President's 2009 Budget reaches balance in 2012 by restraining spending and keeping tax rates low to promote economic growth and maintain healthy growth in revenues. CBO's recent analysis confirms that the President's approach will produce a balanced budget.

The Budget proposes full funding for the war in FY 2008 and includes a \$70 billion placeholder for FY 2009. The Administration submitted its proposal for FY 2008 more than a year ago, but Congress has yet to act on it, even though the fiscal year is nearly half over. Funding needs for FY 2009 will be reassessed when Congress completes its work for FY 2008 and after General Petraeus issues his update on conditions in Iraq this spring.

The growing number of taxpayers subject to the AMT is a genuine problem. The Budget includes a one-year AMT patch for the 2008 tax year, in order to provide time to craft a long-term revenue-neutral solution to the problem, in the context of fundamental tax reform.

- **How does the Administration plan to address long-term structural imbalances in the budget?**

The nation's critical budgetary challenge in the long-term is the unsustainable growth in entitlement spending, particularly for Social Security, Medicare, and Medicaid. No conceivable tax increase will be sufficient to place the budget on a sustainable basis as long as spending for these programs continue to grow faster than the economy.

The Administration has made specific proposals for entitlement reforms that would constitute a sizeable downpayment on the problem. These proposals include an approach to Social Security reform that includes personal retirement accounts, progressive indexation of benefits, and other measures. The complex nature of the Medicare program will likely mean that the imbalance in that program will need to be addressed require a series of incremental solutions. In the 2009 Budget the Administration proposed reforms that would address about one-third of the program's unfunded obligation.

2. Long-term budgeting. Director Nussle, in your confirmation hearing you talked about initiating institutional processes to deal with long term structural imbalances in the budget and “pick the rock” of long term imbalances.

- **How does the Administration plan to address long-term structural imbalances in the budget? What institutional processes have you initiated?**

As noted in response to the previous question, the Administration believes that the long-term structural imbalances must be met by reducing the unsustainable rates of growth in entitlement programs. This year, for the first time, the Administration issued a summary of the U.S. Government Financial Report that highlights the entitlement problem and the challenges it will pose for the nation's future finances. The Administration has made specific proposals to address growth in entitlement spending, and looks forward to those proposals and others being considered by the Congress and enacted into law.

- **Do you believe that adequate information about the long-term cost implications of current policies and programs is available through the budget process?**

The President's Budget includes information about the long-range implications of current policy and the Budget's proposals, and CBO and GAO release regular studies of the nation's long-run fiscal path. While more information could be added to the budget process, the key challenge is not lack of information but lack of a sense of urgency in the public and in Congress for addressing these challenges. The new summary of the Financial Report issued this year is one important step to raise public awareness of these issues.

- **Do you think modifications should be considered to bring a more future-oriented focus to the budget process with respect to both aggregate fiscal policy and the composition of the government's commitments? If so, what do you propose?**

The President's Budget proposes several useful reforms that would bring a more future-oriented focus to the Budget process. First, the Administration proposes to strengthen the existing Medicare funding warning to include automatic reductions in payments if the program's statutory general revenue threshold is exceeded. Second, the Administration proposes a new funding warning for the Social Security Disability Insurance program that would provide advance notice of fiscal problems in that program. Finally, the Administration has proposed new procedures for long-term unfunded obligations of major entitlement programs that would report on changes in these obligations from year to year and impose a point of order on any legislation that worsened those obligations.

3. Electronic Government/Lines of Business initiatives. The Committee's understanding is that in at least four Lines of Business initiatives (Budget Formulation and Execution, Grants Management, Geospatial, and IT Infrastructure) significant portions of agency contributions are being used to directly fund or to contract for substantial amounts of administrative expenses including, in some cases, to fund OMB reporting requirements, such as completing and submitting exhibit 300s, rather than to fund program improvements.

- **Is OMB aware of concerns that a significant portion of agency contributions are going to fulfill reporting requirements and administrative costs rather than improve programs and benefit the participating agencies?**

Effective management and oversight, based on information and data, is critical to the success of IT programs in both the government and industry. The reporting performed by the E-Government (E-Gov) and Lines of Business initiatives supports such oversight while furthering agencies' missions and the goals of accountability and transparency. The information provided allows both agency and OMB executives to monitor program progress and to proactively identify issues before they become problems. Furthermore, the E-Gov Act of 2002 (Section 3602) requires OMB to oversee the implementation of E-Gov in a manner consistent with the Capital Planning and Investment Control processes established by authority of the Clinger Cohen Act.

Information collected includes:

- *Business Cases (Exhibit 300) – Provides summarized financial, performance, and operational status for the budget deliberation process. The public versions of the Exhibit 300, published soon after the release of the President's budget provides for transparency and accountability on what decisions were made;*
- *Quarterly E-Gov Implementation Plans – Establishes key milestones for both managing partners and customer agencies. This shared understanding furthers accountability and fosters utilization and adoption of the initiatives; and*
- *Quarterly Managing Partner Workbooks – Provides performance metrics, project funding status/milestones. This information is based on that tracked by program*

managers used Earned Value Management systems and other management tools – and supports the efficient allocation of resources across project components. Additionally, the performance measures as reported are shared with public, in a single on-line location, via www.egov.gov.

We manage the oversight of the initiatives through these reports which are essential for any program managers. Rather than being administrative, the information provided (and the associated reports) supports strategic decisions to further program success. The actual completion of reporting templates, while administrative, takes minimal effort if the requisite information is being tracked on a regular basis.

- **For each of the four Lines of Business named, please provide the proportion of funds budgeted for FY 2008 that supports program improvements benefiting participating agencies, as well as the proportion the supports administrative costs, including the fulfillment of reports required by OMB.**

Table 1.1 (below) provides the approximate Program Management Office (PMO) to overall Initiative cost ratio. However, a majority of PMO costs are not administrative in nature. Non-administrative PMO activities include: monitoring project performance including implementation, technical and implementation support, working with partner agencies to create fair and equitable funding models, stakeholder relationship management and constituent outreach to determine future requirements.

FY08 Costs	Geospatial LOB	Grants Management LOB	Budget Formulation & Execution LOB	IT Infrastructure LOB
Non-PMO	\$563,000	\$1,296,000	\$1,632,000	\$3,373,708
PMO	\$841,000 (60%)	\$544,000 (30%)	\$731,000 (31%)	\$2,606,292 (44%)
Totals	\$1,404,000	\$1,840,000	\$2,363,000	\$5,980,000

Table 1.1 - Specific E-Gov Initiative FY08 Budgeted Costs

- **Of the amount that supports administrative costs, what proportion is used for contracted services?**

OMB currently only tracks PMO costs at the aggregate level, not at the specific activity level. Please note of the costs in the table above, OMB believes most of the PMO costs are related to contracted services.

4. OMB’s Program Assessment Rating Tool (PART): In a response to a question for the record for the OMB hearing in 2007, OMB described the PART process and included an explanation of why the Department of Health and Human Services’ Social Services Block Grant program receives low PART scores and is proposed for significant budget cutbacks each year. As I stated last year, I believe this is an important program since it provides

resources in support of critical services to the Nation's most vulnerable low-income individuals, especially children, the elderly, and disabled. OMB's explanation was as follows:

“While the Social Services Block Grant program provides States flexibility in determining the services they provide, it does not have performance measures to document that the program is achieving results. In addition, there are no program evaluations of sufficient scope or regularity to inform or demonstrate program performance.”

I believe that some programs lend themselves to quantifiable performance measures, while others do not. The fact that a program does not lend itself to quantifiable performance measures does not mean that it is an ineffective program. The benefits of helping states deliver a wide range of social services to at-risk populations can't always be neatly quantified and presented on charts, graphs, or multi-colored scorecards. In such cases, PART scores are subjective and arbitrary.

What is the correlation between PART scores and funding decisions?

Program performance, as assessed with the PART, is an important factor in budget decisions, but it is only one factor. We work to invest taxpayers' dollars into programs that produce the greatest results, but we also need to meet all the nation's priorities, including improving the performance of key programs. A good PART rating does not guarantee a specific level of funding. A program may be Effective, but if it has completed its mission, if it is unnecessarily duplicative of other programs, or if there are higher priorities, its funding may be reduced. Likewise, an Ineffective or Results Not Demonstrated (RND) rating does not guarantee decreased funding. A program rated RND may receive additional funding to address its deficiencies and improve its performance.

Rating	2008 Actual	2009 Request	2008 Enacted (vs. 2007 enacted)	2009 Proposed (vs. 2008 enacted)
Total	2222617	2298069	5%	3%
Effective	114473	117019	3%	2%
Moderately Effective	1398506	1465331	5%	4.8%
Adequate	586761	600474	3%	2%
Ineffective	17787	15049	4%	-15%
Results Not Demonstrated	105090	100196	8%	-5%

- **What will the Administration do to ensure that worthwhile social programs that may not lend themselves to quantitative analyses of performance are given adequate funding?**

As the previous response stated, program performance is an important factor in budget decisions, but it is only one factor. The Administration is committed to measuring and improving the performance of all government programs. As you know, with this budget, the sixth year of using the PART, the Administration has evaluated about 98 percent of the Budget.

While OMB does not track "social programs" as a category of its Program Assessment Rating Tool, it does track grant programs, which have had difficulty demonstrating quantitative results. Factors that hinder the ability of some grant programs to demonstrate results include the wide breadth of purpose of some grants, lack of agreement among grantees and Federal parties on the purpose and performance measures, and therefore lack of focused planning to achieve common goals. Program managers are working to develop new and creative ways to measure their performance.

One example is the Department of Education's Title I Grants to Local Educational Agencies. This program provides supplemental education funding, especially in high-poverty areas, for local activities that help improve the performance of low-achieving students or, in the case of school-wide programs, to help all students in high-poverty schools to meet challenging State academic standards. The program has developed meaningful long-term performance measures, established baselines, and set annual targets required to meet ambitious statutory academic proficiency goals. First-year data show a rate of progress consistent with meeting annual performance targets. The Department of Education has expanded and strengthened its monitoring of State and local program implementation, including compliance with statutory requirements and fiscal management practices.

Another example is Medicaid, which is a means-tested, Federal-State funded entitlement program that provides medical assistance, including acute and long-term care, to families with dependent children as well as aged, blind, or disabled individuals. The Centers for Medicare and Medicaid Services (CMS) provides Federal oversight of this program. CMS created new performance measures that assess health quality and focus on improving program management. More work needs to be done; CMS is working on a national strategy to improve the quality of care across State Medicaid programs and is developing a national payment error rate for Medicaid. However, the Federal government matches all allowable State dollars spent on Medicaid, regardless of the amount or quality of service. This funding structure leaves Medicaid vulnerable, and has enabled States to shift costs to Medicaid that may not be appropriate.

5. **PART evaluations. Please provide several examples of programs in the FY 2009 budget that:**

1) received additional funding due to strong PART scores;

The following programs received additional funding and also had to correct deficiencies identified by PART:

- *Food and Drug Administration: This program is conducting evaluations of the new human drug program under the PDUFA III performance management program, which are expected to yield efficiency improvements and contribute to the accomplishment of long-term outcome goals regarding new drug approval times. Funding for this program increased from \$2292 million in FY 2008 to \$2357 million in the FY 2009 Budget request, an increase of 65 million.*
- *Economic Research Service: This program is conducting an independent evaluation of the Agricultural Management Survey (ARMS) and integrating research and market analysis for commodities. Funding for this program increased from \$77 million in FY 2008 to \$82 million in the FY 2009 Budget request, an increase of \$5 million.*
- *National Institutes of Health - Buildings and Facilities: This program will ensure that approved design and construction projects are executed on time, on scope, and on budget by implementing and monitoring an earned value analysis and management system. Funding for this program increased from \$127 million in FY 2008 to \$133 million in the FY 2009 Budget request, an increase of \$6 million.*
- *Self-help Homeownership Opportunity Program (SHOP): This program will complete an independent evaluation of program effectiveness, and identify areas for improvement. SHOP is also developing additional annual and long-term outcome measures to assess community level impact of the SHOP program. Funding for this program increased from \$27 million in FY 2008 to \$40 million in the FY 2009 Budget request, an increase of \$13 million.*

2) received additional funding to correct deficiencies, as measured by PART; and

The following programs received more funding to correct deficiencies identified by PART:

- *HHS Bioterrorism Biosurveillance program: The purpose of the biosurveillance program is to improve the Federal government's ability to rapidly identify and characterize potential bioterrorist attacks or other public health emergencies through three sub programs, BioSense (collecting data from hospitals), Quarantine Stations, and the Laboratory Response Network. The purpose and importance of the program is clear, but results have not yet been demonstrated. The program is developing measures and targets through a collaborative effort between COPTER and programs. Developing milestones and targets associated with outcome goals and measures. Independent evaluations are underway for*

both BioSense and the Laboratory Response Network, however they have yet to be completed. Funding for this program increased from \$53 million in FY 2008 to \$101 million in the FY 2009 Budget request, a 91% increase

- *Transportation Security Administration: Air Cargo Security Programs: The program develops and deploys advanced programs and systems to ensure the safe and secure transport of passengers and property in air transportation. TSA is improving methods to evaluate risks and vulnerability in the air transportation system as it relates to air cargo. The program has recently developed interim long-term and annual measures to measure program effectiveness. However, due to data limitations, the program is unable to measure the risk reduced as a result of implementing program objectives. Work remains to close security loopholes, including improving screening efforts and refining procedures to approve indirect air carriers. The program has developed a strategic plan and is deploying a new security screening system, both of which are steps in the right direction. Improving methods used to evaluate risks and vulnerability in the air transportation system through the "Freight Assessment System." TSA will fully deploy this system in 2008. Funding for this program increased from \$73 million in FY 2008 to \$86 million in the FY 2009 Budget request, a 18% increase*
- *Food Stamp Nutrition Education: Food Stamp Nutrition Education is a Federal-State program with the goal of improving the likelihood that persons enrolled in and eligible for the Food Stamp Program will make healthy food choices within a limited budget and choose physically active lifestyles consistent with the current USDA dietary guidelines. There are no standardized performance measures across State programs to gauge progress. The scope of nutrition education efforts varies widely, making it difficult to establish meaningful outcome measures to capture the program's progress. While States collect some data on participation, the data collected is limited and ambiguous and varies across programs. The program's mission and goals are not clearly established in statute or regulation. The program relies on guidance to establish program policies. While nutrition education is clearly intended to contribute to advancing the program's purpose, the Food Stamp legislation and regulations are silent on the specific goals of nutrition education. It is unclear if funds are spent effectively to increase participation and improve nutrition-related behaviors. The program is developing efficiency measures to assess program effectiveness related to its goals. It is also developing a plan to increase the use of evidence-based food and nutrition education initiatives across States. The program is also using \$2 million from the Food Stamp Account to test and rigorously evaluate promising food stamp nutritious education practices. The Administration is also seeking legislation to make nutrition education a component of the Food Stamp Program and developing a plan to publicize regulations. Funding for this program increased from \$293 million in FY 2008 to \$322 million in the FY 2009 Budget request, a 10% increase.*

3) received less funding due to poor performance, as measured by PART.

The following programs received less funding or were proposed for termination, in part, due to their PART rating. These proposals will result in savings to taxpayers and improved Government services by eliminating or restructuring low-priority programs and programs that are not producing results. The proposals were guided by criteria that considered whether the programs met the Nation's priorities, constituted an appropriate and effective use of taxpayer resources by the Federal Government, and produced the intended results.

- *National Writing Project: This program provides a non-competitive grant to a nonprofit educational organization that promotes kindergarten through college level teacher training programs in writing. The 2006 PART assessment conducted by the Department of Education and OMB rated this program as Results Not Demonstrated. The program does not have data on its annual performance or long-term performance measures, and it lacks a rigorous evaluation of its effectiveness. Funds for training teachers in all academic subjects are provided under the Teacher Quality State Grants program. This program was received no funding in the FY 2009 budget request.*
- *Physical Education: This program supports physical education programs (including after-school programs) for students in K-12. The Department of Education and OMB assessed the program in 2005 using the PART and the program received a rating of Results Not Demonstrated. Physical Education programs have historically been supported by States and LEAs. This program was received no funding in the FY 2009 budget request.*
- *Health Resources and Services Administration's (HRSA) Maternal and Child Health small categorical grants (Universal Newborn Hearing Screening, Traumatic Brain Injury, and Emergency Medical Services for Children): In 2004, the Traumatic Brain Injury and Emergency Medical Services programs both received ratings of Results Not Demonstrated when the Department of Health and Human Services and OMB assessed them using the Program Assessment Rating Tool (PART). A 2005 PART evaluation of the Universal Newborn Hearing Screening Program determined that the program had completed its intended objective of helping States to implement universal newborn hearing screening. This program received no funding in the FY 2009 budget request.*
- *The Health Professions Training Grants: This program assists academic institutions in helping to meet the costs of training and educating students to become nurses, doctors, dentists, and other health professionals. These grants were authorized in the early 1960s, partially in response to an anticipated national shortage of physicians that does not exist today. Between 1992 and 2004, the U.S. physician population increased by 36 percent, over twice the rate of growth of the total population. Evaluations have not linked the Health Professions training grants to changes in supply, distribution, and minority representation of*

physicians and other health professionals. The budget proposes to reduce funding from \$350 million in FY2008 to \$110 million in FY 2009, a reduction of \$240 million.

- *Oil and Gas Research and Development: These R&D activities typically fund development of technologies that can be commercialized quickly, like improved drill motors. Therefore it is more appropriate for the oil and gas industry to perform these activities. In addition, the programs have not demonstrated results, as identified in the 2003 Program Assessment Rating Tool (PART) review and updated annually. The industry has both the financial incentives and resources to develop inexpensive and safe methods to extract oil and gas. This program received no funding in the FY 2009 budget request.*
- *Rural Housing and Economic Development (RHED): The Department of Housing and Urban Development was first authorized in 1989 to encourage different approaches to serve the housing and economic development needs of the Nation's rural communities. In 2004, the Administration's crosscutting review of Federal community and economic development programs found that many of these programs, including RHED, had unclear objectives, did not coordinate effectively, were duplicative, and were unable to demonstrate measurable and sustained economic gains for communities. The Program Assessment Rating Tool (PART) assessment conducted by HUD and OMB rated RHED as Ineffective. Its major problems include its lack of annual and long-term outcome measures, duplicative mission, and inability to produce transparent information on results. This program received no funding in the FY 2009 budget request.*

6. Tax expenditures. GAO has reported that tax expenditures in some years exceed discretionary spending and yet they are not in the financial statements, they are not part of the budget process, and they are not part of the appropriations process. GAO has recommended that OMB work with the Secretary of the Treasury on reporting better information on tax expenditure performance and including tax expenditures under budget review processes.

What actions have you taken to:

- a. Present tax expenditures in the budget together with related spending to show a truer picture of Federal support?**

Tax expenditures are listed in chapter 19 of the Budget's Analytical Perspectives volume. They are updated annually by the Treasury Department's Office of Tax Analysis.

Develop a framework for evaluating tax expenditures?

The Treasury Department has the main responsibility for analyzing the U.S. tax code where the tax expenditures are found. In Congress, tax policy is under the jurisdiction of the Senate Finance and the House Ways and Means Committees.

i. Specifically, what actions has OMB taken to determine which agencies will have leadership and how to coordinate reviews?

Any analysis of tax expenditures would be conducted by the Department of Treasury. The tax expenditures are not the responsibility of any other Department or agency.

ii. Have you set a schedule for conducting tax expenditure reviews or identified additional resources needed to complete such reviews?

The question should be directed to Treasury.

b. Develop guidance for agencies on how to incorporate tax expenditures in their plans and performance and accountability reports?

The only agency with responsibility for tax expenditures is the Treasury Department. The Administration has no intention of assigning responsibility for the tax code to any department other than Treasury.

c. Require tax expenditures be included in the PART process and other performance review processes? OMB set up ExpectMore.gov to share information about traditional spending programs, but what are OMB's plans on expecting more from spending channeled through the tax code?

Treasury is responsible for tax policy and tax expenditures, but OMB has occasionally reviewed the performance of tax expenditures through the PART process. Specifically, OMB has assessed the New Markets Tax Credit, EITC compliance, and Health Care Tax Credit administration. The reviews have focused on how these tax provisions are administered. More rigorous evaluation of the performance of these programs would require careful consideration.

7. Cancellations, terminations and reductions. The President's budget proposes 151 discretionary cancellations, terminations and reductions for a combined savings of \$18 billion.

- **What are agencies doing with the FY 2008 funds that were appropriated for programs that the President proposes for cancellation, termination or reduction in the FY 2009 budget? Are they withholding funds appropriated by Congress for any of these 151 programs from obligation?**

2008 enacted funding for programs proposed to be terminated or reduced in the 2009 budget remain available for obligation, and follow the same apportionment requirements as programs not proposed for termination or reduction. Similarly, proposed cancellations of 2008 enacted funding in the 2009 budget continue to remain available for obligation. However, in some cases funds proposed for cancellation are due to large unobligated balances that are not projected to be obligated in 2009. Some proposed cancellations are for 2009 budget authority, which are not yet available for obligation.

8. General provisions. The FY 2008 Financial Services appropriations bill included three longstanding provisions (sections 701, 709, and 716) that were made permanent by inserting "Hereafter," at the beginning. Both the House and Senate reports accompanying the FY 2008 bill specifically note that the bill "makes permanent" each of these sections. The legislative history is, therefore, quite clear. However, the President's FY 2009 budget request repropose two of these provisions and deletes "Hereafter" from the proposed language. OMB referred to "Hereafter" as an "ambiguous reference."

- **Why does not OMB consider the enacted FY 2008 language to be permanent?**
- **Given the legislative history, what is ambiguous about the language?**

In OMB's letter to the Appropriations Committees of February 4, 2008, OMB explained that the President's FY09 Budget proposed to retain, with modification, sections 701 and 716 of the FY08 government-wide general provisions, with the modification being in each case "to delete ambiguous reference to 'Hereafter'" in those sections. It was for this same reason that the FY09 Budget proposed to delete section 709, which prior Budgets had also proposed to delete.

As an initial matter, we should note that the FY 2008 Financial Services appropriations bill was enacted into law on December 26, 2007 (Pub. L. No. 110-161). The President's Budget was transmitted on February 4, 2008.

*We viewed the "hereafter" language in sections 701, 709, and 716 to be ambiguous because, while the term "hereafter" in some circumstances can sometimes be indicative of an intention of futurity (i.e., application beyond the current fiscal year), the term is not sufficiently unambiguous in this regard for us to have concluded, that the addition of the "hereafter" language overrode the well-established presumption that provisions in appropriations acts do not extend beyond the current fiscal year. This presumption is embodied, for example, in 31 U.S.C. § 1301(c)(2) and in Section 603 of the FY 2008 Financial Services bill, and it has long been recognized by the Supreme Court. See *Minis v. United States*, 40 U.S. 423, 445 (1841) ("It would be somewhat unusual to find engrafted upon an act making special and temporary appropriation, any provision which*

was to have a general and permanent application to all future appropriations. Nor ought such an intention on the part of the legislature to be presumed, unless it is expressed in the most clear and positive terms, and where the language admits of no other reasonable interpretation.”); United States v. Vulte, 233 U.S. 509, 514-515 (1914) (stating the presumption, quoting Minis).

In this regard, we note that another part of the Consolidation Appropriations Act, 2008, includes a general provision that begins with "hereafter" but which does not appear to reflect a congressional view that the provision is permanent law. This provision is section 507 of Division B. Section 507 is identical to Section 606 of the Science, State, Justice, Commerce, and Related Agencies Appropriations Act, 2006 (Pub. L. No. 109-108), which was in effect during both fiscal years 2006 and 2007 (due to the full-year FY 2007 continuing resolution). Thus, in two consecutive appropriations acts, for fiscal years 2006 and 2008, Congress enacted the same general provision that began with "hereafter." This re-enactment of a general provision beginning with "hereafter" suggests that Congress did not consider Section 606 of the FY 2006 appropriation to be permanent law when Congress was considering and passed the FY 2008 appropriation and re-enacted this same general provision as Section 507. Moreover, this re-enactment is especially noteworthy here, in that Congress in the FY 2006 appropriations act added the term "hereafter" to this general provision, which had been included in prior-year appropriations acts. Specifically, in Section 607 of Division B of the Consolidated Appropriations Act, 2005 (Pub. L. No. 108-447), and in Section 608 of Division B of the Consolidated Appropriations Act, 2004 (Pub. L. No. 108-199), this general provision did not begin with "hereafter." Congress in the FY 2006 appropriations act added "hereafter" to the beginning of the provision, and then Congress in the FY 2008 appropriations act re-enacted this same provision, again beginning the provision with "hereafter." (Sections 608, 607, 606, and 507 are reprinted below.)

Accordingly, in light of the ambiguous nature of the "hereafter" language in Sections 701, 709, and 716 of the Financial Services Appropriations Act, 2008, and due to the need to finalize and submit the FY09 Budget a few weeks after those sections were enacted into law, the FY09 Budget proposes to retain Sections 701 and 716, with modification, and to delete Section 709. These proposals are consistent with the proposals for these three sections in prior-year Budgets.

Section 608 (FY 2004):

SEC. 608. None of the funds made available in this Act may be used to implement, administer, or enforce any guidelines of the Equal Employment Opportunity Commission covering harassment based on religion, when it is made known to the Federal entity or official to which such funds are made available that such guidelines do not differ in any respect from the proposed guidelines published by the Commission on October 1, 1993 (58 Fed. Reg. 51266).

Section 607 (FY 2005):

SEC. 607. None of the funds made available in this Act may be used to implement, administer, or enforce any guidelines of the Equal Employment Opportunity Commission covering harassment based on religion, when it is made known to the Federal entity or official to which such funds are made available that such guidelines do not differ in any respect from the proposed guidelines published by the Commission on October 1, 1993 (58 Fed. Reg. 51266).

Section 606 (FY 2006):

SEC. 606. Hereafter, none of the funds made available in this Act may be used to implement, administer, or enforce any guidelines of the Equal Employment Opportunity Commission covering harassment based on religion, when it is made known to the Federal entity or official to which such funds are made available that such guidelines do not differ in any respect from the proposed guidelines published by the Commission on October 1, 1993 (58 Fed. Reg. 51266).

Section 507 (FY 2008):

SEC. 507. Hereafter, none of the funds made available in this Act may be used to implement, administer, or enforce any guidelines of the Equal Employment Opportunity Commission covering harassment based on religion, when it is made known to the Federal entity or official to which such funds are made available that such guidelines do not differ in any respect from the proposed guidelines published by the Commission on October 1, 1993 (58 Fed. Reg. 51266).

9. **Real Property Disposal.** The Administration's proposed section 735 of the Government-wide General Provisions proposes a pilot program for disposal of Real Property that would exclude pilot disposals from the McKinney-Vento Homeless Assistance Act (42 U.S.C. 11411). Title V of the McKinney-Vento Act provides suitable Federal properties categorized as unutilized, underutilized, excess, or surplus for use to assist homeless persons. Properties are made available to States, units of local government, and non-profit organizations. They can be used to provide shelter, services, storage, or other uses of benefit to homeless persons.

How would the Federal government benefit from the proposed exemption from established rules?

The Real Property Disposal Pilot provides an opportunity for the Federal government to explore alternatives to the existing disposal requirements under Title 40, U.S. Code (the Property Act) and create additional opportunities to right-size the real property asset portfolio. The objective of the pilot is to improve the overall management of the Federal real property portfolio via an expedited process for real property disposals in order to:

- *bring eligible surplus properties to market sooner;*
- *reduce costs for operating and maintaining unneeded assets; and*
- *retain sales proceeds which can be targeted towards improving the condition of existing assets (e.g., making property improvements that can help agencies meet mission objectives more cost effectively).*

The pilot is not intended for properties that are suitable for the homeless under the McKinney-Vento Act or other public use benefit conveyances.

Are the McKinney-Vento provisions inhibiting the disposal of excess or surplus Federal real property?

The provisions in McKinney-Vento Act provide an important tool to screen excess property for suitability for use by organizations that provide services to the homeless. The screening process can take 100-256 days depending on the outcome of the suitability determination as follows:

- ***For all assets:** HUD has 30 days to make suitability determination*
- ***For unsuitable assets:** HUD has 20 days to publish properties in the Federal Register. Organizations providing services to the homeless have 20 days to appeal; HUD has 30 days for making the determination. (Total = 100 days)*
- ***For suitable assets:** Agency or GSA has 45 days to notify HUD that the property is surplus or there is a Federal need. HUD has 15 days to publish in the Federal Register. After the property is determined to be suitable, there is a 60 day "hold" on agency action and a 90 day application period. Finally, HHS has 25 days to rule on the application. (Total = 265 days)*

At any given time, there are thousands of Federal surplus properties listed in the Federal Register for consideration by the homeless. However, 84 properties, or less than one percent of properties screened, have been transferred to organizations providing services to the homeless since the McKinney Act was enacted in 1987. Thus, a great number of these properties may be "clogging the docket" and making it more difficult for homeless organizations to identify those properties that are viable transfer candidates.

While the central objective of the pilot is to expedite the process to dispose of unneeded assets that are not suitable for use by homeless organizations or other public benefit use conveyance, the pilot would also allow the Executive Branch to pursue new approaches for ensuring homeless organizations have better transparency and insight into those properties that are better transfer candidates. Regardless, the OMB Director will review properties for suitability for use by homeless organizations, and only properties that are not deemed suitable for the homeless will be approved for sale under the pilot.

Please provide a list of specific properties that the Administration would dispose of under section 735 that could not effectively be disposed of under current rules. For each property, please explain the specific circumstances that cause the McKinney-Vento provisions to inhibit or otherwise complicate their disposal.

Under the pilot, agencies will submit potential candidates to the OBM Director and the Director will select the properties to be included in the pilot. Until the legislation is passed, there is no way of knowing which specific properties will be selected. However, a list of surplus and excess property that has the potential to be recommended for the pilot can be found in OMB's June 15, 2007 "Response to Section 408 of Public Law 109-396." The annual operating cost of these assets exceeds \$130 million.

What specific criteria will the Director of OMB use when determining which real properties are eligible for the pilot program?

The criteria to be used by the Director to determine which properties are eligible for the pilot have not yet been determined. However, OMB will be looking for properties that are not appropriate for use by homeless organizations or for other public benefit conveyances. The following is a preliminary (and non-comprehensive list) of criteria that will be used by the Director for making a determination that properties may be considered for participation in the pilot:

- *size greater or equal to 100,000 square feet (note that surplus or excess properties for which the predominant use is housing would likely not be included in the pilot regardless of its size).*
- *location within a secure Federal installation, campus, or compound that are not suitable for off-site location*
- *proximity to flammable or explosive material*
- *locations not accessible by road*
- *location in a floodway*

Under the proposed pilot program, agencies would recommend candidate disposition properties to the Director of OMB: What standards will the Administration use to prioritize and select pilot properties from agency recommendations? How would the Administration fund the direct expenses of disposal for properties disposed of under this proposal?

The criteria to be used by the Director to determine which properties are eligible for the pilot have not yet been determined. However, the Director will place a high priority on properties whose disposal creates the most benefit to the taxpayer. For example, properties that carry high maintenance costs will be given a higher priority than properties with lower maintenance costs.

Regarding administrative expenses, Section 624 of the bill provides that agencies will be reimbursed for administrative expenses associated with the disposal of properties sold under the pilot. For the first properties sold under the pilot, agencies will cover expenses from funding in existing appropriations; however, reimbursement of those expenses will be made after the sale. Future property sales can be funded from proceeds from previous sales. Notably, the cost of retaining an unneeded asset today is often less than the costs to make the asset ready for sale (e.g., environmental remediation costs) giving agencies a disincentive to dispose of these assets. The pilot gives an incentive for agencies to dispose of unneeded assets in a cost-effective manner and lower overall maintenance costs of property portfolios.

The Administration's proposal would also allow the disposing agency to retain 20% of the proceeds of sale. How does the Administration's proposal impact landholding agencies that already have authority to retain 100% of proceeds from sale?

The pilot is intended to complement, not supersede, existing authorities. Section 623 (d) states "Nothing in this subchapter shall be construed as terminating or in any way limiting authorities that are otherwise available to agencies under other provisions of law to dispose of Federal real property..." It should be noted that while some agencies have 100% retention authority, this authority does not always apply to every property in their portfolio. For example, the USDA Forest Service agency has 100% retention authority but this authority does not extend to properties managed by other USDA agencies. Thus, the pilot could serve as a supplemental tool for agencies with current authorities.

Which landholding agencies currently do not have authority to retain 100% of proceeds from sale? Within those agencies, how much property is potentially available for disposal?

The following agencies do not have authority to retain proceeds from the sale of surplus property:

- *Commerce*
- *Education*
- *Environmental Protection Agency (EPA)*
- *Health and Human Services (HHS)*
- *Housing and Urban Development (HUD)*
- *Department of the Interior (DOI)*
- *Department of Justice (DOJ)*
- *National Archives and Records Administration (NARA)*
- *Treasury*
- *Department of Transportation (USDOT)*

The following agencies have partial authority to retain proceeds from the sale of surplus properties:

- Agriculture (Limited to Forest Service)
- Department of Homeland Security (DHS) (Limited to the Coast Guard)
- Department of Labor (DOL) (Limited to Job Corps Centers)
- Social Security Administration (SSA) (Limited to Trust Fund Property)

A list of surplus and excess property that has the potential to be recommended for the pilot can be found in OMB's June 15, 2007 "Response to Section 408 of Public Law 109-396." The Section 408 response is also attached.

10. **Electronic Government Fund.** The FY 2009 budget request of the General Services Administration includes \$5 million for the Electronic Government Fund, an increase of \$2 million over the FY 2008 appropriated level. GSA's Congressional Justification (CJ) explains that this increase would support USASpending.gov, a website that is already operational.

- **Please explain what additional work is required to comply with the Federal Funding Accountability and Transparency Act of 2006 that would be funded from the \$2 million requested.**

USASpending.gov launched December 14, 2007. The Act requires the site be updated with agency award data every 30 days. The additional funds also support the collection and processing of this agency data to inter-operate with the USASpending.gov application. Additionally, the Act requires a pilot to be conducted for sub-contractor and sub-grantee information to be included into the website. We will be working to support the activities required for the implementation of this information into the existing website, if determined feasible.

We also envision enhancing the application to improve its ease of use by the general public, based on ongoing feedback as received from users and other stakeholders.

- **Please provide a detailed justification, by project, for the \$5 million requested for this Fund in FY 2009.**

Project	Amount	Description
IAE Grants & Loans	\$1M	In efforts to ensure all awards transactions uniquely identify the award recipient, the Integrated Acquisition Environment (IAE) leveraged its relationship with Dun & Bradstreet (D&B) to establish a method by which agencies can get a Data Universal Numbering System (DUNS) number as the unique identifier for each

Project	Amount	Description
		recipient. The funding for the IAE – Loans and Grants initiative assists the government in acquiring the functionality required on a government-wide basis to support this capability. In FY 2008, funding from the E-Gov Fund will be allocated to the IAE – Loans & Grants initiative to supplement the Small Business Administration's FY 2008 contribution to the initiative. This agreement was made to ensure the full funding of the initiative.
<i>USASpending.gov</i>	\$2M	See previous question
<i>IPv6</i>	\$0.425M	The IPv6 funding will be used to facilitate the establishment of a lab accreditation and product testing program which will allow any accredited public and private testing laboratory to test and certify products for conformance with the Federal government IPv6 standards profile.
<i>Trusted Internet Connection (TIC) Initiative</i>	\$1.575M	The Trusted Internet Connections (TIC) initiative aims to optimize individual network services into a common solution for the federal government. This common solution facilitates the reduction of our external connections, including our Internet points of presence, to a target of fifty. This funding will continue to support inter-agency coordination and collaboration, identification and dissemination of best practices, government-wide policy development, and monitoring of agency progress.

- **Please provide the correct estimate of FY 2008 total obligations, an obligation plan by project, and year-to-date actual obligations through February 31, 2008, by project.**

GSA's CJ correctly reports that the planned obligations in FY 2008 are \$8.976 million. During the first quarter of FY 2008, each E-Gov project was reviewed to determine if the level of funding allocated to that project was appropriate. All but 3 projects between FY 2002 and FY 2006 were considered complete and \$1.052 million was determined to be available for reallocation. The FY 2008 spending plan, which will be transmitted to the Appropriations Committees soon, reflects the reallocation of funds based on this review.

Currently there are 3 projects that began prior to FY 2007 that still have unobligated balances. All balances will be obligated by the end of FY 2008 or, if the funding is determined not to be necessary at the end of FY 2008, the funds will be reallocated in FY 2009.

Project	Funding Level	Obligations FY 2007 and prior	Obligations FY 08 through February 29	Unobligated Balance
E-Government Standards	\$1,000,000	\$891,631	\$37	\$108,332
Application Development	\$470,000	\$307,322	\$0	\$162,678
E-Forms	\$1,600,000	\$1,517,289	\$82,711	\$0
Total	\$3,070,000	\$2,716,242	\$82,748	\$271,010

There are 7 projects that received initial or additional funding through the FY 2007 spending plan. All balances are projected to be obligated by the end of FY 2008.

Project	Funding Level	Obligations FY 2007 and prior	Obligations FY 08 through February 29	Unobligated Balance
ITI, Geospatial and Budget LOB	\$1,948,555	\$1,500,000	\$0	\$448,555
E-Gov, LOB Refinement & Support	\$1,200,000	\$0	\$0	\$1,200,000
Architecture Development for LOB	\$1,111,343	\$0	\$811,343	\$300,000
Developing and Monitoring of Cost Savings Efforts	\$500,000	\$0	\$0*	\$500,000
Improvement and Monitoring of Performance Results	\$470,000	\$0	\$0*	\$470,000
Federal Accountability and Transparency Website Development	\$400,000	\$0	\$400,000	\$0
Support Government-wide Solutions	\$696,000	\$255,000	\$441,000	\$0
Total	\$6,325,898	\$1,755,000	\$1,652,343	\$2,918,555

**Contracts are in place for "Developing and Monitoring of Cost Savings Efforts" and "Improvement and Monitoring of Performance Results". \$0.97 million will be obligated by April 2008.*

In summary, \$1.735 million has been obligated through February 29, 2008 and commitments have been made for \$0.97 million. The remaining \$2.219 million unobligated balance associated with the current E-Gov projects will be obligated by the end of FY 2008. A spending plan for the new FY 2008 authority of \$3 million and the re-

allocation of \$1.052 of prior year funds will be submitted to the Appropriations Committee soon.

11. A-76 restrictions. The FY 2008 Financial Services Bill included a government-wide prohibition, section 739(d), against 1) OMB directing or requiring agencies to prepare for, undertake, continue, or complete any A-76 activity; 2) any agency following OMB's direction or requirements to prepare for, undertake, continue, or complete any A-76 activity. On February 20, OMB issued guidance to ensure compliance with several A-76 related provisions in the bill. Conspicuously absent from that OMB guidance was any discussion of section 739(d).

- **Has OMB implemented section 739(d)?**
- **If so, how has that happened? Has OMB issued guidance that makes clear that OMB will not force agencies to meet privatization goals if the agencies determine privatization is inconsistent with their missions? Please provide the subcommittee with copies of that direction to agencies and show me how agencies' A-76 schedules have changed.**
- **If not, why? Is it reasonable to expect that the Congress will allow the Administration to pursue its A-76 agenda if OMB disregards section 739(d)? Should A-76 activity, as of the date of enactment of section 739(d), be suspended, administratively or legislatively, until the prohibition is satisfactorily implemented?**

OMB has not issued guidance on section 739(d) because guidance is unnecessary. OMB does not direct or require – and has not directed or required – agencies to plan for, announce, or complete a public-private competition or direct conversion. Competitive sourcing is a management tool and decisions regarding its use are vested with the agency. Agencies make all decisions regarding whether and what to compete and the timing of any competition. Agencies have used public-private competition in a reasoned and responsible manner to achieve significant performance improvements and savings and should continue to have the discretion to use this tool when they determine that competition makes sense.

12. Administration earmarks. As you know, this Congress has made great efforts to promote transparency and accountability, make earmarks easy to find and promote effective outcomes. Mr. Nussle, during your remarks before this subcommittee, you said that the President does not

submit earmarks. However, during your confirmation hearing you asserted that transparency in earmarks is the hallmark of this administration and you acknowledged, in response to a question from Senator McCaskill, a willingness to make all of the President's earmarks transparent in the budget. You also said that "the President has to put all of that on the table in the budget."

- **Are there no earmarks in the President's budget, or are they in the budget and transparent?**

The President's FY 2009 Budget contains no earmarks. President's Budget requests for funding are determined based on merit-based or competitive processes, under applicable laws. The details of the President's budget are contained in Agency budget justifications. OMB requires those justifications to be posted to the Agency's website.

- **If, as your response to Senator McCaskill seems to indicate, the President does earmark in the budget, could you tell the subcommittee where the Administration identifies presidential earmarks in the fiscal year 2009 budget and provide the Committee with a list of those earmarks?**

The FY 2009 Budget contains no earmarks. Earmarks are funds provided by the Congress for projects or programs where the congressional direction (in bill or report language) circumvents the merit-based or competitive allocation process, or specifies the location or recipient, or otherwise curtails the ability of the Administration to control critical aspects of the funds allocation process.

This subcommittee received detailed budget materials from the Office of National Drug Control Policy which provided specifics of the Administration's plans for distributing FY 2009 High Intensity Drug Trafficking Areas funds, including specific amounts for several HIDTAs: Chicago, New York-New Jersey, Lake County Indiana, Milwaukee, and the Southwest Border. Although most HIDTAs received an across-the-board decrease to their base funding, Chicago received an increase, while Lake County and Milwaukee received substantial decreases.

- **Aren't these funding allocations earmarks?**
- **Is the Administration practicing transparency if it, on one hand, claims that it doesn't earmark, and on the other hand submits these earmarks as part of its budget justification materials?**

- **Please describe in detail the process that determined these HIDTA allocations, and whether the process included the input of stakeholders such as HIDTAs themselves.**
- **Could you state whether or not these proposed HIDTA allocations were determined in a fully open and transparent manner? If they were, please indicate the steps in the process that ensured openness and transparency. If they were not, why not?**

The HIDTA allocations do not constitute earmarks. The Administration uses a transparent process that is based on the applicable statute. The process used to provide a funding request for these entities are as follows:

Section 301 of the ONDCP Reauthorization Act of 2006, P.L. 106-469, continues the establishment of the High Intensity Drug Trafficking Areas (HIDTA). Specifically, Section 707 (i) states that within the "annual budget request for the Office, the Director shall submit to Congress a budget justification that includes - (1) the amount proposed for each high intensity drug trafficking area, conditional upon a review by the Office of the request submitted by the HIDTA and the performance of the HIDTA, with supporting narrative descriptions and rationale for each request." Therefore, included in the FY 2009 ONDCP Congressional Budget Submission is a request for each of the 28 HIDTA's, not only the Lake County HIDTA and the Chicago HIDTA.

13. GWOT Allowance. In addition to the \$86.7 billion supplemental already enacted for FY 2008, the President's budget requests enactment of another \$102 billion in GWOT supplemental funding, for a total of about \$189 billion. However, for FY 2009 the budget includes an "allowance" of \$70 billion, which is less than 40 percent of the funds requested for FY 2008.

- **Please explain this "allowance" and what it is intended to fund.**

The \$70 billion emergency allowance is intended to fund Global War on Terror (GWOT) costs into FY 2009. Due to the fluid nature of events on the ground in Iraq and Afghanistan, and the uncertainty of when Congress will act on the remaining \$108 billion FY 2008 war request, it is currently too early to predict what the full GWOT costs will be in 2009.

Once the President has a clearer sense from his commanders in the field what resources will be necessary to fund the wars in 2009, he will provide a request to Congress.

14. Biennial budgeting. The President has once again proposed biennial budgeting. One of the claims for biennial budgeting is that it would free up time for oversight. But that only works if "off-year" submissions are limited to truly unexpected events.

- **Given that the Administration hasn't even done one-year budgeting in Defense (but has chosen to fund the war through supplementals), how can you be proposing biennial budgeting?**
- **How is the "allowance" of \$70 billion consistent with biennial budgeting?**

Most agency operating budgets remain relatively stable and controllable from year to year, and it would be reasonable to budget for two consecutive years. Biennial budgeting would not necessarily preclude changes to the second year amounts if necessary to react to changing circumstances.

There will inevitably be a need for mid-course corrections, as there is now under the annual budget process. Most of these mid-course corrections take the form of supplemental appropriations to cover unanticipated events. These will be more manageable under a biennial process.

In the case of the FY 2009 War Supplemental, \$70 billion is a reasonable assessment of what will be needed until the next Administration is in place. It is also an assumption of what is necessary at a minimum given that final action on FY 2008 funding has not been completed. In addition, War costs are not permanent and outyear costs remain difficult to predict because it is impossible to predict the situation on the ground in Afghanistan and Iraq one to two years in advance.

Congress routinely has provided multiple-year or no-year appropriations for accounts when it seemed to make sense to do so. Further, many biennial budget proposals allow for two 1-year appropriations.

Given this, what would be gained from changing the entire cycle to biennial? Wouldn't this change just lead to more supplementals?

Annual budgeting is a very inefficient process. Enormous amounts of time and energy are spent every year on setting funding levels for the next year that could be spent better focusing on program management and effectiveness issues as well as expiring authorizations. Reaching agreement on budget priorities and providing appropriations for two years would allow more time for oversight in the off year.

Two-year appropriations also would provide government agencies with more stable funding, which would facilitate longer-range planning. The effectiveness of certain Federal programs, such as defense procurement and education programs, depends on multi-year or advanced funding. Adoption of a biennial budget process would ensure this type of budget certainty for these and other programs, as agencies and recipients of Federal funding would be better able to plan their operations.

There will inevitably be a need for mid-course corrections, as there is now under the annual budget process. Most of these mid-course corrections take the form of supplemental appropriations (including cancellations) to cover unanticipated events such as emergencies and unexpected changes in operations. These will be more manageable under a biennial process. My understanding is that most agency operating budgets remain relatively stable and controllable from year to year and do not experience volatile swings.

15. **Accrual budgeting.** GAO has recommended the selective use of accrual measurement in the budget in areas where it would enhance obligation-based control such as federal employee pensions, retiree health, and federal insurance programs.

▪ **What are your thoughts on the GAO recommendations?**

We understand that GAO has suggested that accrual measures may be useful supplements to the current cash- and obligations-based measures used in the budget for certain programs. Specifically, we understand that GAO has suggested that accrual budgeting may be useful for capturing the annually accruing costs of federal employee pensions and retiree health benefits, federal insurance programs, veterans compensation and environmental liabilities. We note that these accrual measures are already reported in the financial management reports, and their use in the budget process, alongside primarily cash-based measures would need to be discussed with all participants in the budget process.

▪ **How do you think we should improve budgeting for such programs so that Congress has the best available information when it makes programmatic decisions?**

We believe that the existing primarily cash-based measures used for these and other Government programs provide the best information about the timing of Government expenditures and the Government's financing needs. In addition, we believe that the existing obligations-based measures used for these and other Government programs provide the best information about the Government's binding commitments. For these reasons, we believe that the existing cash- and obligations-based measures promote transparency and accountability.

Decisionmakers also benefit from the presentation of accrual measures, such as those presented in financial management reports (e.g., the annually accruing costs for retiree health benefits for federal employees). In its 2003 Budget, the Administration proposed budgeting for retiree health benefits on an accrual basis and doing the same for those federal employee pensions not already on a full accrual basis. This proposal was intended to improve transparency and efficiency by encouraging agencies to make better-informed decisions about allocating resources across programs. However, it was rejected by the Congress.

16. COO/CMO. Recently GAO recommended that the Director of OMB work with the President's Management Council to use criteria GAO identified for determining the type of Chief Operating Officer/Chief Management Officer (COO/CMO) positions that ought to be established in the federal agencies that are members of the council and once the types of COO/CMOs have been determined, use the key strategies GAO identified in implementing these positions.

▪ **What efforts have you undertaken to implement GAO's recommendations?**

Agencies are required to appoint Chief Operating Officers with responsibility for overall agency performance and management. These officials make up the President's Management Council. To support their efforts to address many of the criteria identified in the GAO report, President Bush issued an Executive Order that formalizes the commitment of the Government to spend the taxpayers' money wisely and more effectively every year. The Executive Order ensures agency and program performance is transparent so that taxpayers have the critical information needed to hold Government accountable.

The Executive Order also requires each agency head to appoint a Performance Improvement Officer (PIO) to coordinate management improvement activities of the agency and employ all of the strategies GAO identified to improve the performance of their agency. It also established the Performance Improvement Council (PIC) to facilitate the exchange of best management practices among agencies. Many of the PIO responsibilities are similar to those a CMO would have within an agency, including leading the Department's efforts to respond to GAO high risk items.

17. Printing of the budget. For the first time, OMB did not provide to Congress printed copies of the President's FY 2009 budget request. Instead, OMB made an electronic copy available, claimed \$200,000 in "savings", and asserted that it was being "environmentally friendly" by not printing the budget. However, many in Congress objected because OMB was not providing Congress what it needed to do its job with respect to evaluating the President's budget. Committees and Members' offices rely on the printed budget as one of many tools available to analyze the President's request, and GPO incurred the expense of providing copies to congressional offices. OMB's decision appeared to be an issue of shifting costs to the Legislative Branch from the Executive Branch.

If the Administration wants Congress to give due consideration to the President's priorities, why would you take away one of the tools Congress needs?

The Administration, through the E-Budget, provided the Congress with an easy-to-use, downloadable, and searchable set of electronic documents that permits Members of Congress, their staff, and members of the press and public to more quickly locate the exact information they seek and more easily work with the data they contain. We hope that these features permit Congress to give even better consideration to the President's proposals.

- **As the primary audience for the President's budget proposals, why was Congress not consulted before this decision was made?**

The Budget and Appropriations Committees were notified nearly a month before the President's E-Budget was posted. GPO was provided all materials to print the Budget in a timely fashion so that Congress and the public could order printed copies if they preferred that format.

OMB's request for its own FY 2009 budget shows a \$200,000 savings in FY 2009 compared to FY 2008 due to not having to print a budget.

- **OMB didn't print the budget in 2008, so how can OMB's budget be showing savings between FY 2008 and FY 2009?**

Due to contractual arrangements made last fall with the Government Printing Office (GPO), OMB spent approximately \$100,000 of the budgeted amount towards GPO's printing costs. The remaining \$100,000 was used to help offset the increased cost of the January 2008 pay adjustment.

18. Inherently governmental functions. What considerations go into determining whether an activity is an "inherently governmental function" when reviewing whether that activity could be performed by contractors?

The Federal Activities Inventory Reform (FAIR) Act defines an inherently governmental activity as one that is so intimately related to the public interest as to require performance by federal government employees. Determining whether a particular function is an inherently governmental function depends upon an analysis of the totality of the circumstances. Circular A-76 provides a set of considerations to help avoid transferring inherently governmental authority to a contractor, including the degree to which official discretion is or would be limited if work is performed by the private sector. In addition, the Federal Acquisition Regulation provides a list of examples of functions

considered to be inherently governmental. These include activities that involve the determination of agency policy, federal program priorities, the award of contracts, and the direction of federal employees.

Pursuant to the FAIR Act and Circular A-76, agencies prepare inventories of their inherently governmental and commercial activities. OMB reviews agency inventories prior to their publication. However, all final determinations regarding the classification of activities as either inherently governmental or commercial are made by the agency.

19. Contractor workforce ethics. Mr. Nussle, during the hearing I asked about situations where contractor employees and Federal employees work side-by-side, and the contract employees are covered by different ethics rules, or perhaps no rules at all, depending on the situation. While I am not claiming knowledge of specific ethical violations, I am concerned about the potential problems that this situation creates. Here are some examples to illustrate my point:

- Financial conflicts of interest – an agency may hire a contract consultant to review program integrity and may not be aware that the consultant has a financial interest in the contractor that is subject to the review.
- Impartiality – a contractor employee who is responsible for providing recommendations on new contracts recommends a company owned by relatives.
- Misuse of information – a contractor employee who has inside knowledge of the draft acquisition strategy for a program leaks that information to a potential bidder; since the acquisition strategy discussion was only preliminary, the contract employee's actions may not be covered by the Procurement Integrity Act.
- Misuse of authority – a contractor employee implies that he or she is a government employee in order to obtain information for personal benefit.
- Misuse of government property – a contractor employee uses government computers and copy machines to support his or her business.

In each of these examples, existing statutory or regulatory provisions cover similar actions by Federal employees. Many of these laws and regulations do not cover contractor employees, and there is no guarantee that a contracting company has comparable ethics rules, or that it enforces those rules, for its employees.

- **You stated at the hearing that you would be happy to work with me and investigate my concern. Could you comment on whether you agree this is a concern, and, if so, what steps OMB will take to address the concern?**

As we increasingly rely upon contractors to bring expertise and innovation to help agencies accomplish their missions, we need to guard against contractor conflicts of interest and ethical violations that could deprive the government of receiving the best advice, information, or services. OMB is working closely with procuring agencies, the Justice Department, and the Office of Government Ethics to develop and implement rules that will accomplish this objective. Last November, the Federal Acquisition Regulatory Council (FAR Council), which is chaired by OMB's Office of Federal Procurement Policy, published an amendment to the Federal Acquisition Regulation (FAR) that, among other things, requires contractors to have a code of ethics and to encourage employee reporting of improper conduct. In addition, the FAR Council is currently considering proposed regulations that would, among other things, require contractors to disclose violations of criminal law in connection with the award or performance of a government contract or subcontract and establish internal controls and training requirements to ensure effective implementation of contractor ethics codes and cooperation with federal officials.

Chairman Serrano submits the following question on behalf of Mr. Mollohan:

20. Decennial Census. The Appropriations Committee has been informed by the Commerce Department that there are serious problems with the 2010 Decennial Census, especially with respect to the handheld contract (Field Data Collection Automation or FDCA). The handhelds will not be ready for dress rehearsal, and may not be fully functional for the Decennial Census itself. It is expected that significant additional funding will be required to enhance functionality of the handhelds, or, in a worse case scenario, allow the Census bureau to resort to paper for the Non-response follow up (NRFU).

During the week of February 25th, the Committee heard from the Department of Commerce's Inspector General and GAO that the costs of the 2010 Decennial Census have increased exponentially, and could be as much as 20 percent of the lifecycle costs—currently estimated to be \$11.5 billion. On March 5th, GAO put the 2010 Decennial Census on its High-Risk list.

- **Do you believe the situation with the 2010 Decennial Census is critical?**
 - **If not, why not?**

It is clear that the 2010 Decennial Census program has entered a critical period and that the Census Bureau needs to make important decisions about the operational plans for the upcoming census. Part of the plan for the 2010 Census was to automate the large field

operations (Address Canvassing and Non-Response Follow Up) through the use of handheld computers, which would allow the Census Bureau to realize efficiency gains. In May 2006, the Census Bureau awarded the Field Data Collection Automation (FDCA) contract to the Harris Corporation to accomplish these goals.

However, based on experiences to-date in the Dress Rehearsal, Government Accountability Office and Commerce Inspector General reviews, and internal Census Bureau assessments, concerns have grown about the ability to timely implement the FDCA systems with the needed functionality. This schedule concern has been compounded by the Census Bureau only very recently providing final requirements to Harris.

Therefore, the Commerce Department created a task force chaired by a former acting Census Director to evaluate alternatives to the FDCA contract "baseline", including significantly descoping elements of the original plan. Recommendations of the task force as well as of an independent panel of experts will be considered by the Secretary of Commerce, who I anticipate will make decisions as quickly as possible in order for the Census Bureau to be adequately prepared for nationwide operations beginning in 2009.

- **Given the constitutionally mandated date for the Decennial, will the Commerce Department be requesting supplemental funding for FY 2008?**
 - **If not, why not? OR How much will the Department request?**

I do not know whether the Commerce Department will request supplemental funding for FY 2008. Changes to the 2010 lifecycle cost by fiscal year will be driven by the programmatic and operational decisions currently being determined by the Census Bureau. Since options are still being assessed, detailed fiscal year cost implications are not yet available.

- **Will the Commerce Department be requesting additional funding for FY 2009?**
 - **If not, why not? OR How much will the Department request?**
 - **Has OMB placed a gag order on the Department of Commerce to discuss the fiscal requirements for a FY 2008 supplemental and additional FY 2009 appropriations request?**

I do not know whether the Commerce Department will request additional funding for FY 2009. Changes in funding requirements by fiscal year will be determined through the task force and expert panel processes, which are currently on-going.

OMB has not placed a gag order on the Department of Commerce. In reality, cost-driving decisions have not been made, and no solid cost estimates for various options are available, nor have even the preliminary option estimates been carefully evaluated by the Department or OMB.

Last fall, OMB failed to allow Commerce to request an anomaly in the Continuing Resolution, thus in large part precipitating the present crisis.

- **Since the current Administration will not be in office when the 2010 Decennial Census is conducted, perhaps it is OMB's intent to allow it to fail?**

The Administration is committed to conducting a successful, accurate, and cost-effective Decennial Census.

Chairman Serrano submits the following two questions on behalf of Mr. Olver:

21. Highway Trust Fund Borrowing Authority. In this budget, the President is requesting temporary authority to allow the Highway Account of the Highway Trust Fund to borrow money from the Mass Transit Account if there is insufficient cash available in the Highway Account to pay the bills of the highway program.

Based on the Administration's projections, the Highway Account would drop to roughly a negative \$3 billion balance at the end of FY 2009, while the Mass Transit Account would maintain a positive balance of about \$4 billion.

If funds were drawn from the Mass Transit Account in order to keep the Highway Account from falling below zero, based on these projections, the Mass Transit Account would be left with only about \$1 billion.

In last year's testimony before this Committee, Administration officials stated that \$1 billion was roughly within the margin of error of these projections because economic conditions, driving habits, and other factors can change over time. This means that, if we were to grant the Administration this borrowing authority, we could run the risk of depleting both the Highway Account and the Mass Transit Account before the end of FY 2009. This puts both the highway and transit programs in jeopardy.

Why is the Administration willing to gamble with the solvency of the Mass Transit Account in this manner?

The Administration's proposal to allow the Highway Account to borrow from the Transit Account explicitly contemplates the variability in Highway Trust Fund receipts and outlays. Specifically, the proposed language would only enable borrowing if the

Secretary of the Treasury (after consultation with the Secretary of Transportation) determined that such a transfer was necessary. Based on OMB's projections (as well as CBO's), the proposal would provide enough flexibility to ensure the solvency of both the Highway and Transit Accounts. More broadly, since this funding is derived from the same source, the transfer proposal is a practical way to address the issue through FY 2009.

Even if, by some miracle, there is some money left in these two accounts at the end of FY 2009, it will be minimal at best. Given that these two programs combined are funded at roughly \$50 billion a year, what is the Administration's plan for FY 2010 once the Highway Trust Fund is completely depleted?

As the Secretary has testified, the Administration believes that there are serious deficiencies with the current framework to finance Federal surface transportation spending. Spending is not directed to clear, national-level priorities and is not driven by performance. Revenues do not encourage efficient allocation of resources or deliver transparent benefits to the users of chronically congested roads. Overall, the Administration believes that the exhaustion of the Highway Trust Fund is a wake-up call to re-examine both the appropriate level of Federal spending for surface transportation, as well as pricing mechanisms that could raise additional revenue and enhance the system's efficiency.

22. Highway Program at Zero. The Federal-aid highway program is a reimbursable program, meaning that States incur obligations, begin projects, and are then later reimbursed for eligible costs incurred.

Given that OMB's projections show the Highway Account plummeting to negative \$3 billion by the end of FY 2009, which is less than 19 months from now, could you please explain to us how you plan to administer the highway program once the Highway Account hits zero? How do you plan to reimburse States for the bills they have already paid when there is no money left in the Highway Account?

The Administration has submitted a proposal to avoid insolvency in FY 2009.

Questions for the Record from Mr. Regula

Administration Earmarks

The fiscal year 2009 budget request for the Office of National Drug Control Policy, an agency within the Executive Office of President, includes many Administration earmarks for local law enforcement task forces and at least one non-profit. For example, the request proposes \$6.6 million for the Chicago High Intensity Drug Trafficking Area, \$1.75 million for the Lake County High Intensity Drug Trafficking Area, and \$7.3 million for the US Anti-Doping Agency, a non-profit located in Colorado. I think we all agree that the Federal government should be combating drug trafficking and abuse. Can you describe the process used by the Administration to earmark funding for these particular organizations?

The process used to provide a funding request for these entities are as follows:

Section 301 of the ONDCP Reauthorization Act of 2006, P.L. 106-469, continues the establishment of the High Intensity Drug Trafficking Areas (HIDTA). Specifically, Section 707 (i) states that within the "annual budget request for the Office, the Director shall submit to Congress a budget justification that includes - (1) the amount proposed for each high intensity drug trafficking area, conditional upon a review by the Office of the request submitted by the HIDTA and the performance of the HIDTA, with supporting narrative descriptions and rationale for each request." Therefore, included in the FY 2009 ONDCP Congressional Budget Submission is a request for each of the 28 HIDTA's, not only the Lake County HIDTA and the Chicago HIDTA.

Section 701 of the ONDCP Reauthorization Act of 2006 designates the United States Anti-Doping Agency (USADA) to serve as the independent anti-doping organization for amateur athletic competitions recognized by the United States Olympic Committee. Congress, in sections 702 and 703 of the Act, authorized funding for USADA and required the organization to maintain complete records of its federal funding and provide Congress with an annual report describing its activities. Historically, funds to support USADA have been included in ONDCP's annual appropriation. The FY 2009 ONDCP Congressional Budget requests funding to support USADA's authorized anti-doping mission. The Administration believes that USADA's efforts are consistent and complimentary to ONDCP's efforts to combat drug use in sport. ONDCP intends to provide USADA its federal funding in the form of a grant to ensure fiscal and administrative oversight and accountability.

If funded, should these earmarks count against the President's suggestion that earmarks

be reduced by 50 percent?

The funding proposals cited are not earmarks.

Regulatory Good Guidance

Last year, there was an amendment to the bill prohibiting the use of funds to implement an Executive Order providing agencies with direction on the development of regulatory guidance. The Administration issued a veto threat concerning this amendment. Can you describe how Executive Order 13422 impacts the regulatory process and why the Administration objected so strongly to this funding prohibition?

Executive Order 13422 supplemented the existing framework for coordination of regulatory activity that was established by President Clinton in 1993 through Executive Order 12866, and which has remained in effect throughout the current Administration. Executive Order 12866, "Regulatory Planning and Review," directs the process within the Executive Branch for centralized review of agencies' significant regulations. Most importantly, EO 13422 (in conjunction with OMB's Good Guidance Practices Bulletin issued on the same day) confirms the process within the Executive Branch for centralized review of agencies' significant guidance documents. The good government purpose of this amendment to the EO (and of the Good Guidance Practices Bulletin) is to improve the way that the Federal government does business by increasing the quality, public participation, and accountability of agency guidance documents and their development and use. EO 13422 also institutionalized informal processes and added additional transparency and clarity to EO 12866's requirements. For example, EO 13422 memorialized the practice of utilizing a Presidential appointee from an agency (someone accountable to the head of the agency and to Congress) as its Regulatory Policy Officer. Likewise, EO 13422 updated and clarified the "market failure" language contained in EO 12866 to reflect OMB guidance that was issued after 1993.

The Administration issued a Senior Advisors veto threat because the amendment to HR 2829, involving a matter directly affecting the operation of the Office of Management and Budget, would inappropriately intrude into the President's management of the Executive Branch, unnecessarily weaken a process that has worked well since 1993, and deprive the public of the benefits of a more transparent and consistent approach regarding the issuance of agency guidance documents to regulated parties and the public.

It is worth noting that the American Bar Association's Section of Administrative Law and Regulatory Practice sent letters to Congress expressing support for the guidance document provisions of EO 13422 (and the Good Guidance Practices Bulletin) and urging them to oppose HR 2829. Additionally, a coalition of more than 60 associations also wrote to Congress strongly urging similar strong opposition to this provision in HR 2829.

Contracting Out Federal Jobs

There has been much criticism of the Administration's Competitive Sourcing initiative where Federal employees and contractors compete to perform specific activities in order to improve the operations of the Federal government. The Administration has stated that these competitions have saved an estimated \$7 billion, and I understand that Federal employees win about 80 percent of the competitions.

- Is this accurate? Has the program improved the operations of the Federal government and saved billions of taxpayer dollars?

The reasoned and strategic application of competition is helping agencies achieve greater efficiencies and better performance. Competitions completed between FYs 2003-2007 are projected to save \$7 billion over the next 5-7 years. Total accrued actual savings to date are over \$1.5 billion. Federal employees have been selected to perform approximately 80 percent of the work competed. Savings and performance improvements are being accomplished in a variety of ways, including through the adoption of new technologies, leveraged purchasing, consolidation of operations, and restructured contract support. By reducing the cost of commercial support services, agencies have more resources to spend directly on their missions.

Information Technology

The Federal budget includes \$71 billion for information technology. Information technology is an integral tool for almost all the Federal government's activities. Yet, historically the Federal government continues to have difficulty developing new complex information technology projects such as IRS's Business System Modernization program, the FBI's case management system, the National Archives' Electronic Records Archive, and the Census Bureau's failures to develop a handheld computer device for enumerators to use for the 2010 census.

- Why do Federal IT development projects continue to fail?

A disciplined approach to management is integral to the success of Federal IT projects including a clear definition of success for the project. To foster such success, OMB has instituted a number of policies requiring agencies to:

- *Implement earned value management to measure cost, schedule and performance;*
- *Maintain strong capital planning and investment controls;*
- *Have qualified project managers (as defined by Federal CIO Council) for all projects;*

- Define and utilize performance metrics to measure progress and results; and
- Develop enterprise architecture insuring maximum interoperability and alignment with agency and mission goals.

Where agencies do not consistently apply these policies, the risk of failure is increased. While risk can be reduced, it can never be truly eliminated. To better manage risks we utilize the Management Watch List to identify investments which appear to be not well planned and/or the High Risk Project List for IT projects requiring additional oversight.

- What more can OMB do to ensure that every agency considering the development of new complex information technology systems has people with the necessary technology, program management, and contract management expertise in place before proceeding?

Skilled personnel are essential to any IT project. While ultimately it is the responsibility of the agency to ensure they have adequate personnel for their IT projects, we have instituted a number of government wide efforts.

The bi-annual Human Capital Workforce Survey conducted by the Office of Personnel Management (OPM) allowed agencies to identify competency and skill gaps, training needs, and effects of retirement on their individual workforces. To address identified issues, agencies have implementation plans in place developed in conjunction with their Chief Information Officer (CIO) and Chief Human Capital Officer to close identified gaps in their workforce. The CIO Council through the IT Workforce Committee has targeted recruitment in mission critical areas, and work structure improvement methodologies to facilitate sharing of best practices among the agencies.

With regards to IT project managers, OMB requests that agencies identify their project manager qualification status on their Exhibit 53 submissions. Furthermore, project managers of major IT investments are required to have sufficient status under the Federal Acquisition Certification for Program and Project Managers as identified by the Office of Federal Procurement Policy memorandum (from January 20, 2006).

**Rep. Peter Visclosky's Questions for the Record for OMB Director Jim Nussle
Hearing of the Subcommittee on Financial Services and General Government
March 6, 2008**

Increase in Chicago HIDTA's funding

In their FY 2009 budget, ONDCP proposed an increase in the Chicago HIDTA's budget due to a "threat that continues to exist on a large scale as it moves from the Chicago urban areas to the outlying suburbs." Lake County Indiana is contiguous to Chicago and would logically be affected by this "large scale" threat moving to the city's outlying areas.

- **Why then does ONDCP recommend a 40% in the Lake County HIDTA's budget, while increasing funding to the Chicago HIDTA by 20%? Doesn't this reduction run contrary to the reasons ONDCP cites for increasing the funding to the Chicago HIDTA?**

The Chicago Metropolitan area is experiencing an increase in the importation of illegal drugs and the ensuing violence and drug gang related activities. As a result of law enforcement activities, including those led by Chicago HIDTA initiatives, some of the threat has been pushed to outlying suburbs. ONDCP indicates that most information shows that this movement is to the west of Chicago, and not into the area encompassed by the Lake County HIDTA. If the drug trafficking situation in Chicago can be minimized, there will be a positive impact on many other parts of the United States.

Increase in Homicides

In 2007, homicides increased by over 30% in Lake County, Indiana, reaching their highest level since 2000. In the county's largest city, Gary, there were 71 homicides in 2007, compared to 55 in 2006. This 40% increase in homicides has resulted in Gary having the unfortunate moniker of the "Murder Capital" of the United States for 2007.

- **Given this increase in homicides, how can ONDCP argue that there is a "diminished treat when compared to other areas of the country?" Are murders not part of ONDCP's threat assessment?**

In the Lake County HIDTA, the FBI-led Gang Response Investigative Team (GRIT) Initiative has been funded to address drug-related violence such as murder and other violent crime. As I understand it, in its funding recommendation for the Lake County HIDTA, ONDCP does not intend to eliminate this initiative.

Further, within the 2009 Budget for the Department of Justice, the Administration has proposed a new competitive grant program, the Violent Crime Reduction Partnership (VCRP) Initiative, which will help State and local law enforcement agencies form multi-jurisdictional partnerships with Federal law enforcement agencies to tackle the most serious crime issues in their areas. This new program, funded at \$200 million, focuses on building and supporting multi-jurisdictional partnerships to prevent and, where

necessary, investigate and prosecute particular types of crime where they are becoming too great a challenge for local law enforcement to handle alone.

Lake County HIDTA's 2007 Improvements

At the urging of ONDCP, in 2007, the law enforcement community of Lake County made dramatic changes to the structure of the Lake County HIDTA to increase its effectiveness. This transition is still ongoing. I have supported ONDCP in these efforts and think the changes have already led to a more efficient organization. However, what I don't understand is how ONDCP, less than 1 year after they first approached my office to alert me of the need for improvements to the HIDTA, is recommending a 40% budget cut.

- **Why did ONDCP push for these changes and then not even give them the chance to take effect?**

In its oversight and coordination role for the High Intensity Drug Trafficking Areas (HIDTA) program, ONDCP expects all HIDTAs to be operating efficiently and effectively. As I understand it, ONDCP is encouraged with some improvements that have occurred within the Lake County HIDTA and continues to work closely with the HIDTA's Executive Board. Nonetheless, in preparation for ONDCP's FY 2009 Congressional Budget Submission, ONDCP considered many factors, including performance and threat information (pursuant to Section 707(i) of The ONDCP Reauthorization Act of 2006), in recommending allocations for each of the HIDTAs. Based on this information, ONDCP determined that the Lake County HIDTA proposed funding should be reduced.

Corps of Engineers

1. OMB has declared each project in the fiscal year 2008 Corps of Engineers Operation and Maintenance account a congressional earmark. Yet, OMB's own backup for the Operation and Maintenance account shows only 138 projects for \$119 million, while the summary sheet for the Corps lists 844 earmarks for a total of \$2,157 million. For the record, provide an explanation of this explain the discrepancy between your documents.

The correct number and dollar amount of earmarks for the Corps of Engineers Operations and Maintenance account is 844, for a total of \$2,157 million, as posted on the Earmarks website (earmarks.gov).

2. The approach proposed by the Administration for the Corps O&M account is simply a project-by-project budget which has been regionally aggregated to give the appearance of a regional or systems-level approach, primarily to avoid congressional reprogramming limits and any comparison to past appropriations.

Congress offered to consider the regional approach once the Corps actually proved that it was budgeting on the basis of systems-level and directed the Corps in the FY2008 omnibus bill to prepare systemized budget for four regions to support a regional approach to Operation and Maintenance, what is the status of this effort?

The Corps of Engineers Civil works budgets for Fiscal Years 2007 and 2008 proposed funding allocations for Operations and Maintenance on a regional basis, with both budgets allocating funding by 21 watersheds as delineated by the U.S. Geological Survey's watershed and sub-watershed identification system. The FY 2009 Budget uses a similar approach, but allocates funds among 54 areas based on sub-watersheds. We believe these allocations are consistent with the intent of the FY 2008 Omnibus Bill that the Corps prepare a systemized budget that supports a regional approach to its Operation and Maintenance program. In fact, the regions identified by the Congress in the Omnibus are already incorporated into the Corps O&M program and sub-watershed approach.

Using this framework will increase the efficiency of the Corps' O&M activities. Managers in the field will be better able to allocate funds to adapt to uncertainties and to address emergencies, as well as other changed conditions over the course of the year.

3. The Corps of Engineers has included a new category in the budget request – project completions. This category includes the Columbia River Channel Deepening project, at a request of \$36 million. Given that there are out-year monitoring costs and a potential additional scope of \$25 million for blasting of rock that are not included this request does not appear to be a completion.

- ⇒ Please explain the rationale the Administration used to include this project.
- ⇒ What is the schedule for determining if the additional \$25 million is necessary?
- ⇒ What are the total project costs for the out-years, assuming a \$36 million appropriation for fiscal year 2009?

This Administration's budgets for the Army Corps have Engineers have consistently focused available funding on completing construction of those projects within the Corps main missions that are already underway in order to realize the benefits of those projects. The Administration also specifically cites "Project Completions" as a key allocation criterion in the FY 2007 Budget.

The FY 2009 Budget was developed based on the information available at that time, which indicated that construction could be completed with the \$36 million provided in the 2009 Budget, although the Corps had studies underway to determine whether additional rock blasting might be required. The Corps expects lab results from rock sampling to be available by the end of May. These results will be coordinated with the blasting expert that is on contract and a final determination of its impact on the project will be made by June of this year.

The intent of the "Project Completion" guideline is to realize the project's intended benefits as soon as possible. For the Columbia River project, these benefits can be realized while the Corps undertakes its outyear monitoring efforts. Outyear monitoring costs are estimated to be \$4 million. At this point, the Corps does not know whether there will be any additional costs associated with rock removal.

Question for the Record for Director Nussle submitted by Congressman Maurice Hinchey:

A proposed rule by the USDA, which has been held up by the Office of Management and Budget for (OMB) two years, would allow the public release of the names of retailers who have received and potentially sold recalled meat products.

Your office has required that the USDA continue to consider the information as "proprietary." Today, after questioning both Dr. Raymond of FSIS, and yourself on the subject, it is more clear than ever that your office is dragging its feet at the detriment to the American public. I believe that this is just another example of the White House, and your office in particular, stonewalling Congress.

During our conversation at the hearing, you responded that you would look into this matter.

Specifically, why has OMB not allowed the USDA to move forward with a rule that will drastically improve the safety of the American public by providing information as to what meat is dangerous for consumption and where that meat is sold?

What are the specific reasons for delay and why have these impediments been allowed to stand for two years when the health of every American family and their children is at risk without the information this rule would assist in providing?

In response to both questions, USDA issued a proposed rule on March 3, 2006. The comment period for the rule closed on June 11, 2006. USDA has been working on the rule. After working on the rule for 19 months, USDA recently began discussions with us on this final rule. USDA has not submitted a draft final rule to OMB in accordance with E.O. 12866. We cannot begin formal review until USDA submits their draft. If you have any questions, please contact USDA.

Do you believe that if this rule was implemented that it would negatively affect businesses?

If so, do you believe that this impact is more important than protecting American consumers from eating and serving meat that has been recalled because it is unfit for consumption?

As noted above, USDA has not submitted a draft final rule to OMB. Because this is a deliberative process, we are not able to respond further to these questions.

Question from Mr. Hinchey: Are private contractors providing security functions at West Point and other military installations? If so, why? Are the contractors performing inherently governmental functions?

My staff has followed up with the Army and understands the following: Contract security

guards are used at West Point and other Army installations to perform a limited set of security-related activities, primarily screening and checking identifications at access control points. These contracts have been entered into to provide increased performance of security at military installations in response to 9/11, consistent with express authority provided by section 332 of the National Defense Authorization Act (NDAA) for FY 2003 and subsequent amendments to this section.

Security guard contracts are overseen by several layers of federal employees and held to the same training standards as federal personnel performing these functions. Contractors perform no inherently governmental activities. Their activities and discretion are limited by Army policy, the contract terms, and any additional guidelines established by the Installation Commander. They have no arrest authority and do not exercise control over, or otherwise direct, federal employees. Overall management responsibilities for installation security remain with the Installation Commander, military law enforcement personnel, and Army civilian police.

TUESDAY, APRIL 15, 2008.

INTERNAL REVENUE SERVICE

WITNESSES

DOUGLAS SHULMAN, COMMISSIONER OF INTERNAL REVENUE
LINDA STIFF, DEPUTY COMMISSIONER FOR SERVICES AND ENFORCE-
MENT

CHAIRMAN SERRANO'S OPENING STATEMENT

Mr. SERRANO. Good morning to all.

For those who may wonder, although there shouldn't be anyone who wonders, the 42 in front of my nameplate is a tribute to number 42 for the Brooklyn Dodgers, Jackie Robinson. Today is Jackie Robinson Day throughout baseball. It is the day when all baseball players are being asked to wear 42, or at least a couple of members on each team.

Of course, my beloved Yankees have the only person grandfathered with 42, Mariano Rivera. As soon as he retires, that number will not be used any longer.

And it is just a small way for me to pay tribute to a person who not just integrated baseball, but in my opinion, he integrated our country. I don't think our country has been the same since that 1947 season, and it has been for the good.

And just an aside, Mr. Regula. We claimed that we work a lot of times under pressure, and we do. I can't imagine what it must have been like to play that first season under that pressure and still perform at Rookie of the Year quality. This is a special person.

The National Archives, one of the agencies in our portfolio of agencies, just published a document about Lieutenant Jackie Robinson and his refusal to sit in the wrong bus as an officer of the military. There was a bus for African American soldiers, there was a bus for white soldiers, and there was a bus for officers. So he went into the officers' bus, and he was sent into the bus for African American soldiers. And he said, "I am an officer, and officers go in that bus." He was court-martialed. They didn't get too far with it, but it just shows you, especially if you are younger than some of us on this panel, what an incredible person that he was. And so today we honor, at least this Chairman, and I know this committee joins me, in honoring number 42.

We would like to welcome our guests today.

The subcommittee will now come to order.

And today is April 15th, not only the day when we honor Jackie Robinson but it is also the day when we pay our taxes. And I hope everybody did. I filed, e-filed, and my 22-cent return came back immediately.

It is fitting that the subcommittee is meeting today to hear testimony from the Internal Revenue Service on its budget request for

fiscal year 2009. As the largest component of the Financial Services and General Government Appropriations bill, comprising more than half the total amount of funds provided by our subcommittee in fiscal year 2008, the IRS is clearly a major focus of our work.

In addition, as the collector of approximately \$2.4 trillion in Federal revenue each year and as an employer of more than 100,000 people, the IRS is an important presence in the Federal Government.

The IRS plays a very public role as a representative of our Federal Government in the lives of most Americans. In many cases, it is one of the few contacts many Americans have with the Federal Government. It is up to all of us to ensure that the IRS is able to perform its functions in a fair, competent manner and to ensure that the IRS has the resources to do so.

Today the IRS is involved in numerous activities, including explaining tax law, answering taxpayers' questions, assisting with tax return preparation, processing returns, conducting criminal investigations and much more. At the same time, the IRS is working to improve its business processes and computer systems through the multiyear business systems modernization program.

Currently the IRS is playing a vital role in helping to implement the Economic Stimulus Act of 2008 and the rebate program, in addition to processing nearly 140 million individual tax returns.

We look forward today to discussing some of the issues facing the IRS.

In the area of taxpayer service, the IRS is in the midst of implementing the Taxpayer Assistance Blueprint, a 5-year plan for improving IRS taxpayer services. At the same time, however, I am concerned that the IRS budget request freezes funding for taxpayer services at last year's level, even as funding for tax enforcement is proposed for a 7 percent increase. I look forward to discussing the IRS budget request today.

Another major concern is the ongoing private debt collection program at the IRS. If you hear any hissing in the background, it is not by any Members of Congress; it is just the general feeling. I continue to oppose the private debt collection program, as many other people do. The program allows private companies to collect unpaid taxes and to pocket up to 24 percent of the tax revenue they help collect.

This issue was raised at the Commissioner's Senate confirmation hearing as well as at this subcommittee's recent hearing with Secretary Paulson. And I look forward to discussing the issue again today, as well. It is my hope that although he has just begun in his new position, the new Commissioner will have come to the same conclusion as many in Congress—that this program should not be continued.

On March 13th, Douglas Shulman was confirmed by the United States Senate to be the 47th Commissioner of Internal Revenue.

We thank you for your service. We thank you for joining us today. We thank you for accepting this important position in our Government, this 5-year appointment.

And we look forward to your testimony. We remind you that your testimony should be held to 5 minutes. Your full statement will go

in the record, and then we will have a chance, as taxpayers, to get even with you on this special day.

And now a man who has always paid his taxes on time—in fact, he asks the Government to take more, just to be a great American—there he is, Mr. Regula.

MR. REGULA'S OPENING STATEMENT

Mr. REGULA. I think I saw somewhere that there is a proposal for legislation that would allow those who feel that taxes aren't high enough to add an additional amount to the taxes they pay. I believe that is a legislative proposal floating around here somewhere along those lines.

Mr. SERRANO. Well, I send an extra bunch of money to New York every month, but that is because they don't take out city taxes.

Mr. REGULA. Right.

Well, you covered this topic pretty well. I think what the taxpayers really want is to feel a sense that everyone is paying their fair share. They understand that you need taxes to operate Government, but when they read in the paper that \$300-plus billion are not collected that should be, that is always a little bit distressing to the average taxpayer, because he or she thinks, "Well, I am paying my fair share and filing a return. Why doesn't everybody else have to?"

And I just saw an article—I think it was in Time or Newsweek, one of them—where a number of corporations aren't paying all the taxes they owe. And those are the kinds of things that distress the public.

And I see that, in our budget, we have an additional \$358 million to enhance your collection procedures. And I hope that in your role as the Commissioner that you do push hard to ensure that we have fair and adequate enforcement of the tax laws so that everybody is paying their fair share.

One other comment. I think you have done a remarkable job of adapting to Congress's constant changes of the tax law. And this year, particularly with the requirement for the extra funding for citizens and also the changes in the AMT, that you have had challenges in getting forms out. I am sure this was quite a difficult problem, to get everything out on time for taxpayers who wanted to file and were required to file. So we will be as supportive as possible of programs that ensure fairness and ensure prompt information to the taxpayers so they can make the right decisions in filing their own tax returns.

And it has to be a challenging assignment, to say the least, because going back to biblical times, tax collectors were not the most popular people in town, when you read about their role in ancient history. And so we wish you well in your new assignment.

Mr. SHULMAN. Thank you.

Mr. SERRANO. Thank you, Mr. Regula.

You know, Mr. Regula and I were discussing the other day—of course, he is leaving Congress, much to the loss of the Nation. He is leaving Congress, but next year at this time, what do we do about hearings and about conversations with a new President, new administration and a lot of new folks that, at this point next year, may not even know what their budgets should be like, you know.

And we just had a comment from Mr. Nussle, where he said they would not prepare a budget.

And yet you are one of the few—you, I believe the Archivist and just a couple of other people—in the Government who don't have to leave. And so we hope to establish a relationship with you that will carry over to the next administration at the White House.

So we welcome you once again, and we welcome your testimony.

COMMISSIONER SHULMAN'S TESTIMONY

Mr. SHULMAN. Thank you, Chairman Serrano and Ranking Member Regula, and thank you to all the members of the subcommittee for having me be here today.

I have been Commissioner for 3 weeks, as you said. And I would like to reiterate to all the members what I have assured the Chairman and Ranking Member in private conversations: that I look forward to working with this Subcommittee for the years to come, and to address all the critical issues facing the IRS.

I would also like to introduce the two Deputy Commissioners of the IRS, Richard Spires and Linda Stiff, and really commend them for doing an excellent job running the agency for the last 6 months while I was going through the confirmation process—Linda, as Acting Commissioner; Richard, as Deputy. They helped guide the agency through a difficult filing season and the stimulus payment process, which is ongoing.

This morning what I would like to do is touch on the filing season, stimulus payments and the 2009 budget, take a minute or two to discuss a few important issues to me as IRS Commissioner, and then I'd be happy to take your questions.

We are completing what, by all measures, looks like a successful filing season. I have some statistics from April 5th that I would like to share with you.

One is the substantial increase in the number of electronic filers, a substantial—up 10 percent from a year ago. Mr. Chairman, I was heartened to hear that you are an electronic filer. And I know, Mr. Regula, you prepare your own taxes.

The number of returns prepared by volunteers through our VITA program and tax-counseling-for-the-elderly program is up 26 percent year-to-date. Our usage of the Free File program, which allows 70 percent of Americans to prepare and file their returns electronically, is up almost 20 percent. And the IRS Web site, which is really designed to give assistance to taxpayers, has seen the usage increase 21 percent.

We are also having what looks like a successful filing season, despite the late enactment of the AMT patch and the fact that we have been simultaneously preparing to send out economic stimulus payments to millions of Americans.

Regarding economic stimulus, we conducted extensive outreach to make sure that the American public understands this program. And we have put special emphasis on the group of Americans who normally wouldn't have to file their tax returns, but need to file a tax return this year to get the stimulus payment. That group includes people on Social Security, people getting veterans benefits, low-income workers.

I also want to urge this subcommittee to support full funding of the IRS's proposed 2009 budget. The budget will allow us to continue our strong focus on both taxpayer service and enforcement.

During my confirmation process, I was asked the question that I think all IRS Commissioners are asked: "Are you going to focus on service or enforcement?" What I told the Senate Finance Committee and what I tell you is I actually believe this is a false choice. I fervently believe that, in order for the IRS to achieve its compliance goals, it needs to focus on both.

If I state that another way, in my own language, the IRS should do everything it can to make it as seamless and easy as possible for those taxpayers who are trying to pay the right amount of taxes navigate our organization, get their questions answered, pay their taxes and get on their way.

But for those who understand their Federal tax obligations but fail to comply, we must have an aggressive enforcement program. The IRS has been very active in its compliance programs in recent years. We collected \$59 billion in additional revenue through enforcement activities last year, which is a substantial increase over the last 5 years. And that is only direct revenue attributable to specific enforcement actions, not taking into account the deterrent effect of enforcement programs.

Another area of focus during my tenure will be maximizing the effectiveness of IRS's technology and systems. The evolution of technology has profoundly altered the way that both business and Government operate. The IRS is continuing to adapt to this changing world. And our goal is pretty simple: It is to get the right information into the right hands of the right people at the right time.

My vision for modernization starts at a fundamental place, which is that the expectations of taxpayers are high and only getting higher, and we owe it to them to do everything we can to meet those expectations.

And finally, during my tenure as IRS Commissioner, we—like other Federal agencies and other private-sector industries that are facing a retiring workforce, a change in the demographics of the workforce—are going to need to continue to focus on our leadership development and our workforce. A talented, dedicated workforce will form the foundation of what we do in the future.

Thank you again, Mr. Chairman, for the opportunity to appear this morning before this Subcommittee. In my short tenure, I have found the issues complex at the IRS, but the people and the professionals who lead the IRS and work at the IRS to be professional, hard-working and dedicated.

You have my commitment to show up every day and try to provide taxpayers the high level of service that they deserve and to pursue enforcement actions against those unwilling to meet their tax obligations. Of course we need resources to execute our plan. I hope this Subcommittee will support full funding of the Administration's 2009 budget proposal.

Thanks again for having me here, and I am happy to respond to questions.

[The information follows:]

**WRITTEN TESTIMONY OF
DOUGLAS SHULMAN
COMMISSIONER OF INTERNAL REVENUE
BEFORE THE
HOUSE APPROPRIATIONS COMMITTEE
SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL
GOVERNMENT
ON
FY 2009 IRS BUDGET**

APRIL 15, 2008

Introduction

Chairman Serrano, Ranking Member Regula, and members of the Subcommittee, thank you for the opportunity to appear today. This is my second hearing as the IRS Commissioner, and I look forward to working with the Members of this Subcommittee in the future as we address issues related to the IRS.

As I settle in to my new role, it becomes clearer to me each day what a privilege it is to be the Commissioner of the IRS. The IRS and its employees represent the face of U.S. government to more American citizens than any other government agency. We administer America's tax laws and collect over 96 percent of the revenues that fund the federal government each year.

My most recent experience has been as the Vice Chairman of the Financial Industry Regulatory Authority (FINRA), formerly the NASD. In 2007, NASD consolidated with the member regulation, enforcement, and arbitration functions of the New York Stock Exchange to form FINRA. Based on my previous experience, I believe that leaders of large organizations – public and private – always must be focused on ensuring that resources are aligned with strategic priorities. It is incredibly important that there be a balance of resources between day-to-day execution and investments for the longer term. In my first four weeks, I have been working with the senior executive team of the IRS to understand how resource allocation decisions have been made. The Subcommittee can expect ongoing dialog and personal engagement from me on these issues.

2008 Filing Season

The biggest challenge the IRS faced at the end of 2007, as it approached the 2008 filing season, was the uncertain status of legislation to address the situation of an additional 21 million taxpayers who otherwise would have become subject to the alternative minimum tax (AMT).

On October 30, 2007, Chairman Rangel, Ranking Member McCrery of the House Ways and Means Committee and their counterparts on the Senate Finance Committee, sent a

letter assuring the IRS that Congress intended to enact AMT relief (the AMT patch) in a manner acceptable to the Senate, the House of Representatives, and the President. I am told that this letter was very helpful because it allowed the IRS to move forward on certain planning and design aspects of implementing the AMT relief legislation, shortening the implementation process by a number of weeks.

However, the IRS indicated at the time that its key systems could accommodate only one programming option without introducing excessive risk to the filing season. As a result, the IRS was able to proceed only so far without actual legislation being enacted. When the President signed the AMT relief law on December 26, 2007, the IRS immediately began the detailed reprogramming of systems to accommodate the new law. IRS employees worked diligently to modify systems to implement the changes in a very short time period. My thanks go out to all of those dedicated employees who worked almost around the clock to enable us to implement this AMT relief legislation in record time.

Given their efforts, we were able to begin the filing season on schedule for most taxpayers. However, the processing of returns filed by approximately 13.5 million taxpayers that included one of five forms associated with the AMT legislation was delayed. These taxpayers had to wait until February 11, 2008, before their returns could be processed.

The other challenge facing us this filing season is the implementation of the economic stimulus package enacted in early February, specifically the planning for the distribution of the stimulus payments to eligible recipients throughout the country this spring. To deliver the 2008 stimulus payments, we have been programming our systems to calculate the appropriate amount for each eligible taxpayer based on their 2007 returns so that the payments can be distributed, through Treasury's Financial Management Service, by direct deposit or by paper check, based on the preferences expressed on the taxpayer's return.

We will begin immediately after the close of the filing season to distribute those payments with the expectation that the first payments will be sent electronically starting in the first week of May and with the first paper checks being mailed shortly thereafter. We have established a distribution schedule that is published on the IRS website on a page dedicated to informing citizens about the economic stimulus payments.

However, there are millions of individuals who may be eligible for economic stimulus payments, but who typically do not have an income tax filing requirement. This group includes retirees or those who have minimal income and are thus not required to file. But in order to receive the 2008 stimulus payment, the recipient must file a tax return for 2007. To reach these recipients and educate them requires an extensive outreach program that includes the mailing of information packets and IRS coordinating with the Social Security Administration and Department of Veterans Affairs, along with private groups such as the AARP.

Despite the challenges presented by the late enactment of the AMT patch and the implementation of the economic stimulus payments, I am proud to report that thus far the filing season has gone very well. Allow me first to give an update on some of the numbers we are looking at as we close out the filing season.

Numbers Thus Far

We expect to process nearly 140 million individual tax returns in 2008, and we anticipate continued growth in the number of those that are e-filed. In the 2007 filing season, almost 60 percent of all income tax returns were e-filed. We fully expect to exceed that number this year. As of April 5, we have received over 67 million tax returns electronically, an increase of 10 percent compared to the number of returns that were e-filed during the same period last year.

This increase in e-filing is being driven by people preparing their own returns using their personal computers. The total number of self-prepared returns that are e-filed is up by 18.2 percent compared to the number of self-prepared returns filed during the same period a year ago. Over 19 million returns have been e-filed by people from their personal computers, up from just over 17 million for the same period a year ago.

Overall, nearly 70 percent of the returns filed through April 5 have been e-filed. Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in two weeks or less. That is about half the time it takes us to process a paper return. For the IRS, the error-reject rate for e-filed returns is significantly lower than that for paper returns.

More people are choosing to have their tax refunds deposited directly into their bank account than ever before. As of April 5, we have directly deposited over 53.6 million refunds, or over 71 percent of all refunds issued this tax filing season.

People are also visiting our web site – IRS.gov – in record numbers. We have recorded over 132 million visits to our site this year, up over 21 percent from 109 million for the same period a year ago. The millions of taxpayers that have visited IRS.gov have benefited from many of the services that are available through the IRS.gov web site. The web site:

- Allows taxpayers to obtain information on the economic stimulus package including determining the payment amount they can expect to receive and learning when they can expect their payment based on their Social Security Number (SSN);
- Assists taxpayers in determining whether they qualify for the Earned Income Tax Credit (EITC);

- Assists taxpayers in determining whether they are subject to the Alternative Minimum Tax (AMT);
- Allows more than 70 percent of taxpayers the option to prepare and file their tax returns at no cost through the Free File program. This includes giving a free option for those taxpayers who normally do not file a tax return, but are required to this year in order to receive their stimulus payment;
- Allows taxpayers who are expecting refunds to track the status via the "Where's My Refund?" feature; and
- Allows taxpayers to calculate the amount of their deduction for state and local sales taxes.

We have issued 75.1 million refunds as of April 5, for a total of \$183 billion. The average refund thus far is \$2,436. In addition, nearly 28 million taxpayers have tracked their refund on IRS.gov, up nearly 20 percent over last year.

As of March 29, our Taxpayer Assistance Centers (TACs) are reporting over 2.1 million taxpayers assisted. Our telephone assistors have answered over 13 million calls, and over 17 million callers received automated services.

Free File

Over 3.6 million people have utilized Free File as of April 5, 2008, an increase of 19.7 percent compared to the number of taxpayers that used Free File during the same period a year ago. This year anyone with adjusted gross income of \$54,000 or less is eligible for Free File, which includes 97 million taxpayers. The number of Free File returns compared to the prior year has been steadily increasing, and we expect to meet or exceed 2007 totals by the end of the filing season. One reason for this increase is that we have committed additional resources to promote the Free File program.

VITA/TCE Sites and Other Community Partnerships

The use of tax return preparation alternatives, such as volunteer assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased over the years. In 2007, over 2.6 million returns were prepared by volunteers. As of April 5, 2008, volunteer return preparation is up over 26 percent compared to the number of volunteer-prepared returns filed during the same period a year ago. This is reflective of continuing growth in existing community coalitions and partnerships.

We also have made a concerted effort to expand outreach to taxpayers, particularly those taxpayers who may be eligible for the EITC. For example, we sponsored again this year EITC Awareness Day on January 31, 2008, in an effort to partner with our community coalitions and partnerships to reach as many EITC-eligible taxpayers as possible and urge

them to claim the credit. Over 125 coalitions and partners hosted local news conferences and issued more than 100 press releases highlighting EITC Awareness Day this year.

A Commitment to Service, Enforcement and Modernization

I understand that in FY 2007, the IRS continued making improvements in our service and enforcement programs as well as having significant successes in our IT modernization program. A few highlights of the IRS' FY 2007 accomplishments include:

- The IRS customer assistance call centers answered 33.2 million assistor telephone calls and 21.1 million automated calls. We maintained an 82.1-percent level of service on the telephone with an accuracy rate of 91.2 percent on tax law questions.
- Outreach and educational services were enhanced through partnerships between the IRS and public organizations. Through its 11,922 VITA and TCE sites, the IRS provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. Over 76,000 volunteers filed 2.63 million returns for these individuals. Additionally, the IRS established 6 new tax clinics in rural areas to help low-income taxpayers meet their tax obligations.
- Enforcement revenue has risen from \$33.8 billion in FY 2001 to \$59.2 billion, an increase of 75 percent. These numbers do not include the deterrent effect that an increased enforcement presence has on voluntary compliance.
- Both the levels of individual returns examined and coverage rates have risen substantially. The IRS conducted nearly 1.4 million examinations of individual tax returns in FY 2007, an 8-percent increase over FY 2006. This level of examinations is over three-quarters more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the audit-coverage rate has risen from 0.6 percent in FY 2001 to 1 percent in FY 2007. This increase was achieved without a significant increase in resources as compared to the previous fiscal year.
- The Customer Accounts Data Engine (CADE) Release 3.2 was delivered on time (January 14, 2008) for this filing season and is doing well in production. As of April 11, CADE had processed 24.98 million returns, which is more than 25 percent of all individual returns filed to date for this year. CADE also has issued almost \$38 billion in tax refunds.
- Modernized e-File (MeF) is the IRS designated e-File platform (electronic filing system) for the future and provides e-Filing capability for large corporations, small businesses, partnerships, and non-profit organizations. As of April 5, MeF has accepted 1.82 million corporate, partnership, and tax exempt tax returns, a 45-percent increase from this same period a year ago. MeF Release 5 went into production as planned in January 2008 and provides the ability to file

electronically Form 1120F (tax returns for foreign corporations) and Form 990N (so called electronic postcard for small tax-exempt organizations to meet their filing requirement).

The Administration's FY 2009 Budget Funds Taxpayer Service and Enforcement

The FY 2009 Budget request funds activities that promote better tax administration and compliance with the tax laws. The FY 2009 Budget request for the enforcement program is \$7,487,209,000, an increase of \$489,983,000, or 7 percent, over the FY 2008 enacted level. The Administration proposes to include these enforcement increases as a Budget Enforcement Act program integrity cap adjustment. The enforcement program is funded from the Enforcement appropriation and part of the IRS Operations Support appropriation.

Budget Request

For FY 2009, the President is requesting a total of \$11,361,509,000 for IRS activities. This amount is a \$469,125,000 increase, or 4.3 percent, over the FY 2008 enacted level.

The overall IRS budget is broken down into the following five appropriations:

- Taxpayer Services – The FY 2009 requested level for this area is \$2,150,000,000. This is the same as the FY 2008 enacted level. The Operations Support account provides an additional \$1.5 billion to support taxpayer service activities.
- Enforcement – The FY 2009 request is \$5,117,267,000. This level is an increase of 7.1 percent from the FY 2008 enacted level. As mentioned earlier, the Operations Support budget provides an additional \$2.4 billion to support enforcement activities.
- Operations Support – The FY 2009 request is \$3,856,172,000. This level is an increase of 4.8 percent from the FY 2008 enacted level.
- Business Systems Modernization – The FY 2009 request is \$222,664,000. This level is a reduction of 16.6 percent from the FY 2008 enacted level. This appropriation funds the planning and capital asset acquisition of information technology to modernize the IRS business systems, including labor and related contractual costs.
- Health Insurance Tax Credit Tax Administration. The FY 2009 request for this program is \$15,406,000. This is an increase of 1.1 percent from the FY 2008 enacted level. This appropriation funds costs to administer a refundable tax credit for health insurance to qualified individuals, which was enacted as part of the Trade Adjustment Assistance Reform Act of 2002.

The justification for the requests in each of these areas is discussed in detail below.

Adjustments from FY 2008 Levels to Help Improve Compliance

The IRS total requested funding increase for FY 2009 is \$469,125,000. This increase will go to improving compliance. These investments fund increased front-line enforcement efforts, enhanced research, and implementation of legislative proposals to help narrow the tax gap. By FY 2011, these investments are projected to increase annual enforcement revenue by \$2.0 billion. In addition, the legislative proposals included in the FY 2009 Budget to improve tax compliance are estimated to generate \$36 billion over the next ten years, if enacted.

Specific increases to improve compliance include:

- Reduce the Tax Gap for Small Business and the Self Employed (+\$168,498,000 / +1,608 FTE) – This enforcement initiative will increase enforcement efforts to improve compliance among small business and self-employed taxpayers by: increasing audits of high-income returns, increasing audits involving flow-through entities, implementing voluntary tip agreements, increasing document-matching audits, and collecting unpaid taxes from filed and non-filed tax returns. This request will generate \$981 million in additional annual enforcement revenue once new hires reach full potential in FY 2011.
- Reduce the Tax Gap for Large Businesses (+\$69,488,000 / +519 FTE) – This enforcement initiative will increase examination coverage of large and mid-size corporations, including multi-national businesses, foreign residents, and smaller corporations with significant international activity. It also will enable the IRS to use existing systems further to capture other electronic data through scanning and imaging. The initiative will allow the IRS to address risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for non-compliance is significant. Funding of this request will generate \$544 million in additional annual enforcement revenue once the new hires reach full potential in FY 2011.
- Improve Tax Gap Estimates, Measurement, and Detection of Non-Compliance (+\$51,058,000 / +393 FTE) – This enforcement initiative will support and expand ongoing research studies, including the National Research Program, of filing, payment, and reporting compliance to provide a comprehensive picture of the overall taxpayer compliance level. Research allows the IRS to target better specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively. Improved research data will be used to refine workload selection models, reducing audits of compliant taxpayers.
- Increase Reporting Compliance of U.S. Taxpayers with Offshore Activity (+\$13,697,000 / +124 FTE) – This enforcement initiative will address domestic taxpayer offshore activities. Abusive tax schemes, under-reporting of flow-through income, and certain high-income individuals are prime channels or candidates for tax evasion. This initiative will focus on uncovering offshore

credit cards, disguised corporate ownership, and brokering activities in order to identify individual taxpayers who are involved in offshore arrangements that facilitate noncompliance. Funding of this request will generate \$102 million in additional annual enforcement revenue once the new hires reach full potential in FY 2011.

- **Expand Document Matching (+\$35,060,000 / +413 FTE)** – This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program. This program matches third-party information returns (e.g., Form W-2 and Form 1099 income reports) against income claimed on tax returns. When potential underreporting is discovered taxpayers are contacted to resolve the issue. This request will produce \$359 million in additional annual enforcement revenue once the new hires reach full potential in FY 2011.
- **Implement Legislative Proposals to Improve Compliance (+\$23,045,000 / 0 FTE)** – While the IRS continues to address compliance by improving customer service and using traditional methods of enforcement, the FY 2009 Budget also includes legislative proposals that would provide additional enforcement tools to improve compliance. It is estimated that these proposals, if enacted, will generate \$36 billion in revenue over ten years (see the Treasury Blue Book, available on the Treasury Department web site, for more information). The proposals would expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties. This enforcement initiative includes funding for purchasing software and making modifications to the IRS IT systems necessary to implement the proposals. The specific legislative proposals are discussed below.

Specific Legislative Proposals

The Administration's FY 2009 Budget includes a number of legislative proposals intended to improve tax compliance while minimizing the burden on compliant taxpayers as much as possible. These include:

- *Expand information reporting* – Compliance with the tax laws is highest when payments are subject to information reporting to the IRS. Specific information reporting proposals would:
 - (1) Require information reporting on payments to corporations;
 - (2) Require basis reporting on security sales;
 - (3) Require information reporting on merchant card payment reimbursements;
 - (4) Require a certified Taxpayer Identification Number (TIN) from contractors;
 - (5) Require increased information reporting on certain government payments;
 - (6) Increase information return penalties; and

- (7) Improve the foreign trust reporting penalty.
- *Improve compliance by businesses* – Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:
 - (1) Require electronic filing by certain large organizations; and
 - (2) Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes.
 - *Strengthen tax administration* – The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:
 - (1) Expand IRS access to information in the National Directory of New Hires for tax administration purposes;
 - (2) Permit disclosure of prison tax scams;
 - (3) Make repeated willful failure to file a tax return a felony;
 - (4) Facilitate tax compliance with local jurisdictions;
 - (5) Extend statutes of limitations where state tax adjustments affect federal tax liability; and
 - (6) Improve the investigative disclosure statute.
 - *Expand penalties* – Penalties play an important role in discouraging intentional non-compliance. A specific proposal to expand penalties would impose a penalty on failure to comply with electronic filing requirements.

Improve Tax Administration and Other Miscellaneous Proposals

The Administration has put forward additional proposals relating to IRS administrative reforms. Five of these proposals are highlighted below:

- The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.
- The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.
- The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding \$50,000. This proposal requires that the Secretary of the Treasury establish standards to determine when an opinion is appropriate.

- The fourth proposal extends the IRS authority to use the proceeds received from undercover operations through December 31, 2012. The IRS was previously authorized to use proceeds it received from undercover operations to offset necessary and reasonable expenses incurred in such operations. This authority expired on December 31, 2007.
- The fifth proposal equalizes penalty standards between tax return preparers and taxpayers, reducing unnecessary conflicts of interest between them. The standard applicable to tax return preparers for undisclosed positions would be "substantial authority" but for certain reportable transactions with a significant purpose of tax avoidance, the existing standard would persist (i.e., the preparer should have a reasonable belief that the position, more likely than not, would be sustained on the merits).

Conclusion

Thank you again, Mr. Chairman, for the opportunity to appear this morning and update the Subcommittee on the filing season and the FY 2009 proposed IRS Budget. In my short tenure, I have found IRS employees to be professional, hardworking, and dedicated.

I am committed to working hard everyday to provide taxpayers the high level of service they deserve and to pursue enforcement actions against those unwilling to meet their tax obligations.

We need resources to execute against our plan, and I hope this Subcommittee will support the full funding of the Administration's FY 2009 proposed budget.

I also urge this Subcommittee to support the enactment of the legislative proposals included in the Budget to improve compliance. Collectively, they will generate more \$36 billion over the next 10 years if enacted.

I will be happy to respond to any questions.

ECONOMIC STIMULUS REBATE CHECKS

Mr. SERRANO. Well, I thank you.

And I want to echo momentarily what Mr. Regula said. If there is ever a problem, it is the belief by many Americans—for our purposes, say some Americans—that some folks are not meeting their obligations. And sometimes, for instance, when we see in the budget or we read that there is more emphasis being made on lower-income or Earned Income Tax Credit folks in terms of auditing them and that corporate America is getting less and less audits, that adds to that perception that Mr. Regula speaks about.

Let me talk to you briefly about the economic stimulus rebate checks. As we all know, the IRS is working with the Financial Management Service on getting out the rebate checks for taxpayers as part of the Economic Stimulus Act.

One thing I would just like to clarify with you: As long as an individual files a tax return and fits the income qualifications for getting a rebate check, they will, in fact, get the check as long as they don't owe back taxes, Federal taxes—am I correct?—or have outstanding debts like student loan debt or overdue child support. Is that correct?

And my understanding of outstanding student loan debt means not that they are ongoing in their payments but that they are behind in their payments.

Mr. SHULMAN. That is correct.

Mr. SERRANO. So a person who has a student loan outstanding is not in trouble here, just a person who hasn't made their payments.

Mr. SHULMAN. That is correct.

Mr. SERRANO. Okay. Now, does that include also child support issues?

Mr. SHULMAN. I believe so. Yes, I believe so. It is about if they are behind in payments, not just that they have child support payments, student loan payments. And you are correct, as we had a chance to discuss, regarding Federal taxes.

Mr. SERRANO. Okay. Now, do States get into the act?

Mr. SHULMAN. No. This is a Federal program, not involved with State—

Mr. SERRANO. So if you owe State taxes, this does not affect your ability to get the check?

Mr. SHULMAN. Correct.

Mr. SERRANO. Have you clarified with the territories—one of my favorite subjects—how those checks will go out to the territories?

You know, our big victory was including the territories in the rebate. Now, we know that they don't have Federal tax lists for you to work off, so the money has to go—the funds have to go to the local government. Can the local government then say, "You owe us, the Commonwealth of Puerto Rico, you owe Guam money; therefore, we are going to take that out of these"? Because then technically what we would be doing is using Federal dollars to subsidize a local issue.

Do we have a reading on that?

Mr. SHULMAN. Well—

Mr. SERRANO. And I don't think we should, just for the record.

Mr. SHULMAN. As you know, the territories were included in this stimulus program that the Congress passed and the President signed. We do not administer the tax laws in jurisdictions of the territories. Actually, we are working with the territories now—it is in the hands of the Treasury Department—to work out exactly how we will be refunding them their payments. The final details of those are not settled yet, but my understanding is, the talks are going very well, and that these discussions—that a decision is relatively imminent. It should happen soon.

Mr. SERRANO. But these are more Treasury discussions than IRS discussions, is what you are saying?

Mr. SHULMAN. Correct.

Mr. SERRANO. But if it comes by your desk, it wouldn't make any of us unhappy if you reminded the territories that this is not to pay for any local debt.

Mr. SHULMAN. Understood.

Mr. SERRANO. The idea is for them to go spend that money and stimulate the economy. That was the purpose.

IRS PRIVATE DEBT COLLECTION

Mr. SERRANO. Let's turn to something more controversial, the private debt collectors or, as I have said on a couple of occasions here, a wonderful idea for a "Sopranos" episode, collecting debt.

The Commissioner doesn't get it.

Any time you give somebody an incentive of 24 percent on the dollar, the behavior could be something that we live to regret.

I asked this question of Secretary Paulson, and I would like to ask it today as well. This time last year, the IRS was planning to greatly expand the number of private companies conducting IRS collection work, but now you are planning on sticking with just the current two companies.

What are your thoughts on the program? Do you believe it should continue? Does this change in plans indicate that the IRS is starting to have the same doubts about the usefulness of this program? Or is it an IRS reaction to the many people in Congress who disagree that this program should continue?

Mr. SHULMAN. I am well aware of this program. I had a number of conversations with Senators about this program throughout my confirmation process.

If I can step back just a little bit, with the topic of the hearing being the budget and resource allocation, it is very clear to me that one of the most important parts of my job is going to be getting my arms around all of the activities of the IRS, both the service activities that help taxpayers voluntarily send in their money and provide services to them, as well as all of our enforcement tools, whether it be collection—our internal systems or this private debt collection—our audit program, our enforcement program, our criminal investigation resources. And how we choose to fund and focus those resources will be some of the most important decisions I make.

This program specifically, like a lot of programs, I am just getting my arms around it. I make a commitment to all members of this Committee that this program is one I will focus on, understand

better and come to my conclusions about whether it is meeting its purpose.

A couple of things I have seen. One is, it is my understanding it has been authorized by Congress, and I know that the people at the Service are doing their best to run it well. "Run it well" means to meet the intent of bringing in taxes that otherwise wouldn't be collected, as well as making sure that taxpayer rights and data privacy are protected and that there is proper oversight.

I think it is too early in my tenure to really have a lot more opinions about the program, but I understand the concerns that you and others have expressed, Mr. Chairman. And you have my commitment to get my arms around the program and come back for more conversations.

Mr. SERRANO. Sure. Thank you for that answer.

And let me just clarify something for you in a very friendly way. You made an interesting point and a right, correct point. You said this is a budget hearing. There are two things you should know about the appropriations process. One is we are not supposed to legislate on appropriations bills, but it happens all the time. And secondly, we are only supposed to discuss budget at these hearings, but most of the time we end up also discussing issues that are not necessarily just budget issues, although they all have dollars attached to it. So this stopped being, really, a discussion of dollars a long time ago and just of the process.

But speaking of dollars, the IRS taxpayer advocate noted in a hearing last month that the IRS projects that the program will generate gross revenue averaging about \$23 million this year and next year. At the same time, it is costing \$7.6 million a year in appropriated funds, as well as roughly \$4.6 million in tax collections that the companies get to keep for themselves, the 24 percent.

If these two expenditures, the \$7.6 million and the \$4.6 million in lost revenue, were instead invested in IRS employees to work these same cases, how much revenue do you believe could be collected?

Mr. SHULMAN. Again, I am still getting my arms around these issues. I have seen a lot of the numbers, and I need to understand them better.

And if I can just make the point, by no means was I giving a broad budget update. Any discussion, of course, this Committee wants to have, I am happy to have.

Mr. SERRANO. It was a very friendly comment. Nothing that is nasty on Jackie Robinson Day, trust me.

I have many more questions, but we will move on now to Mr. Regula, our Ranking Member.

Mr. REGULA. Well, as I said earlier, what most taxpayers want to have is a sense that everyone else is paying their fair share. And the question then arises on private debt collection whether or not that does enhance the ability of the Government to ensure that that number, whatever it is, \$300 billion or so, is collected.

And they estimate that this increases revenue by \$600 million over 10 years. And I know there are other agencies who have successfully used private contractors, such as Education, Health and Human Services. And there is some concern that this takes away from employees, but I think it really provides assistance to them.

What do you see—and I realize it is early in the program—as the benefits of this program?

Mr. SHULMAN. Well, my understanding is that it was authorized specifically as money to go toward collection efforts for cases that otherwise wouldn't be pursued by the IRS. And I know, again, there is a lot of debate about both sides of this. And so, to the extent it is money that we wouldn't otherwise get and to the extent it is going after cases we wouldn't otherwise get to, I think that is the obvious benefit.

Mr. REGULA. Well, if the private debt collectors can collect, why can't agents of the IRS do the same?

Mr. SHULMAN. Well, again, I am still getting my arms around it, and I apologize to the Committee to come so early and that I still have to get my arms around it. But I want to make sure that any conversation I have with you is fully informed.

My understanding is that, because these are private contractors, there are some limitations on the kinds of cases that they can work. And they clearly can't use some of the tools that the IRS has, like liens and levies and other things.

So these are cases where there is clearly debt owed, some lower-dollar-amount cases. The IRS only has so many resources. It can't pursue every single case and every single time that we think that there is money that ought to be coming. We have to allocate our resources appropriately. And so these are cases that otherwise weren't being worked, that meet those criteria, and the IRS can pursue these cases with these—

Mr. REGULA. I don't think the public would believe that you can't pursue some cases. If they have dealt with the IRS, they have been convinced that you do, just like the FBI or whatever. There isn't any place to hide.

It seems to me you ought to at least take a good look at whether your collection procedures are adequate, and if therefore you would not need private debt collectors. They certainly can't have any magic, as to how they get it done, as opposed to what could be done by your own agents.

But, again, this is part of ensuring the public that everybody is paying their fair share.

I have a number of questions for the record, a couple of things.

IRS TAXPAYER SERVICES

Do you let the public know about your taxpayer services adequately, like the Taxpayer Advocate Service, Voluntary Income Tax Assistance and so on? I am not sure the public realizes that these services are available, and maybe there ought to be some enhancement of letting people know.

Mr. SHULMAN. Yes, you know, people have asked me. One of the main reasons I took this job is because this agency touches and has interaction with every single individual adult in the country, as well as every business and every nonprofit group. It has a profound effect on the way that Americans view their Government.

And I believe—again, I am still getting my arms around our exact outreach, et cetera. I am very committed to making sure our service programs are effective when people come to us and people understand that the IRS can help.

Because I happened to take this job right around April 15th, which in addition to Jackie Robinson Day is a big day for us, I had the opportunity to go out and talk with a variety of people and some media outlets. And one of the interesting questions that came to me was, "if someone just can't pay, what should they do?" And my notion—you should reach out to us, you shouldn't disappear, you shouldn't go dark, you should call us and we have people who will help you work through those issues—I think a lot of people don't recognize.

And under my tenure, I am going to make sure, it is a major focus of ours to make sure our services are excellent and let everybody know that those services are available.

Mr. REGULA. Well, I am always struck when I see the TV ads from the professionals who say, "Got a problem with IRS? Call us." And they imply that their services will result in your tax bill being substantially reduced. Now, I question that. The law is the law, and they don't have any magic understanding of the law. But at least, if you have the services I have just described, they ought to be available to taxpayers, in lieu of having to pay these professionals to do the job.

SIMPLIFYING THE TAX CODE

Tax complexity, we always—that is a very popular thing on the campaign circuit, is to say, well, we are going to reduce the tax code and so on. But, of course, so long as you don't reduce any preference that I might have, why, it is a good idea to simplify the tax code—1,395,000 words.

I was really struck by the fact that Tom Friedman, in his book, "The World is Flat," said that 400,000 U.S. tax returns were done in India last year. I find that rather appalling, in a way, that people have to send their tax returns to India to be done and that we can't do that in this country. And there is an increase in the use of tax consultants, if you will. I know it is not your responsibility. In a way, it is up to the Congress to deal with the complexity in the tax code. And we usually end up adding instead of subtracting.

But do you have any capability in the agency to reduce the number of outsiders that do tax returns? Is there any simplification that you can build into the returns themselves?

Mr. SHULMAN. Well, it is a good question. It is one that I have asked myself.

What I would say is, I am on the record, I think the tax code is complex. And as the representative of the Government trying to interact with the American people getting their taxes done, the simpler we can make the tax code, the better.

With that said, I am going to stay out of tax policy questions, leave that to Congress, the Treasury and people who are more engaged in tax policy than I am.

I think to the extent we can make life easier for people and simplify things, we should. I actually did some surfing on our Web site as I was preparing for this hearing and through my confirmation process. I think we have done a pretty good job of posting frequently asked questions, having the ability to get questions answered. I think the more we can do to get good information out there, the better.

Regarding tax preparers and who prepares people's taxes, what I will tell you is I want to make sure—you know, they are a vital part of the system. Whether we like it or not, a lot of people use professionals to prepare their taxes—sure we have good information for individuals, we make it as easy and cheap as possible for them to comply, and we support the professional community so that their costs are low for people using them.

Mr. REGULA. I was in a bookstore, and I saw a whole array of volumes, and they looked like a telephone book, of how to prepare your taxes, "J.K. Lasser" just one of many. And it must be sort of overwhelming to the average citizen to go in there and see all these different volumes of information on how to do your taxes. And I suppose simplification lies somewhere out in the far distant future.

Thank you, Mr. Chairman.

Mr. SERRANO. Thank you.

I must tell you, Mr. Commissioner, that I know some of these questions seem leading to some difficulty in the future, some tough issues. But the good news is that when Mr. Hinchey and I started out in politics on the same day in 1975, elected office, the two most disliked agencies in my district were the IRS and Immigration. Well, since September 11th, you are not even an issue; Immigration outweighs you. They are highly disliked in my district, trust me.

And, you know, the Commissioner has a connection to both of our States. He is from Dayton, Ohio, and he was a school teacher in my congressional district.

Mr. REGULA. Teach for America?

Mr. SHULMAN. I was involved in the starting of it, Teach for America. And I taught at Bronx Regional High School off of Prospect Avenue for a while.

Mr. SERRANO. There you go.

Mr. REGULA. As someone very interested in education, if you will permit me, Teach for America I think is a terrific program. And you were involved in starting it?

Mr. SHULMAN. I was one of the first few staff members who put it together. So I am one of the original co-founders.

Mr. REGULA. I congratulate you.

Mr. SERRANO. You served how many years on the Ed and Labor Committee?

Mr. REGULA. Oh, well, I was Chairman for 6 years, where we had labor and education and so on.

And I know last year Teach for America had 20,000 applications, with something like 2,000 slots. Terrific program.

Mr. SHULMAN. Yes, it is an amazing thing, what they have done. Wendy Kopp, who runs it, has done a phenomenal job over the years.

Mr. SERRANO. Mr. Hinchey.

Mr. HINCHEY. Thank you, Mr. Chairman.

Mr. Shulman, it is a great pleasure seeing you, and thank you very much for being here. Meeting you has been very comforting and instilling in confidence. I think that we are very fortunate to have someone as intelligent and wise and committed as you are working on this very important job. As you said, it is the one aspect of Government with which people have the most contact, and

stays in their minds more than any other aspect of this Federal Government.

And I very much appreciate our Chairman for the questions he asked and the opening statements that he made. I think they were really right on target. As he said, we have been friends and associated for a long time. The only difference now is immigration is not as big a problem in my district as it is in his. It is a little bit different situation in upstate New York as it is in the Bronx.

Mr. SERRANO. It was a couple hundred years ago.

Mr. HINCHEY. Yeah, it was, I know. When you are having fun, time flies.

OUTSOURCING DEBT COLLECTION

There is an interesting story in the Post today about—the headline is, “Collectors Cost IRS More Than They Raise,” which was an important question that was raised by the Chairman. I know it isn’t anything that you have been involved in, but it is something that you have to deal with.

And the interesting part of the story is that we are paying more for the outsourcing of this activity, almost twice as much as is being taken in. So it doesn’t seem to me to make an awful lot of sense, and I think it is something that the Congress really has to address its attention to, as to whether or not this is the best way for the Internal Revenue Service to have to function.

I think that it has always functioned best when the work was done here, locally, internally, within our own country. And the idea of sending some of this work out to countries in other parts of the world, particularly as far away as India, just doesn’t make any sense whatsoever. The outsourcing of that work is, I think, a big mistake.

It is something that was done intentionally, I think, and it began back in 1995 when a new Congress came into effect. And the results of what they put into place has reduced the number of IRS employees by—I think the number is more than 27,000, reduction in IRS employees.

I think that needs to be corrected. I think we need to change this set of circumstances and bring back the Internal Revenue Service wholly within our country and wholly within the Government. That is the best way that we can make sure that it operates effectively and in accordance with the law. I think there are a whole host of potential problems that arise by the privatization of this kind of work, including the potential exploitation of people who could have that kind of situation inflicted upon them as a result of the privatization.

So I just raise these issues, knowing that this isn’t anything that you have had anything to do with. You are just coming into a situation where you have to confront these issues. But over time, I would greatly appreciate it if you would consult with us and provide us with information that you accumulate as a result of your ongoing experience here, to let us know what you think about this situation, the outsourcing of this work, the downgrading in the number of employees.

There is some legislation now which is pending. In fact, the bill in the House here, I believe, has recently passed through the Ways

and Means Committee, which would change the privatization and the outsourcing of this work and bring it wholly back within our own country, within our own Government, so that I think it works in a much better way.

So I just want to express to you my appreciation and gratitude. I know you have only been here a few weeks, but you are going to be here hopefully for a good number of years. What is it, 10 years?

Mr. SHULMAN. Five.

Mr. HINCHEY. Five. Well, maybe it will be 10. At least 5, because I have a great sense of confidence in the way in which you will be able to carry out this very, very important job.

And as I have asked, if you wouldn't mind keeping in touch with us and letting us know what you see, insightfully from your position as the Commissioner now, about how this outsourcing is working, what we need to do about this cutting back on 27,000 people to make the IRS weaker. And I think a lot of that weakness was intentionally focused on the highest potential taxpayers in the country. But that is my own observation based upon the legislation that was passed back in 1995, something that I opposed then and continue to oppose, because I believe that this is an issue that the Government should be involved in, and it should be held accountable to the people of the country. And I think that is the best way to do it.

So other than that, I don't have any questions. But I just want to say again, I am very grateful to you for being here. I have a lot of confidence in the way in which you are going to operate the situation. And I hope that you will provide us with the insightful information that you acquire over the course of the next few years.

Thank you very much, Mr. Shulman.

Mr. SHULMAN. Thank you. I appreciate the confidence. And as I said, I am looking forward to an ongoing dialogue with you and other members of the Committee.

Mr. HINCHEY. Thank you.

Mr. SERRANO. Thank you.

Say, are movie stars allowed to claim clothing and other things? Does anybody know? Because we are on stage a lot.

Mr. SHULMAN. Somebody does, not me.

Mr. SERRANO. Let's find out if they do. Because, you know, Mr. Hinchey has to keep up an appearance and all that.

Mr. REGULA. Deduct our suits?

Mr. SERRANO. Why not? We are on stage most of the time.

The gentleman who is never on stage but always performing properly, Mr. Bonner.

Mr. BONNER. Thank you, Mr. Chairman. I wondered if you thought about seizing this opportunity with the Commissioner and asking for the Internal Revenue Service to look into that dastardly act of some Red Sox fan trying to plant a jersey at the new Yankees stadium. That seems to be a case worthy of the IRS's attention.

Mr. SERRANO. Let me tell you what almost happened to me, and I was saved by something wonderful from up above. I was going to put out a statement saying, "The nerve of these outsiders who come and work in the Bronx, work in a poor community, make a

lot of money, and then leave and go upstate or Long Island and insult us." Turns out, the guy lives in the Bronx, who did that.

But we took it out of there, at the cost to the management company, to the construction company. And in typical New York fashion, we kind of gave it back to them. We took the shirt and sent it to The Jimmy Fund, and The Jimmy Fund will auction it off in Boston. And it will probably get more than the Barry Bonds baseball.

Mr. SCHIFF. Will the Chairman yield?

Mr. SERRANO. Only if you say something pro-The Bronx.

Mr. SCHIFF. I just want to say, go Red Sox. So I yield back to the Chair.

Mr. HINCHEY. Not after the last two days.

Mr. SERRANO. Does the phrase "no earmarks" sound familiar?

Mr. Bonner.

IRS SCRUTINY OF POLITICAL ACTIVITY

Mr. BONNER. Mr. Chairman, thank you.

I think each of us represents somewhere in the neighborhood of 635,000, 640,000, 650,000 Americans as part of the privilege of serving in Congress. And so I can imagine at least the 635,000 people in my district would probably love to have the chance I have to question, on tax day, the tax man.

So, Commissioner, as you have heard from others, we thank you for your willingness to serve in this important position and certainly look forward to working with you.

Let me ask a couple of questions. Yesterday I don't know if you had a chance to see Roll Call, which is the Capitol Hill newspaper, but there was an article on the front page entitled, "IRS Scrutinizing Political Activity." And it went on to say that the Service has focused on charities and churches in the past to ensure that they don't violate the tax code by participating in excessive political activity.

How, in your judgment, would you like to see the Service intensify its scrutiny of social welfare groups in addition to charities and churches?

And the article also indicates that the IRS may believe that its strong arm could be more effective than, say, the Federal Elections Commission in reeling in nonprofits. And I was just curious if you had any thoughts about how the IRS could provide more effective enforcement.

Mr. SHULMAN. Let me say a few things at a philosophical level around this issue.

Again, like many programs, this is one that I am going to need to gain more familiarity about, but I did discuss the general issue of nonprofits and political activities with the Senate Finance Committee, and I will repeat here a couple of things I said here.

One is I think it is very important that we be viewed as a non-partisan institution that is administering our laws in a fair and equitable fashion. And you have my commitment that will be a focus of ours as long as I am Commissioner of the IRS, and I have every indication to believe that is what we do.

Second, anyone who gets tax-exempt status gets a privilege from the Government and gets some monetary relief from the Govern-

ment and, therefore, has to abide by the rules. And so my belief is that the group in the IRS, the professional staff who has year-in, year-out responsibilities to oversee the tax-exempt groups—and this will include their political activities or any other things that fall within the rules—owes it to the American people to make sure we are fair, we are even-handed, we give clear guidance. Anyone who is abusing the law, we are there. For people who aren't abusing the law, we are out of their way.

And so I will look into it more, but I think the most important thing we can do is be very nonpartisan, by-the-book, and administer the law clearly and fairly in this area.

IRS CUSTOMER SERVICE CALL CENTER ACCURACY

Mr. BONNER. Separately, I will give you the example upon which I am basing this next question. But in your testimony and in your answer to the first question, talking about the importance of a group maintaining its tax-exempt status in a legal way, in your written testimony you provide several highlights of the IRS's 2007 accomplishments, one of which is that your customer assistance call centers last year provided a 91.2 percent accuracy rate on tax law questions.

While that number is pretty high, I think a question—and I will give to your staff the example that I have in mind. How would you like to see the Service respond to cases where the taxpayer is given inaccurate information from the IRS, bases their actions on that information and then brings in a Member of Congress to try to resolve a dispute with the Service? Is there a way that we can get that 91 percent up?

Mr. SHULMAN. Well, my hope would be—and I can't tell you the resources we have, the skill sets we have, et cetera—that when anyone has a question, we answer it in a timely and accurate manner. So that would be my guiding principle.

I think any time there is a mistake by a Government agency, we should do everything we can to right that mistake. I would be happy to follow up on specific issues, so I can understand your question a little better.

Mr. BONNER. All right.

FAIRNESS

And then the last question—the ranking member and the Chairman both talked about that fairness. And I know you were not on the job at the time, but last year there was a pretty high-profile case involving a Hollywood actor who many taxpayers, at least in my district, were shocked when he was found not guilty of Federal tax fraud. It sent a public message to some that you can fail to file a tax return for 6 years, making millions of dollars during that time, and that you may not have to pay taxes.

Since we are talking about fairness, does that create a problem for you and your tens of thousands of employees when yesterday's USA Today had three other high-profile citizens of this country who have had tax problems?

We may all one day come into that situation. But does a situation like the Wesley Snipes case, not to focus specifically on that gentleman, but just—does that create a problem, when average

Americans who don't make that kind of money file their tax returns and feel some sense of frustration that the system is not fair?

Mr. SHULMAN. As I have gotten a little bit of a look at our statistics, there are some interesting trends. One is, for individuals, our audit coverage has increased at the highest rate for million-dollar-plus incomes. And so we now audit one of every 11 people who make over \$1 million a year. I think that is a good signal for the IRS to send out, that people who have a high income must pay their taxes.

The next highest rate is above \$200,000, and then we have some increases for other areas. But we have been putting more and more emphasis on high-income individuals, which I think is appropriate. And so I think those statistics that I have seen, that I support, speak to your question.

Mr. BONNER. Okay.

Thank you, Mr. Chairman.

Mr. SERRANO. Thank you.

Now I would like to recognize my former friend, Mr. Schiff.

ALL SAINTS CHURCH OF PASADENA

Mr. SCHIFF. Thank you, Mr. Chairman.

Commissioner, I want to follow up on Mr. Bonner's first question and familiarize you with a case out in Pasadena that you may not have had a chance to become acquainted with yet.

On June 9th, back in 2005, the IRS notified All Saints Church of Pasadena that it was being investigated for violating rules regulating political speech for tax-exempt charitable and religious organizations. An investigation was launched in response to a sermon delivered by Pastor Emeritus George Regas in 2004 criticizing the President's policy in Iraq.

All Saints is a large and historic congregation of Pasadena with a long history of commitment to social justice and peace values which are deeply rooted in the theology of All Saints. Pastor Regas's speech specifically declined to make any endorsement, saying, quote, "good people of profound faith," unquote, may support either candidate.

In its complaint, the IRS relied on a subjective characterization of the sermon's content from an LA Times article as a, quote, "searing indictment," unquote, of the administration's policies in Iraq and at no point provided a contextual analysis of the sermon to explain why that investigation was warranted. Indeed, the impression was that the article, written by someone who I don't think was even present in the church, and its characterization of the sermon was more important to the IRS than the actual sermon that was given.

Over the next 2 years, the IRS and All Saints exchanged extended correspondence, including an offer from the IRS to consider the matter closed if All Saints would only admit wrongdoing. All Saints refused. Finally, in 2007 the IRS sent a letter to All Saints stating that the investigation had been closed, yet, in a very self-serving way, still stating that All Saints had violated the rules against electioneering.

So the IRS couldn't prove its case. All Saints never admitted wrongdoing. And so the IRS closes the case and says, "Well, you

still did wrong,” effectively slurring All Saints without ever giving All Saints the opportunity to clear its good name.

I am deeply concerned, Commissioner, that nearly 2½ years after the first notice of a church tax inquiry and after hundreds of pages of correspondence, All Saints and every other church or tax-exempt entity in the Nation has no better understanding of why the IRS found them to be in violation of their responsibilities as a 501(c)(3) organization. The lack of guidance from the IRS on tax-exempt organizations and of a standard of political interference creates the risk that legitimate political speech, and speech that relates to the theological roots of a religious organization to the present world, will be discouraged and shilled.

I have advocated for some time that we develop a brighter line. I don’t support having religious or charitable organizations get involved in electioneering. They should not. But I do think that they should have the ability to speak from the pulpit about issues like war and peace, justice and poverty, without risking losing their tax-exempt status.

And I think that the line that we have now is so vague, it is very hard for religious organizations to know what they can and cannot say. And when the IRS treats a church like All Saints the way they did, saying, effectively, “We think you violated the prohibition, but we won’t tell you why, and we can’t prove it sufficiently, so we are going to close the case, but we are still going to make the declaration that somehow you violated the law,” that I think not only disrespects that church, but also the broader community doesn’t have any guidance from that about what it should think.

All Saints wrote a letter to the Acting Commissioner, Linda Stiff, back in September of 2007 after the IRS closed the case, posing several significant issues with how the IRS conducted the investigation and also posing, I think, some very legitimate questions.

One took issue with the fact that a threshold 7611 determination was never made by a high-level official, as required by law. Second, pointing out that the IRS had discussions with the Department of Justice prior to initiating the investigation and may have violated the privacy rights of the church, in violation of existing law as well, and asking, I think, several legitimate questions about the nature of the investigation.

It has been 6 months since the church made this request of the IRS. It has not heard back on any of these points. I have the church’s letter, Mr. Chairman, as well as a consent to the disclosure of tax information, a waiver by the church, so that you could both speak today about the case if you know any facts of the case or respond to this committee as well.

And I would ask that both of these be admitted for the record.

And I will provide them to you, Mr. Commissioner.

Mr. SERRANO. Without objection.

[The information follows:]



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September 21, 2007

VIA FEDERAL EXPRESS and FACSIMILE (202/622-5756) (without enclosure)

Ms. Linda E. Stiff
Acting Commissioner
Internal Revenue Service
1111 Constitution Ave NW
Washington, DC 20224

Re: **All Saints Church Pasadena, CA (EIN 95-1980801)**

Dear Acting Commissioner Stiff:

On behalf of my client All Saints Church (the "Church" or "All Saints") in Pasadena, California, I am writing to express our serious concerns regarding the treatment we have received from the Internal Revenue Service ("IRS"). I am addressing this letter directly to you because of the important First Amendment implications of the Church's examination and the extraordinary nature of the procedural and legal issues in this case.

I have enclosed a complete record of our correspondence with the IRS in this case for your reference.

Background

On October 31, 2004, the Rev. Dr. George Regas, a guest preacher at All Saints who retired as its Rector in 1995, delivered what the New York Times described as a "fiery antipoverty and antiwar sermon."¹ In that sermon, entitled "If Jesus Debated Senator Kerry and President Bush," (the "Sermon") the Rev. Dr. Regas used the occasion of the 2004 election and a provocative, satirical style to preach about what he believes are "three hugely important issues...ending war and violence, eliminating poverty, and holding tenaciously to hope." During his remarks, which touched upon current, value-laden policy issues ranging

¹ *Taxing an Unfriendly Church*, N.Y. Times, Nov. 22, 2004, at A22.

from the Iraq war to the social implications of tax cuts, he did not state a preference for either of the candidates or for any political party. On the contrary, he assured the congregation that “Jesus does win! And I don’t intend to tell you how to vote.” While listeners could probably have guessed Rev. Dr. Regas’s personal preferences, he acknowledged that “[g]ood people of profound faith will be for either George Bush or John Kerry for reasons deeply rooted in their faith,” and he praised both Senator Kerry and President Bush for being “devout Christians—one a Roman Catholic and the other a Methodist.” He reminded parishioners that they should vote consistently with their moral values and the teachings of Christianity: “take with you all that you know about Jesus, the peacemaker...[t]ake all that Jesus means to you...[and] vote your deepest values.”

On June 9, 2005, the IRS sent the Church a Notice of Church Tax Inquiry, signed by the Director of Exempt Organizations, Examinations, purporting to initiate a “Church Tax Inquiry” under section 7611(a) of the Internal Revenue Code² (the “Inquiry Notice”). By its own account, the Government’s “concerns” were based solely on a November 1, 2004 Los Angeles Times article³ and the Sermon, both of which were attached to the Inquiry Notice. Rather than quoting from the Sermon itself, however, the Inquiry Notice relied on one reporter’s characterization of the Sermon as “a searing indictment of the Bush administration’s policies on Iraq, criticism of the drive to develop more nuclear weapons, and...tax cuts as inimical to the values of Jesus.” There is no evidence in the Inquiry Notice that the IRS focused on any of Rev. Dr. Regas’s explicitly neutral statements—for example, that both President Bush and Senator Kerry are “devout Christians” and that he did not intend to tell anyone how to vote.

By letter dated June 24, 2005, the Church responded to all of the IRS’s questions. The Church’s response placed the guest Sermon in the historical context of the Church’s longstanding commitment to promoting peace and justice, explaining that “[t]he Church does not endorse particular candidates or parties. The Church does, however, address social justice issues from a biblical and theological perspective.” The Church also explained that, in accordance with the Church’s “open pulpit” tradition, Rev. Dr. Regas was invited to preach the Gospel as God’s Spirit directed him that morning. No member of All Saints’ clergy, staff or Vestry reviewed his text in advance. Moreover, the Church’s response clarified that 28 years of service had earned Rev. Dr. Regas the title “Rector Emeritus,” but he has not received compensation, nor held any official title or governing position with the Church, since 1995. The Church also confirmed that there were no specifically identifiable costs associated with the preaching of the Sermon and that no materials were distributed specifically in conjunction with the Sermon.

² All section references are to the Internal Revenue Code (the “Code”) of 1986, as amended.

³ Josh Getlin, *The Race for the White House: Pulpits Ring with Election Messages*, L.A. Times, Nov. 1, 2004, at A1.

On September 2, 2005, the IRS sent the Church a Notice of Church Examination (the "Examination Notice") and an Information Document Request ("IDR"), neither of which provided any indication that the agency had even considered the Church's responses to the Inquiry Notice. On September 22, 2005, the Church invoked its right under section 7611 of the Code to a conference with the IRS. During that conference, the IRS representatives explained that the Area Manager would review the case and consider whether to pursue the examination. During the telephone conference, the IRS's Area Counsel characterized the Sermon as "inferential" political campaign intervention. At that time, the IRS offered All Saints the possibility of resolving the matter without further action if the Church would admit that the Sermon violated the political campaign prohibition of section 501(c)(3) and would promise not to make similar statements in the future. Believing that no violation had occurred and that such an admission would require a disavowal of the core tenets of their faith, All Saints declined that offer and decided to await a decision at more senior levels of the IRS as to whether the Service would, in fact, proceed with an examination.

By fax dated October 5, 2005, the IRS informed the Church that the Area Manager had decided to pursue an examination and that the Church could expect to receive a second IDR in early November. Contrary to this communication, however, another eight months passed before the Church received the next written communication from the IRS.

In the meantime, when the IDR did not arrive as promised, the Church (through its counsel) contacted the IRS in an effort to resolve the uncertain status of the case. In its letter, dated December 13, 2005, the Church reiterated its steadfast belief that the Sermon did not constitute political intervention and questioned whether the IRS had complied with the Congressionally-mandated procedural safeguards intended to protect churches from unnecessary audits. The Church took issue with the IRS's apparent lack of analysis of the Sermon itself and requested clarification regarding the specific facts that were considered in forming the belief that political intervention had occurred. The Church also noted that the implication of the IRS's position in this case—that a minister cannot criticize government policies (for example, by speaking out against war)—is inconsistent with the IRS's own guidance for churches.⁵ Moreover, quoting from the Code and regulations as well as from publicly released IRS memoranda,⁶ the Church noted that the threshold "reasonable belief" decision had been delegated far below the statutorily-required authority level, and requested that the IRS revisit the decision in light of the Congressional mandate reflected in the statute.

⁵ See IRS Publication 1828, *Tax Guide for Churches and Religious Organizations* at 7.

⁶Memorandum for All EO Examinations Managers and Revenue Agents from R.C. Johnson, Director, EO Examinations regarding the Political Intervention Project dated March 31, 2005.

Having heard nothing from the IRS for several months, on March 29, 2006, the Church again wrote to the IRS to inquire regarding the status of the examination and to reiterate its concerns regarding the procedural infirmities of the Government's investigation.

Eventually, on July 24, 2006, after the better part of a year of inaction in the case, the IRS issued an Information Document Request ("IDR") to the Church. In addition to the questions that were posed in the IDR enclosed with the Notice of Examination, the IRS added additional demands, including some that the Church had already addressed in its response to the Inquiry Notice. In addition, the IDR was recast from its earlier iteration to include questions that would yield a large number of results that bear no relevance to the subject or purpose of the examination. For example, one question asked for "sermons identifying candidates for public office" and another asked for "written or oral communications identifying one or more candidates."

By letter dated August 17, 2006, the Church respectfully declined to provide the requested information. In the same letter, the Church explained its objection to some of the questions, on the grounds that they were too broad and that they represented an intrusion by the Government into its religious worship services, implicating the Church's First Amendment rights. The Church explained that, consistent with the traditions of the Anglican liturgy, All Saints' congregation regularly offers prayers for the country's leaders by title, name or both, at Holy Eucharist and at other religious services. As an example, the Church noted that it follows the Anglican practice of praying for the leader of the country, President George W. Bush, by name during all of its Holy Eucharist services. Because some of the leaders for whom the Church prayed, including the President himself, were running for office in 2004, these prayers technically would be responsive to the questions, but the sheer volume of paper would have been both overwhelming and irrelevant to the examination.

In addition to raising these objections and in order to preserve its right to challenge the Government's actions in court, if necessary, the Church also requested that the IDR be issued as an administrative summons. In response, the IRS served All Saints and its rector, the Rev. J. Edwin Bacon, Jr., with two administrative summonses issued by the IRS Examination Division office in Des Moines, Iowa. In letters dated September 21, 2006 and October 24, 2006, the Church respectfully declined to provide the summoned data, and Rev. Bacon declined to appear to testify, explaining that the IRS had not corrected a series of procedural defects under section 7611.

After the Church and its Rector declined to respond to the Summonses, we understand that the Internal Revenue Service subsequently referred the case to the Department of Justice ("DOJ") for summons enforcement. DOJ never, however, sought to enforce either Summons in court, and the Church once again heard nothing from the IRS for almost a year. Despite the fact that the IRS garnered no new information following the conclusion of the Church Tax Inquiry, the Church finally received a letter from the IRS dated September 10, 2007, that simultaneously—and incongruously—both closed the examination with no change and asserted

that the Sermon constituted political campaign intervention. Despite that conclusion, the letter is silent as to whether the IRS intends to impose excise taxes under section 4955 on either the Church or any of its managers. Moreover, the IRS failed to enclose a copy of the Revenue Agent's Report ("RAR"), as required by section 7611(g) and the Internal Revenue Manual ("IRM") § 4.76.7.8. Absent a final conference or a copy of the RAR, the Church is left to wonder which factors, specifically, led the IRS to conclude that the Sermon constituted campaign intervention.

From the Outset, the Examination was Procedurally Flawed in Significant Respects

1. Threshold 7611 Determination Was Not Made by a "High-Level" Official

As you know, section 7611 requires the IRS to follow certain procedures when conducting examinations of churches. In this case, the IRS failed to follow one of the most fundamental requirements—the approval of an appropriate "high-level Treasury official" before initiating a Church Tax Inquiry.

Section 7611(a)(2) requires that, before initiating a church tax inquiry, an appropriate high-level Treasury Department official must reasonably believe (on the basis of facts and circumstances recorded in writing) that a church may not be tax-exempt under section 501(a) or may be engaged in certain taxable activities. Section 7611(h)(7) defines "appropriate high-level Treasury official" as "the Secretary of the Treasury or any delegate of the Secretary whose rank is *no lower than that of a principal Internal Revenue officer for an internal revenue region.*" (Emphasis added.)

After notice and opportunity for public comment, the Treasury Department and the IRS issued regulations in "question and answer" format interpreting section 7611. Treas. Regs. § 301.7611-1. In language mirroring the statute and legislative history, Answer 1 explicitly states that the IRS "may begin a church tax inquiry only when the appropriate Regional Commissioner (or higher Treasury official)" makes the "reasonable belief" determination.

Because of the IRS Restructuring Act of 1998 and the abolition of the Regional Commissioner position, however, the agency's structure no longer comports with the statute and Regulations. Nevertheless, the IRS could comply with both the statute and the Regulations by using the alternative method provided: a higher official (e.g., the Deputy Commissioner) could make the reasonable belief determination. Despite this alternative, the IRS has chosen to delegate this power to the Director of Exempt Organizations, Examinations—an official significantly less senior than a Regional Commissioner—in clear violation of both the statute and the Treasury Regulations. Thus, the Church was not afforded the protections guaranteed by section 7611 in the initiation of the Church Tax Inquiry.

2. *The IRS May Have Compromised the Church's Privacy Rights*

While our concerns regarding section 7611 and the violation of the Church's First Amendment rights have been well documented, we have recently received information that raises additional questions regarding the confidentiality rules in the Code and whether political appointees may have been involved in the examination. Documents that we received pursuant to our requests under the Freedom of Information Act ("FOIA") reveal that DOJ was involved at an early stage in this case well before the IRS actually made, or could have made, any formal referral of the case to that agency. Specifically, it appears from the email correspondence (enclosed for your reference) that representatives of the IRS Chief Counsel's office were closely coordinating with DOJ representatives to solicit their "views on the All Saints case," and even sharing drafts of a proposed IDR as early as February 2006. At that time, there was no court proceeding even on the horizon, because the Summonses had not yet been issued. Thus, it appears that these discussions may have violated the rules intended to prevent inter-agency disclosure of a taxpayer's return information, rules that were implemented in the wake of Watergate scandal to insure taxpayers' privacy. See section 6103(h)(2). It is even possible that the extraordinary delays in the examination are a direct result of extensive coordination with DOJ at an inappropriate point in the process.

3. *DOJ Coordination Heightens Concerns Regarding Possible Political Influence*

The correspondence described above reflects a number of meetings and discussions with one or more DOJ employees early in the case, apparently regarding all aspects of the examination, including the decision to request information and the nature of information to request by an IDR. Indeed, the FOIA documents reflect this coordination was so close that at least one DOJ official apparently expressed concerns about what might have to be provided in the event of court-ordered discovery. Given the high profile nature and First Amendment implications of this matter and the government's apparently intentional short-circuiting of any of the statutory routes for the Church to raise its concerns regarding the IRS's procedural actions, we cannot help but wonder whether political appointees at DOJ may have been involved in approving and planning the examination of the Church.

4. *Inconsistent and Vague Closing Letter Threatens to Chill Religious Speech*

Despite DOJ's obvious reluctance to enforce the Summonses, the IRS failed to close the examination until the time period prescribed for church examinations in section 7611 expired. At that point, rather than following the procedures outlined in IRM § 4.76.7.8 for closing church examinations, the IRS issued a self-serving closing letter, proclaiming that, while the Church had violated the prohibition in section 501(c)(3) against political campaign activity, its exempt status was intact. The letter does not explain which elements of the Sermon, exactly,

led the IRS to conclude that it constituted political campaign intervention. In fact, the IRS's conclusion stands in direct opposition to its resolution of other examinations arising from 2004 election year activities that have been widely reported in the media recently, which concluded that no political campaign intervention occurred. In these situations, allegations were made that the taxpayers in question engaged in political campaign intervention in violation of section 501(c)(3). Based on the press accounts of these situations, we fail to see a material difference between these situations and the Church's. In fact, the Church was never given an opportunity to discuss its concerns with the IRS because the IRS, in conjunction with the DOJ foreclosed such discussions. Indeed, the Government even precluded the Church's ability to force such discussions through a summons enforcement action in court. The Church is at a loss to explain why the IRS needed an additional two years to reach this conclusion—especially given that it mirrored the IRS's initial assessment in the conference of September 22, 2005. Moreover, the letter did not include a final report of the Revenue Agent, as required by section 7611(g) and IRM § 4.76.7.8, nor did it address whether any section 4955 tax attributable to overhead, web posting or other costs would be imposed on the Church or its management.

Due to the magnitude of these procedural flaws, the Church requests the following:

1. Confirmation that an appropriate high-level Treasury official, as defined in section 7611 and the accompanying Treasury Regulations, authorized the Church Tax Inquiry. In the alternative, an acknowledgment that the IRS violated section 7611's "high-level Treasury official" requirement.
2. Confirmation that the Church's privacy/confidentiality rights were not violated in connection with the IRS's coordination with DOJ, and an explanation of what steps were taken to ensure compliance with section 6103(h)(2).
3. Names and titles of all IRS and DOJ personnel who participated in the All Saints matter at any stage of the investigation, the date on which the coordination began, an explanation of whether the DOJ or IRS initiated the coordination, and an explanation of whether the closing letter itself was subject to such coordination.
4. Assurance that no improper political influence was brought to bear in the decision-making, including a description of the procedures utilized to ensure that was the case and assurance that neither the IRS nor the DOJ coordinated with the White House.
5. A copy of the final Revenue Agent's Report, as required by IRM § 4.76.7.8.

6. If the Revenue Agent's Report is unclear, an explanation of precisely which facts surrounding the Sermon the IRS believes constituted political campaign intervention.
7. A closing letter without any advisory language.
8. Confirmation that neither the Church nor any of its managers is subject to the excise tax under section 4955.
9. An explanation regarding the delays and protracted periods of silence on the IRS's part during the examination.
10. A letter of apology from the IRS about the agency's treatment of the Church throughout the course of the examination.

* * *

As you can imagine, the prolonged uncertainty surrounding the examination has been both unsettling and distracting for the Church. Moreover, the Church has expended significant financial resources in defending against an examination the conclusion of which the Church does not comprehend. From the outset, the Church has highlighted the substantive flaws in the IRS's analysis and the procedural defects in the handling of this case, including our repeated inquiries regarding the IRS's threshold determination in this case—was the decision to initiate the Church Tax Inquiry made by the appropriate "high-level" official, as required by section 7611? To date, we have never received an answer to any of these questions. Our recent discovery of the IRS and DOJ coordination only raises additional questions regarding the propriety with which the examination was conducted.

The Church is currently considering its other procedural options, including ways to ensure that the merits of this case and the government's handling of it are subject to judicial review. If we do not receive a satisfactory response within thirty days, the Church will have no option but to pursue these alternatives.

Sincerely,



Marcus S. Owens

Enclosure

cc: All Saints Church (via email)

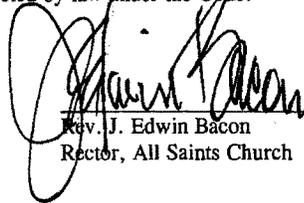
CONSENT TO THE DISCLOSURE OF TAX INFORMATION

All Saints Church Pasadena, CA
132 North Euclid Avenue
Pasadena, CA 91101-1722
EIN 95-1980801

Pursuant to Section 6103 of the Internal Revenue Code ("Code"), All Saints Church, Pasadena, CA, hereby authorizes the Internal Revenue Service to disclose its return information (as defined in subsection 6103(b)(2) of the Code) at the hearing of the United States House of Representatives Committee on Appropriations on April 15, 2008, and in subsequent written responses to questions from Members of the Committee. This waiver is limited to any and all information concerning the Church Tax Inquiry and Examination conducted of All Saints Church's 2004 tax year. This waiver expressly includes, but is not limited to, information relating to the sermon delivered by the Rev. Dr. George Regas that triggered the Inquiry and Examination and to the prosecution of the Inquiry and Examination by the Internal Revenue Service and the Department of Justice.

Except to the extent disclosure is authorized herein, All Saints Church's returns and return information are confidential and protected by law under the Code.

4.14.08
Date


Rev. J. Edwin Bacon
Rector, All Saints Church

Mr. SCHIFF. What I would ask is that, number one, the church has been waiting 6 months to have legitimate questions answered. I would ask that in 30 days that you give the church and this committee a response to the legitimate questions the church has asked. Seven months ought to be a sufficient time to answer these questions. So that is my first request.

And beyond that, I would like to know, if you can, with greater specificity, how you think religious organizations can be guided, what do you advise a church that wants to talk about war and peace, that doesn't want to just talk about it maybe certain times of the year or during certain years but has to forgo discussing it around elections, what kind of advice do you give a religious institution?

So if you could answer both those questions. Will you commit to responding within 30 days? And could you give us your thoughts on how a religious organization is supposed to know, based on this kind of track record, what it can and cannot say?

Mr. SERRANO. The Chair will note that the gentleman's 5 minutes are up. However, this merits an answer, and so we will take the answer.

Mr. SHULMAN. Let me make a couple of brief comments.

One is, as I told you, I am 3 weeks on the job, and am not familiar with the details of this case. I don't want to speak about anything that I can't speak about on a specific investigation. And so I really don't know where this case is and where the request is.

And so I can make a commitment to you that I will go back and look into this and come back in what I view is a prompt fashion. Thirty days, I just—I don't know where this is in the pipeline and most of the information I have about this case comes from you.

Mr. SCHIFF. Let me ask you for this commitment. The church has been waiting 6 months for an answer to this letter. Will you commit to giving a response to this committee in 30 days either to the questions or tell us in 30 days why you can't answer the questions yet?

Mr. SHULMAN. I will commit to come back to you within 30 days and have a discussion.

As a general principle, whether it be for this kind of guidance or other guidance, I think we are well-served as an agency to be as clear as we can with individual taxpayers, corporate taxpayers, nonprofit taxpayers, churches, about what are our rules, how do you stay on the right side of the line, so that there is not confusion.

I have made public statements about that. I have talked to the staff about it, that during my tenure at the IRS I plan to push to have clear guidance. I think in this area, it is especially important that we have clear guidance because it is a sensitive area for churches, for politics, et cetera. It is also incredibly important that we be a nonpolitical, nonpartisan agency. The more we can be clear up front, the more that there is never any question of perception about that.

And so I can't speak to the specific guidance to churches now. I am still getting my arms around a variety of issues. I can tell you, on a general level, I truly do believe that clear guidance is a good thing. This is something that I think is a valid point. And I will definitely be happy to come talk to you and talk to other members

of the nonprofit community and church community about this going forward.

[CLERK'S NOTE.—Upon completion of the hearing, Commissioner Shulman informed Congressman Schiff there had been additional correspondence with All Saints Church in Pasadena, and pursuant to the disclosure waiver, provided the Congressman with a copy. The correspondence is included for the record.]



COMMISSIONER
TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20234

OCT 22 2007

Marcus S. Owens, Esq.
Caplin & Drysdale, Chartered
One Thomas Circle, NW
Suite 1100
Washington, D.C. 20005

Dear Mr. Owens:

Acting Commissioner Stiff asked me to reply to your letter of September 21, 2007, in which you raised a number of questions about the examination of All Saints Church of Pasadena, CA, that the Internal Revenue Service (IRS) recently closed.

The Internal Revenue Code prohibits organizations exempt from taxation under section 501(c)(3) from intervening in any campaign on behalf of or in opposition to a candidate for public office. As the documents you enclosed with your letter show, the IRS's examination of All Saints Church addressed compliance with this requirement of the federal tax law. You asked several questions about the conduct of the examination. You also asked whether IRS contacts with the Department of Justice (DOJ) violated disclosure restrictions, and whether political influence affected the examination.

I believe the IRS complied with the applicable laws and procedures in conducting the examination, including all laws and procedures that protect privacy rights and restrict the confidentiality of tax information. Further, I believe that not only did political influence have no impact on any aspect of the church tax inquiry or examination, but none was brought to bear on the IRS with respect to the examination.

I understand from media reports that you made a request to the Treasury Inspector General for Tax Administration (TIGTA) to review how the examination was handled. Because of the seriousness of your allegations, I agree that a TIGTA review is appropriate. The IRS also referred the case to TIGTA for review. As demonstrated in the past where questions have been raised about the propriety of certain examinations of section 501(c)(3) organizations, TIGTA has the capacity to provide an independent and thorough review of what happened in this case. See TIGTA Final Audit Report 2005-10-035, "Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations," February 2005, where

TIGTA found that the IRS properly operated its program for investigating claims of political campaign intervention by tax-exempt organizations. (Copy enclosed.)

Let me turn to the issues in your letter. First, you asked for confirmation that an appropriate high-level Treasury official authorized the church tax inquiry of All Saints Church. The inquiry was approved by the Director, Exempt Organizations Examinations, who, since the restructuring of the IRS pursuant to the Restructuring and Reform Act of 1998, Pub. L. 105-206 (RRA 1998), is the appropriate high-level Treasury official under section 7611. The Office of Chief Counsel advised that the Director, Exempt Organizations Examinations, satisfies the statutory requirements of section 7611. That advice was publicly disclosed in 2006 pursuant to section 6110 as IRS CCA 200623061. Based on correspondence that you sent to Commissioner Everson on July 17, 2006 that made reference to this legal memorandum, I believe you are familiar with this legal advice, but we enclose a copy in any event.

You asked about authorization for contacts between the IRS Office of Chief Counsel and the DOJ prior to referring a case for summons enforcement. Since the enactment of the Tax Reform Act of 1976 over 30 years ago, it has been the position of the IRS that consultation with the DOJ prior to referring a case for formal action is legally authorized under sections 6103(h)(2) and (3), which govern the disclosure of tax information to the DOJ in order to carry out its statutory responsibility in the civil and criminal tax areas. As the Staff of the Joint Committee on Taxation said in a statement made contemporaneously with the enactment of the statute:

For purposes of this provision, the referral of a tax matter by the IRS to the Justice Department would include those disclosures made by the IRS to the Justice Department in connection with the necessary solicitation of advice and assistance with respect to a case prior to formal referral of the entire case to the Justice Department for defense, prosecution, or other affirmative action.

Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, H.R. 10612, 94th Cong., Pub. L. 94-455, 322 (Dec. 29, 1976), 1976-3 C.B., Vol. 2 344. In addition, in 1996, the Office of Legal Counsel at DOJ issued an opinion concluding that seeking advice from DOJ prior to a formal referral was authorized under the statute. DOJ Participation in the Internal Revenue Service Undercover Review Committee, October 8, 1996 (copy enclosed). In the All Saints case, the IRS Office of Chief Counsel solicited advice and assistance with respect to this examination after the Notice of Church Tax Examination was issued and after the conference of right was completed. I believe the discussions with DOJ with respect to this case were authorized under section 6103.

You requested a copy of the final Revenue Agent's Report which you described as "required by IRM § 4.76.7.8." As you noted in your letter, section 7611(g) provides that a revenue agent's report is evidence of final agency action in a church tax examination that enables a church that is subject to adverse action (e.g., revocation of tax exemption) to exercise its rights to a declaratory judgment under section 7428 of the Code. Where a case has been closed on a "no change" basis with an advisory, the declaratory judgment provisions have no application, and the IRM requires that the organization be provided with a specific description of the issues covered in the examination. As the letter sent to you indicates the specific issue under consideration in your case, the letter is consistent with the IRM and with our practice in other cases in this area.

You were concerned that the closing letter issued to All Saints did not explain which elements of the sermon led the IRS to conclude that it constituted political campaign intervention. Our analysis in this case was straightforward. Rev. Dr. Regas' sermon of October 31, 2004, identified the two major party candidates in the Presidential election of 2004, expressed views on positions taken by the candidates and on actions taken by one candidate, was delivered two days before the election, and closed with a reference to voting. We concluded that it is reasonable to believe that Rev. Dr. Regas' sermon expressed a message on how to vote in the 2004 Presidential election. The fact that Rev. Dr. Regas began his sermon by telling congregants that he did not intend to tell them how to vote did not resolve the issue of potential political campaign intervention given the balance of the communication.

You asked whether tax under section 4955 will be assessed. The examination is now closed and no further enforcement action, including imposition of taxes under section 4955, will be pursued in connection with Rev. Dr. Regas' sermon delivered on October 31, 2004 or any other activities involving All Saints Church that took place during 2004.

You also expressed concern about the lack of guidance on what constitutes political campaign intervention. I concur that it is preferable to have more guidance. We have worked to publish guidance in this area, and, in fact, did so earlier this year. In June, we issued *Revenue Ruling 2007-41, 2007-25 I.R.B. 1421* (June 18, 2007) (copy enclosed), discussing facts and circumstances to be considered and illustrating the application of the prohibition with 21 examples. While the examples cannot address every situation, the Revenue Ruling also provides guidance on the factors to be analyzed. We will continue to review the need for additional guidance in this area.

Revenue Ruling 2007-41 lists relevant factors for purposes of distinguishing issue advocacy from political campaign intervention as including whether a statement identifies one or more candidates for public office, whether the statement expresses approval or disapproval for one or more candidates/

positions and/or actions, whether the statement is delivered close in time to the election, and whether the statement makes references to voting or to an election. Further, under the Revenue Ruling, a speaker who does not explicitly endorse or oppose a particular candidate may nonetheless deliver a message that favors or opposes a candidate.

While I recognize that the pace of this examination was slower than you or I would have liked, I believe that pace was the result of appropriate actions and decisions taken by both the taxpayer and the Service. You have also asked about the identity of those at the Service who participated in the All Saints matter at any stage of the investigation. From documents the Service has provided you, you already are familiar with many of the participants. In addition, we are willing to provide you the names of the senior-level IRS personnel involved.

I hope you find this discussion responsive to your concerns. While we believe we handled the All Saints matter professionally and appropriately, we welcome an objective review by TIGTA of our handling of the case.

Sincerely,



Steven T. Miller

Enclosures

**Review of the Exempt Organizations Function
Process for Reviewing Alleged Political
Campaign Intervention by Tax Exempt
Organizations**

February 2005

Reference Number: 2005-10-035

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 17, 2005

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Review of the Exempt Organizations
Function Process for Reviewing Alleged Political Campaign
Intervention by Tax Exempt Organizations (Audit # 200510008)

This report presents the results of our review of the Exempt Organizations (EO) function process for reviewing alleged political campaign intervention by tax exempt organizations. The overall objective of this review was to evaluate the Tax Exempt and Government Entities (TE/GE) Division's recently established process for reviewing information alleging political campaign intervention by Internal Revenue Code (I.R.C.) § 501(c)(3)¹ organizations and for initiating any associated examinations of these organizations. Specifically, we determined the process established by TE/GE Division management to review referrals of potential political campaign intervention and assessed whether referrals were processed in accordance with established procedures.

In November 2004, the Treasury Inspector General for Tax Administration (TIGTA) received separate requests from the Commissioner of the Internal Revenue Service (IRS) and the Commissioner, TE/GE Division, to evaluate the new process used by the IRS to review allegations of potential political activities by tax exempt organizations. There had been several media reports of allegations that the TE/GE Division was examining this type of activity just before the 2004 Presidential election for politically motivated reasons. We limited our audit to a review of the process followed by the EO function for reviewing these allegations and did not determine whether the activities by the tax exempt organizations involved potentially prohibited political activity. We were alert for any indications that inappropriate actions, such as political influence, may have been taken with regard to the handling of these referrals. Based on the extent of our

¹ I.R.C. § 501(c)(3) (2004).

audit work, we did not identify any indications that the EO function inappropriately handled the information items we reviewed. Furthermore, we did not make any referrals to the TIGTA Office of Investigations during this audit.

In summary, the TE/GE Division took several actions in 2004 to address potential political campaign intervention by tax exempt organizations. Specifically, TE/GE Division management provided education and outreach activities to § 501(c)(3) organizations on their responsibilities related to political activities. In addition, the EO function established a new expedited process to review allegations of potential political intervention by tax exempt organizations because EO function management anticipated an increase in these types of allegations during the 2004 election year. In June 2004, EO function management initiated a Political Intervention Project (PIP) at the request of the Commissioner, TE/GE Division. The main goal of the PIP was to establish a "fast track" process to respond quickly to referrals of potential political intervention during the 2004 election year and prevent recurring violations by the same organizations.

We reviewed samples of information items processed under the PIP during the period July 30, 2004, through November 22, 2004, to determine whether the EO function processed the allegations in accordance with established procedures.² Based on our samples, we determined the EO Referral Committee followed a consistent process when reviewing the information items, regardless of the source of the allegation or the potential political activity. Specifically, the sampled information items were reviewed by a three-person EO Referral Committee of experienced EO function technical employees, as required. In addition, the EO Referral Committee's decision of whether an allegation warranted an examination was documented in each case file. EO function management informed us the EO Referral Committee evaluated the information items based on the "reasonable belief standard."³ Further, we analyzed the EO Referral Committee's decisions and did not identify any cases in which the same criteria were used to select one information item for examination and to decline a similar item for examination.

However, EO function management experienced delays in expediting the classification and examination processes. Specifically, the EO Classification Unit did not always ensure information items were classified and directed to a field examination group timely, contact letters were not always issued to taxpayers within the expedited period,

² We randomly selected 40 of the 80 information items for which the EO Referral Committee determined an examination was warranted, randomly selected 20 of the 41 items for which an examination was not warranted, and selected all 10 of the information items that were classified and determined to be inaccurately categorized as potential political activity, for a total of 70 cases. For the 20 cases, the EO Referral Committee identified several reasons for not selecting the items for examination, including the alleged activity was not prohibited political activity; the referral did not contain a specific, supported allegation of political activity; and the organization was not a § 501(c)(3) organization. For the 10 cases that were inaccurately categorized, the EO Referral Committee determined the allegations did not always contain specific, supported allegations of political activity or the organization was not a § 501(c)(3) organization.

³ For "reasonable belief" to be met, the Committee must determine an information item demonstrates that a violation of the tax laws may have occurred or it appears likely that an examination will lead to the discovery of a violation.

and notices of tax inquiry for issuance to churches were not reviewed and approved within the 15 workday expedited period.

EO function management's ability to effectively accelerate case initiations for potential political intervention allegations was affected by a lack of clear guidance, inadequate resources, and the late initiation of the PIP with less than 5 months remaining before the 2004 elections. As a result, the first contact letter sent to an organization as part of the PIP was not issued until September 21, 2004, 6 weeks before the scheduled elections. Although the IRS' ability to contact tax exempt organizations as part of the PIP is not limited by the timing of the Presidential election, we believe contacting organizations so close to the election and the late publicity about this project contributed to the allegations of improper motivation on the part of the IRS.

During our fieldwork, EO function management decided to discontinue the "fast track" processing of allegations of potential political intervention by § 501(c)(3) organizations. This decision was based on completion of the 2004 elections and was effective for all information items received after November 30, 2004.

We recommended the Director, EO, formalize the draft guidelines that detail how allegations of potential noncompliance with the tax laws by tax exempt organizations should be classified. In addition, the Director, EO, should establish realistic time standards for when information items should be classified and forwarded to an examination group, if warranted, for both election and nonelection years. Additionally, the Director, EO, should ensure any future expedited review process is initiated early enough in an election year to ensure classification and examination actions are completed timely and consistently. Further, to increase public awareness, we recommended the Commissioner, TE/GE Division, should issue a press release in future election years if the IRS plans to implement an expedited process to review allegations of potential political intervention.

Management's Response: The IRS agreed with our recommendations and indicated it is evaluating the prohibited political activity program as it operated during the last election cycle. Based on this evaluation, the IRS expects to make a number of decisions on changes to the program for the next election cycle. TE/GE Division management has drafted and will make effective procedures that specify how allegations of potential noncompliance by tax exempt organizations should be classified. In addition, procedures for future election years and nonelection years will provide realistic time periods for processing information items alleging potential political intervention. TE/GE Division management has drafted and the Director, EO Examinations, is considering procedures for future election years that will ensure the process is initiated early enough to allow classification and examination actions to be completed timely and consistently. Finally, the Commissioner, TE/GE Division, has requested the Director, Communications and Liaison, TE/GE Division, to prepare a press release in future election years advising the exempt organizations community that allegations of potential noncompliance with the tax laws relating to political activity will be processed on an expedited basis. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

**Review of the Exempt Organizations Function Process for Reviewing Alleged
Political Campaign Intervention by Tax Exempt Organizations**

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**Review of the Exempt Organizations Function Process for Reviewing Alleged
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Background

Under the Internal Revenue Code (I.R.C.), § 501(c)(3)¹ organizations are exempt from Federal income tax. Charities, educational institutions, and religious organizations, including churches, are among those that are covered under this Code section. To qualify for and maintain tax exempt status under I.R.C. § 501(c)(3), an organization must be organized and operated exclusively for its tax exempt purpose.

While many charities speak out on public issues as an integral part of carrying on their tax exempt function, the I.R.C. prohibits § 501(c)(3) organizations from the following types of political activities:

- Directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office.
- Making contributions to political campaign funds.
- Making public statements (verbal or written) in favor of or in opposition to any candidate for public office.
- Engaging in activities that may be beneficial for or detrimental to any particular candidate. These activities may constitute intervention, even if they do not expressly call for the election or defeat of a particular candidate, if the activity contains reasonably overt communication that the organization supports or opposes a particular candidate.

Violation of this I.R.C. prohibition may result in denial or revocation of tax exempt status for the § 501(c)(3) organization and the imposition of certain excise taxes on the amount of money spent on the prohibited activity.

The Exempt Organizations (EO) function of the Tax Exempt and Government Entities (TE/GE) Division has responsibility for ensuring charitable or other tax exempt organizations are in compliance with the I.R.C. Allegations of potential noncompliance with the I.R.C., including

¹ I.R.C. § 501(c)(3) (2004).

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allegations of potential political activity by § 501(c)(3) organizations, are reviewed by the EO function. The EO function may conduct an examination to determine if the political activity is a violation of the law and if enforcement action is warranted. EO function personnel select an organization for examination based on information contained on the tax return filed with the Internal Revenue Service (IRS). However, the IRS also has authority to examine a reporting period in which the tax return has not been filed and is not yet due.

In November 2004, the Treasury Inspector General for Tax Administration (TIGTA) received separate requests from the Commissioner of the IRS and the Commissioner, TE/GE Division, to evaluate the new process used by the IRS to review allegations of potential political activities by tax exempt organizations. There had been several media reports of allegations that the TE/GE Division was examining this type of activity just before the 2004 Presidential election for politically motivated reasons. Because the IRS (not the TIGTA) has the authority to administer the internal revenue laws,² which includes determining whether tax exempt organizations are in compliance with those laws, we limited our audit to a review of the process followed by the EO function for reviewing these allegations and did not determine whether the activities by the tax exempt organizations involved potentially prohibited political activity. We were alert for any indications that inappropriate actions, such as political influence, may have been taken with regard to the handling of these referrals. Any inappropriate actions, including political influence, would have been referred to the TIGTA Office of Investigations for review.

This review was performed at the EO function National Headquarters in Washington, D.C., and the EO Examinations office in Dallas, Texas, during the period November 2004 through January 2005. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective,

² I.R.C. § 7803(a) (2004).

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**The Tax Exempt and
Government Entities Division
Took Several Actions in 2004 to
Address Allegations of Potential
Political Campaign Intervention
by Tax Exempt Organizations**

scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Based on our discussions with TE/GE Division management and review of applicable documentation, we determined TE/GE Division management took several actions during 2004 to address potential political campaign intervention by tax exempt organizations. Specifically, TE/GE Division management provided education and outreach activities to I.R.C. § 501(c)(3) organizations on their responsibilities related to political activities. In addition, the EO function established a new process to review allegations of potential political intervention by tax exempt organizations on an expedited basis to respond quickly to these allegations and prevent recurring violations.

The TE/GE Division took actions in 2004 to remind tax exempt organizations of prohibited political activities

We determined the IRS took several actions during the 2004 election year to remind § 501(c)(3) organizations of the prohibition against engaging in improper political intervention, including:

- Workshops conducted by EO function personnel in seven states during May and June 2004 that included a topic on political activities.
- Presentations that addressed prohibited political activities at the IRS Nationwide Tax Forums held in six states during July through September 2004.
- An April 2004 press release discussing prohibited political campaign activities for tax exempt organizations. IRS management indicated they issued similar election-year advisories in 1992, 1996, and 2000.
- A letter related to prohibited political activities, issued in June 2004 to seven national political parties. These included the Republican, Democratic, and Libertarian National Committees and the Green Party of the United States.
- An October 2004 press release reiterating prohibited political activities and outlining IRS enforcement

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activity taken to address potential prohibited political activities by tax exempt organizations.

The EO function established a “fast track” process to review allegations of potential political intervention by exempt organizations

While the EO function receives information items³ of potential political intervention by § 501(c)(3) organizations throughout the year, EO function management anticipated an increase in these types of information items during the 2004 election year. To respond to these referrals, EO function management initiated a Political Intervention Project (PIP). The main goal of the PIP was to establish a “fast track” process to respond quickly to referrals of potential political intervention during the 2004 election year and prevent recurring violations by the same organizations. The PIP used the EO function’s existing process for evaluating referrals, except that it allowed for accelerated case initiations in both the classification and examination processes. EO function management intended for the PIP to remain in effect until the completion of the 2004 election year, when it would be reevaluated for use in future years.

Based on our review of available documentation, the PIP was initiated in June 2004 at the request of the Commissioner, TE/GE Division. On July 26-30, 2004, an eight-member team met in Dallas, Texas, to develop an expedited process to classify and, if warranted, examine information items alleging political intervention by § 501(c)(3) organizations. The team developed proposed procedures for PIP cases, including:

- Establishing an expedited time period for completing the classification of potential political intervention referral cases and directing the cases to an examination group, if warranted, within 7-10 workdays following the receipt of the referrals in the EO Classification Unit. (For non-PIP cases, the EO Classification Unit is required to begin

³ An information item is a communication received by the EO function from an internal or external source related to potential noncompliance with the tax law by an exempt organization, political organization, taxable entity, or individual.

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evaluating information items within 60 days of their receipt in the Unit; however, there is no time standard for completing the classification of non-PIP cases.)

- Requiring the EO Classification Unit's EO Referral Committee to determine which cases should be worked as correspondence examination or field examination.
- Developing contact letters for informing nonchurch § 501(c)(3) organizations that they have been selected for an examination.
- Establishing an expedited review and approval process for the notices of tax inquiries sent to churches to inform them the IRS is considering initiating an examination.

During August 2004, the TE/GE Division revised the proposed PIP procedures and contact letters to be sent to organizations selected for expedited examinations. The EO Classification Unit manager sent the proposed procedures to the EO Examinations office area managers for implementation on August 24, 2004; however, the procedures were not formally issued by the Director, EO Examinations. The contact letters and related attachments were approved for issuance as of September 15, 2004. Consequently, the first contact letter sent to an organization as part of the PIP was not issued until September 21, 2004.

We determined the EO function has draft guidelines for processing, controlling, and tracking all types of information items received by EO function personnel concerning the activities of tax exempt organizations. EO function personnel stated they follow these guidelines when reviewing information items, but the guidelines have been in "draft" status for an extended period and have not been finalized.

According to the draft guidelines, a classifier in the EO Classification Unit is generally responsible for reviewing an information item to determine if the item has examination potential unless the information item is required to be reviewed by the EO Referral Committee. The EO Referral Committee reviews the information items containing

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evidence or allegations of political activities as well as any type of allegations pertaining to churches.

Based on our review of documentation and interviews with TE/GE Division management, the EO Referral Committee was comprised of three members, who were experienced EO function technical employees (e.g., senior examiners, classification specialists, or group managers). The Committee is responsible for considering, in a fair and impartial manner, whether information items referred have examination potential. To make this decision, the Committee evaluates whether an information item meets the "reasonable belief standard" using their experience, judgment, and concern for fairness. For "reasonable belief" to be met, the Committee must determine an information item demonstrates that a violation of the tax laws may have occurred or it appears likely that an examination will lead to the discovery of a violation.

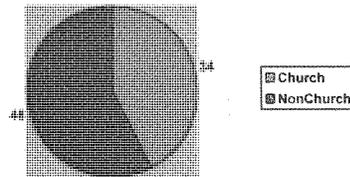
The PIP included two sets of information items, all of them alleging political intervention by § 501(c)(3) organizations. The primary set involved information items received by the EO Classification Unit on or after July 30, 2004. These cases were subject to both expedited classification and expedited examination processing. The second set involved information items received before July 30, 2004, that were in the EO Classification Unit's inventory or information items that involved potential political activity by § 501(c)(3) organizations that were assigned to an examination group but for which no taxpayer contact had been made. These cases were subject to expedited examination processing but not the expedited classification.

Based on information provided by EO function management, we determined that, during the period July 30, 2004, through November 22, 2004, the EO Referral Committee reviewed 131 information items alleging potential political activities by tax exempt organizations. The committee determined 10 information items were inaccurately categorized as potential political activities because they did not involve political activities. Of the remaining 121 information items, the EO Referral Committee determined 80 items warranted an examination based on the "reasonable belief" criteria and 41 items did

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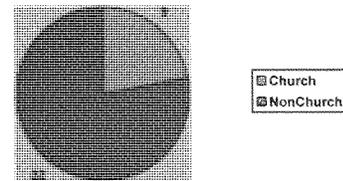
not warrant an examination. Figures 1 and 2 break down these cases by type of organization.

Figure 1: 80 Organizations Selected for Examination



Source: TE/GE Division data.

Figure 2: 41 Organizations Not Selected for Examination



Source: TE/GE Division data.

The “fast track” processing was discontinued as of December 1, 2004

During the fieldwork phase of our review, EO function management decided to discontinue the “fast track” processing of allegations of potential political intervention by § 501(c)(3) organizations. This decision was based on completion of the 2004 elections and was effective for all information items received after November 30, 2004.⁴ Based on our discussion with EO function management, a classifier will begin evaluating information items received after that date within 60 days (rather than classifying and

⁴ EO function management considers the election cycle to end on November 30th of even numbered years.

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directing items to an EO Examinations office group within 7-10 workdays of receipt). All cases processed under the "fast track" procedures prior to December 1, 2004, and assigned to the EO Examinations office were still required to be processed under the "fast track" examination procedures implemented in August 2004. At the end of our fieldwork, EO function management was evaluating whether an expedited process will be implemented in future election years.

EO function management has also designated potential political intervention referral cases as priority work for the EO Examinations office in Fiscal Year (FY) 2005, indicating the TE/GE Division's continued emphasis in this area.

**Allegations of Potential Political
Campaign Intervention Were
Handled Consistently but Were
Not Always Processed Timely**

We reviewed samples of information items processed under the PIP to determine whether the EO function processed the allegations in accordance with established procedures. Based on our samples, we determined the EO Referral Committee followed a consistent process when reviewing the information items, regardless of the source of the allegation or the potential political activity. Specifically, the sampled information items were reviewed by a three-person EO Referral Committee of experienced EO function technical employees, as required. In addition, the EO Referral Committee's decision of whether an allegation warranted an examination was documented in each case file. EO function management informed us the EO Referral Committee evaluated the information items based on the "reasonable belief standard." Further, we analyzed the EO Referral Committee's decisions and did not identify any cases in which the same criteria were used to select one information item for examination and to decline a similar item for examination. Based on the extent of our audit work, we did not identify any indications that the EO function inappropriately handled the information items we reviewed. Furthermore, we did not make any referrals to the TIGTA Office of Investigations during this audit.

However, EO function management experienced delays in expediting the classification and examination processes. Specifically, the EO Classification Unit did not always ensure information items were classified and directed to a

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field examination group timely, contact letters were not always issued to taxpayers within the expedited period, and notices of tax inquiry for issuance to churches were not reviewed and approved within the 15 workday expedited period. EO function management's ability to effectively accelerate case initiations for potential political intervention referrals was affected by a lack of clear guidance, inadequate resources, and the late initiation of the PIP with less than 5 months remaining before the 2004 elections. As a result, EO function management did not send contact letters to organizations until September 21, 2004, 6 weeks before the scheduled elections. Although the IRS' ability to contact tax exempt organizations as part of the PIP is not limited by the timing of the Presidential election, we believe contacting organizations so close to the election and the late publicity about this project contributed to the allegations of improper motivation on the part of the IRS.

To select our samples, we obtained several listings from EO function management of all "fast track" cases processed during the period July 30, 2004, through November 22, 2004. We randomly selected 40 of the 80 information items for which the EO Referral Committee determined an examination was warranted, randomly selected 20⁵ of the 41 items for which an examination was not warranted, and selected all 10⁶ of the information items that were classified and determined to be inaccurately categorized as potential political activity, for a total of 70 cases.

Information items were not always classified timely

To determine if the EO Classification Unit function timely processed the information items we selected, we used two different classification timeliness standards, depending on

⁵ The EO Referral Committee documented its decision not to select these cases for examination for various reasons, including the alleged activity was not prohibited political activity; the referral did not contain a specific, supported allegation of political activity; and the organization was not a § 501(c)(3) organization.

⁶ Our analysis of these cases determined they were similar to those categorized as not selected for examination. Specifically, the cases did not always contain specific, supported allegations of political activity or the organization was not a § 501(c)(3) organization.

**Review of the Exempt Organizations Function Process for Reviewing Alleged
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when the information items were received by the EO Classification Unit. Specifically, information items received in the Unit before July 30, 2004, were considered timely if they were assigned to a classifier within 60 days of receipt by the Unit.⁷ Information items received on or after July 30, 2004, were considered timely if they were classified and sent by the EO Classification Unit to an examination group, if warranted, within 10 workdays of receipt by the Unit. As shown in Figure 3, the EO function did not always classify information items timely.

Figure 3: Timeliness of Classification Process

EO Classification Unit Receipt Date	Number of Cases	Number Not Processed Timely	Percentage Not Processed Timely	Range of Untimeliness (days)
Before 07/30/04	37	4	10.8	1-77 (avg 24 days late)
On or After 07/30/04	33	25	75.8	1-40 (avg 19 workdays late)
Totals	70	29	41.4	

Source: TIGTA analysis of selected information items.

We analyzed the 25 untimely processed information items received on or after July 30, 2004, and identified 2 main causes of untimeliness: delay in classifying the information items by the EO Referral Committee (it took an average of 15 workdays for the EO Referral Committee to classify the items after receipt in the Unit) or delay by the EO Classification Unit in sending the cases to an examination group after a decision was made by the EO Referral Committee (18 of the 25 items were selected for examination but were not sent to an examination group until an average of 19 workdays after review by the EO Referral Committee).

⁷ We considered the evaluation of information items to begin when they were assigned to a classifier.

**Review of the Exempt Organizations Function Process for Reviewing Alleged
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Although the PIP team requested additional resources to meet the expedited time standards, the EO Classification Unit may not have had sufficient resources to meet the PIP time standards. The Unit was allocated only an additional .5 Full-Time Equivalent⁸ to assist in meeting the expedited PIP time periods during the project. EO function management stated EO Classification Unit staffing shortages caused delays in the case-building process (conducting research of both internal and external databases) when information items were received, as well as delays in updating internal databases and preparing the case files before they were sent to EO Examinations office personnel after the EO Referral Committee determined an examination was warranted.

As shown in Figure 3, classifiers timely began the evaluations (i.e., within 60 days of receipt) for the majority of cases in our samples received in the EO Classification Unit before July 30, 2004. However, the information items were not classified by the EO Referral Committee until an average of 111 days (almost 4 months) after receipt by the EO Classification Unit. In addition, when examinations were warranted, the Unit did not send the information items to an examination group until an average of 126 days (an additional 4 months) after the items were classified by the EO Referral Committee.

With the decision to discontinue the expedited processing of potential political intervention referrals and the lack of a time standard for classifying cases, future referrals may once again be delayed in classification. To ensure all information items are evaluated timely, the EO function should establish, for both election years and nonelection years, clear time standards for when these information items should be classified and forwarded to an examination group, if warranted.

⁸ A Full-Time Equivalent (FTE) is a measure of labor hours. One FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2004, 1 FTE was equal to 2,096 staff hours. For FY 2005, 1 FTE is equal to 2,088 hours.

**Review of the Exempt Organizations Function Process for Reviewing Alleged
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**Examination case processing was not always performed
on an expedited basis for PIP cases**

Our analysis of the examination process for the 40 randomly selected information items for which the EO Referral Committee determined an examination was warranted was limited to the initial processing by the examination group as of December 21, 2004. This included the timeliness of case assignment to an agent, issuance of contact letters to nonchurch organizations, and processing of inquiry letters required for church cases. However, TE/GE Division personnel did not always ensure the necessary actions were completed timely.

Specifically, we determined EO Examinations office management did not always ensure information items involving potential political intervention activity were assigned to an agent within the expedited period. We determined 21 (53 percent) of the 40 cases were not assigned to an agent within 1 day of receipt in the group, as required. Delays in the case assignment ranged from 1 to 30 workdays.

For nonchurch PIP cases selected for correspondence examination, a letter should be issued to an organization within 5 workdays of receipt by the agent. For nonchurch PIP cases selected for field examination, an initial letter should be sent to the organization within 2 workdays of receipt by an agent, with a second letter issued no later than 10 workdays after the initial letter. Twenty-five of the 40 information items analyzed related to nonchurch organizations. We determined 10 (40 percent) of the 25 cases had at least 1 instance of a contact letter issued to a taxpayer beyond the established time period. This included initial contact letters for both correspondence and field examinations, as well as second contact letters for field examinations. Timeliness delays ranged from 2 to 23 workdays.

For church cases, the "fast track" PIP procedures require that an inquiry letter be drafted, reviewed by the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), and sent for quality review within 15 workdays following request for assignment of an Office of Division Counsel/Associate Chief Counsel

Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations

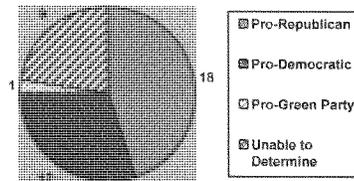
attorney. However, we determined that 6 of the 15 church cases were not sent for quality review within the 15 workday standard. Timeliness delays ranged from 3 to 41 workdays.

Based on our discussions with EO function management and review of recent PIP reports, EO function management indicated that the expedited periods for classification and examination were unrealistic. According to EO function management's analysis of PIP cases in process as of January 13, 2005, contact letters were not issued timely in 40 percent of the correspondence audits and 78 percent of the field audits. In addition, EO function management determined that inquiry letters were not processed timely in 78 percent of the church cases.

The information items we analyzed contained allegations related to various political views and were received from both internal and external sources

Based on our analysis of the information items randomly selected in our samples, we determined tax exempt organizations were allegedly performing activities that were supporting several political parties, as shown in Figures 4 and 5.

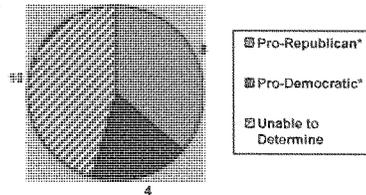
Figure 4: Potential Political Activity by the 40 Organizations Selected for Examination



Source: TIGTA analysis of 40 randomly selected information items.

**Review of the Exempt Organizations Function Process for Reviewing Alleged
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**Figure 5: Potential Political Activity by the 20 Organizations
Not Selected for Examination**



*Two information items alleged political activity that supported both the Republican and Democratic parties and was detrimental to other political parties.

Source: TIGTA analysis of 20 randomly selected information items.

The “Unable to Determine” information items included allegations that we could not directly attribute to any political party, such as those related to local election issues or candidates for local offices.

We also determined the allegations for the items in our random samples were referred by both internal and external sources. Specifically, several information items were received from internal IRS sources, such as EO Examinations office and IRS Communications and Liaison office personnel. Other sources of information items were individual taxpayers, other Federal Government agencies, political candidates, and the Congress.

Recommendations

The Director, EO, should:

1. Formalize the draft guidelines that detail how allegations of potential noncompliance with the tax law by tax exempt organizations should be classified.

Management’s Response: TE/GE Division management has drafted and will make effective procedures that specify how allegations of potential noncompliance by tax exempt organizations should be classified.

**Review of the Exempt Organizations Function Process for Reviewing Alleged
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2. Ensure time standards for accelerated case initiation (both classification and examination) are realistic for future election years based on available resources and priorities.

Management's Response: TE/GE Division management is drafting and will issue revised political intervention procedures for future election years that contain realistic time periods. As additional data from the 2004 election cycle is collected, these procedures may be revised, if appropriate, for the 2006 election cycle.

3. Establish time standards for when potential political intervention allegations received in nonelection years should be evaluated for examination potential and sent to the examination groups, rather than just assigned to an examiner as currently required.

Management's Response: TE/GE Division management has drafted and will implement procedures that set time periods within which information items alleging potential political intervention received in nonelection years are assigned to a classifier and either sent to an examination group or determined that an examination is not warranted.

4. Ensure any future expedited review process is initiated early enough in an election year to ensure classification and examination actions are completed timely and consistently.

Management's Response: TE/GE Division management has drafted and the Director, EO Examinations, is considering procedures for future election years that will ensure the process is initiated early enough to allow classification and examination actions to be completed timely and consistently.

In addition, the Commissioner, TE/GE Division, should:

5. Issue a press release in future election years if allegations of potential noncompliance with the tax laws will be processed on an expedited basis, to increase public awareness of the expedited process.

Management's Response: The Commissioner, TE/GE Division, has requested the Director, Communications and Liaison, TE/GE Division, to prepare a press release in future

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election years advising the exempt organizations community that allegations of potential noncompliance with the tax laws relating to political activity will be processed on an expedited basis.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the Tax Exempt and Government Entities (TE/GE) Division's recently established process for reviewing information alleging political campaign intervention by Internal Revenue Code (I.R.C.) § 501(c)(3)¹ organizations and for initiating any associated examinations of these organizations. Specifically, we determined the process established by TE/GE Division management to review referrals of potential political campaign intervention and assessed whether referrals were processed in accordance with established procedures. To accomplish the objective, we:

- I. Reviewed actions taken by TE/GE Division management during the 2004 Presidential election year to educate I.R.C. § 501(c)(3) organizations on their responsibilities related to political activities.
 - A. Interviewed Exempt Organizations (EO) function management to determine any education and outreach efforts taken during the 2004 election year related to political activity.
 - B. Obtained any press releases, letters, or other correspondence/documentation issued by the TE/GE Division during this period.
- II. Determined the process established by TE/GE Division management during the 2004 election year to review referrals of political campaign intervention and to assess which organizations merit examination.
 - A. Interviewed TE/GE Division management to determine the process established during this period to review allegations of political campaign intervention.
 - B. Obtained any procedures or documentation related to the establishment of the process.
 - C. Obtained any procedures or documentation established by TE/GE Division management detailing the process that should be followed when receiving and reviewing any allegations of political campaign intervention by I.R.C. § 501(c)(3) organizations and in determining whether to initiate an examination.
- III. Assessed whether the referrals received by TE/GE Division management were processed in accordance with established procedures.
 - A. Obtained a listing of all internal and external referrals received by TE/GE Division management during the 2004 election year alleging political campaign intervention by I.R.C. § 501(c)(3) organizations.

¹ I.R.C. § 501(c)(3) (2004).

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- B. Selected three samples of the allegations received to evaluate the process followed by the TE/GE Division when determining whether an examination was warranted.
 - 1. Selected a random sample of the allegations received for which the TE/GE Division determined an examination was not warranted based on its review. We randomly selected 20 of the 41 allegations processed by the EO function during the period July 30, 2004, through November 22, 2004. We used a random sample due to time constraints and because we did not plan to project our results.
 - 2. Selected a random sample of the allegations received for which the TE/GE Division initiated an examination based on its review. We randomly selected 40 of the 80 allegations processed by the EO function during the period July 30, 2004, through November 22, 2004. We used a random sample due to time constraints and because we did not plan to project our results.
 - 3. Reviewed all 10 allegations received by the EO function during the period July 30, 2004, through November 22, 2004, which the TE/GE Division determined were inaccurately categorized as potential political intervention activities.
- C. Obtained and reviewed any case files for the sampled referrals to determine whether established procedures were followed for reviewing the referrals and for initiating any examinations.

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Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)
Nancy A. Nakamura, Director
Jeffrey M. Jones, Audit Manager
Theresa Berube, Lead Auditor
Margaret Anketell, Senior Auditor
Deadra English, Senior Auditor
Donald Martineau, Auditor

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner - Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T
Director, Exempt Organizations, Tax Exempt and Government Entities Division SE:T:EO
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaison: Director, Communications and Liaison, Tax Exempt and Government Entities
Division SE:T:CL

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Appendix IV

Management's Response to the Draft Report

 COMMISSIONER TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION	DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE WASHINGTON, D.C. 20224	RECEIVED, FEB 16 2005
	FEB 15 2005	
MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDIT (SMALL BUSINESS AND CORPORATE PROGRAMS)		
FROM:	 Steven T. Miller	
SUBJECT:	Commissioner, Tax Exempt and Government Entities Response to Draft Audit Report: Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations (Audit #200510008)	
<p>This responds to your draft audit report ("report") concerning the manner in which the Exempt Organizations ("EO") function of the Tax Exempt and Government Entities Division ("TE/GE") initiated and carried out a program aimed at addressing prohibited political activity by Internal Revenue Code section 501(c)(3) organizations during the 2004 election cycle.</p>		
<p>Your review was prompted by requests from both the Commissioner of Internal Revenue and me to look critically at the new processes EO employed in the summer and fall of 2004 to review allegations of potential political activity by tax exempt organizations. Our requests to TIGTA were prompted by public charges, reported in the media, that TE/GE was examining alleged political activity by tax exempt organizations just before the 2004 Presidential election for politically motivated reasons or in response to political direction from outside the IRS.</p>		
<p>Your report notes that, in conducting your review, TIGTA was "alert for any indications that inappropriate actions, such as political influence, may have been taken" with regard to EO's handling of the information items sent to it. The report also notes that if you had found inappropriate actions, you would have referred them to the TIGTA Office of Investigations for review.</p>		
<p>In that regard, I am pleased that the report found:</p>		
<ul style="list-style-type: none"> • that you did not identify any indications that EO inappropriately handled information items you reviewed, and you did not make any referrals to the TIGTA Office of Investigations; • that the EO Referral Committee followed a consistent process when reviewing information items, regardless of the source of the allegation or the nature of the alleged political activity; 		

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- that you did not identify any cases in which the same criteria were used to select one information item for examination and to decline a similar item for examination; and
- that the information items EO selected and did not select for examination concerned organizations reflecting a variety of political views.

We are committed to enforcing the tax law that relates to tax-exempt organizations, including that portion of the tax law that restricts political intervention by 501(c)(3) organizations. The prohibited political activity program is but one aspect of this commitment, and was part of a larger effort that included both an educational and an enforcement component. We initiated our educational efforts well in advance of, and through, the 2004 election cycle. Our enforcement component involved the prohibited political activity program, which became more visible during the active part of the election cycle; that is when violations are likely to occur and when we are most likely to receive information items regarding potentially prohibited political activity by section 501(c)(3) organizations. Through both our educational and enforcement efforts, we were, and continue to be, equally committed to fulfilling our obligation to enforce the tax law without regard to partisan considerations or political direction.

I appreciate your insightful recommendations about actions we can take to improve the administration of our prohibited political activity program in future years. Furthermore, we are evaluating the program as it operated during the last election cycle. By the end of April, we expect to make a number of decisions on changes to the program for the next election cycle, beginning in 2006.

As we make these decisions, and when we begin to implement them, we will ensure that we fully address the problems you identified in the report. We therefore agree with your recommendations and indicate below how we intend to implement them. We do this, however, with the understanding that we may need to modify the manner in which we implement one or more recommendations depending on the changes we make to the program for the 2006 election cycle. We will keep you informed of any revisions to the way we implement any of the recommendations, should they become necessary.

Our response to your specific recommendations follows.

RECOMMENDATION 1

The Director, EO, should formalize the draft guidelines that detail how allegations of potential noncompliance with the tax law by tax exempt organizations should be classified.

Review of the Exempt Organizations Function Process for Reviewing Alleged Political Campaign Intervention by Tax Exempt Organizations

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CORRECTIVE ACTION

We have drafted, are circulating for approval, and will make effective procedures that, among other things, specify how allegations of potential noncompliance with the tax law by tax exempt organizations should be classified.

IMPLEMENTATION DATE

April 30, 2005.

RESPONSIBLE OFFICIAL

Director, EO.

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored in monthly operational reviews conducted with the Director, EO.

RECOMMENDATION 2

The Director, EO, should ensure time standards for accelerated case initiation (both classification and examination) are realistic for future election years based on available resources and priorities.

CORRECTIVE ACTION

We are drafting revised procedures for our prohibited political activity program for future election years. The procedures provide realistic timeframes, based on experience to date. These procedures will be evaluated as cases from the 2004 election cycle are closed, and additional data is collected. EO will revise the procedures further, if appropriate, and will disseminate revised procedures to the field by December 31, 2005, for the 2006 election cycle.

IMPLEMENTATION DATE

We will issue final procedures by December 31, 2005.

RESPONSIBLE OFFICIAL

Director, EO Examinations.

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored in bi-weekly conferences between the Director, EO and the Director, EO Examinations.

RECOMMENDATION 3

The Director, EO, should establish time standards for when potential political intervention allegations received in nonelection years should be evaluated for

**Review of the Exempt Organizations Function Process for Reviewing Alleged
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examination potential and sent to the examination groups, rather than just assigned to an examiner as currently required.

CORRECTIVE ACTION

We have drafted and are implementing procedures establishing set periods within which we will (a) assign information items alleging potential political intervention in non-election years to a classifier, and (b) either send the item from classification to a group or determine that an examination is not warranted.

IMPLEMENTATION DATE

April 30, 2005.

RESPONSIBLE OFFICIAL

Director, EO Examinations.

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored in bi-weekly conferences between the Director, EO and the Director, EO Examinations.

RECOMMENDATION 4

The Director, EO, should ensure any future expedited review process is initiated early enough in an election year to ensure classification and examination actions are completed timely and consistently.

CORRECTIVE ACTION

We have drafted, and the Director, EO Examinations, is now considering, procedures for future election years that cover the start of the prohibited political activity program and ensure that the process is initiated early enough to allow classification and examination actions to be completed timely and consistently. We will issue these procedures by December 31, 2005, for the 2006 cycle.

IMPLEMENTATION DATE

December 31, 2005.

RESPONSIBLE OFFICIAL

Director, EO Examinations.

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored in bi-weekly conferences between the Director, EO and the Director, EO Examinations.

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RECOMMENDATION 5

The Commissioner, TE/GE, should issue a press release in future election years if allegations of potential noncompliance with the tax laws will be processed on an expedited basis, to increase public awareness of the expedited process.

CORRECTIVE ACTION

The Commissioner, TE/GE, has requested the Director, Communications and Liaison, TE/GE, to prepare a press release in future election years, for release in advance of the commencement of future prohibited political activity programs, advising the exempt organizations community that allegations of potential noncompliance with the tax law relating to political activity will be processed on an expedited basis. The Director, Communications and Liaison, TE/GE, has entered this assignment on his calendar system for 2006.

IMPLEMENTATION DATE

Completed.

RESPONSIBLE OFFICIAL

Commissioner, TE/GE.

CORRECTIVE ACTION MONITORING PLAN

No monitoring is required because the corrective action is completed.

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: 200623061

Release Date: 6/9/2006

CC:TEGE:EOEG:E01:

PUBWE-113519-06

UJLC: 7611.00-00

date: May 09, 2006

to: Deputy Area Counsel (Tax Exempt and Government Entities) CC:TEGE:GLGC:DAL

from: Senior Technician Reviewer (Exempt Organizations Branch 1)

CC:TEGE:EOEG:E01

subject: Procedural Matters Related to IRC Section 7611 Follow-Up Examinations and
Delegation of Authority

Issue (1): If the IRS concludes at the end of an examination under section 7611 of the Internal Revenue Code that a church has intervened in a political campaign, but the IRS is not revoking the church's tax exempt status, can the examination function refer the church to the Review of Operations Unit for follow-up in the coming election cycle?

Overview and Section 7611(a) Reasonable Belief Rule

Congress added section 7611 to the Internal Revenue Code by the Tax Reform Act of 1984. By enacting section 7611, Congress intended to protect churches from undue interference from the IRS and to minimize IRS contacts with churches to only those necessary to insure compliance with the tax laws. Section 7611 limits the time and types of contacts the IRS may utilize to determine compliance. Section 7611(a)(1) provides that the IRS may begin a church tax inquiry if "an appropriate high-level Treasury official reasonably believes" that the church may not qualify for tax exemption. Section 7611(f) generally provides that a church inquiry or examination on the same or similar issues within 5 years of the earlier inquiry or examination needs to receive higher level approval before a subsequent inquiry can begin.¹

¹ In addition to the requirement of an appropriate high-level Treasury official's 'reasonable belief,' sections 7611(b)(1)(A) and (B) provide that during the course of an examination (or if expanding the scope of an examination pursuant to section 7611(b)(4)) the IRS may only examine records or activities "to the extent

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In our view, under section 7611, once an inquiry or examination involving a church is closed, the IRS action with respect to the organization on the same issue is final and any action with respect to any subsequent allegations must comply with the procedures of section 7611. This includes the basic requirement under section 7611(a) that IRS needs a reasonable belief before it can begin a later examination of the church. It is our view that the statute does not intend to permit use of the prior inquiry or examination and its outcome by itself in determining whether a reasonable belief exists regarding a subsequent allegation. The fact that a church was revoked for an earlier year, given a strong advisory, or assessed an excise tax does not allow us to start an inquiry several years later unless we have a reasonable belief under section 7611(a)(2) based on a subsequent allegation and information received in connection with it from a referral or from public sources. If the prior allegation or the outcome of the prior examination were sufficient to establish a new reasonable belief, then a single credible allegation could give the IRS perpetual authority to examine a church. Although there is no suggestion that anyone intends to use the old allegation or examination outcome, by itself, to create a basis for reasonable belief, the use of that information to any degree in forming a reasonable belief could be controversial given the policy underlying the statute. Looking to a new allegation for purposes of forming a reasonable belief for a subsequent inquiry will avoid raising questions about the legality of the inquiry under section 7611(a)(2).

This approach does not mean that the official responsible for determining reasonable belief is precluded from having access to administrative files or other information about the prior audit history of the church. This information is relevant in determining whether the proposed subsequent examination is on the same or a different issue than the previous examination. (As discussed below, if it is on the same or a similar issue a higher level of review is generally required before commencing the subsequent inquiry or examination.) This information regarding the previous allegation and examination also assists in providing institutional consistency and may also be considered in setting priorities for the use of resources if examination resources preclude inquiries in all church cases where there is a reasonable belief under section 7611(a). Certainly there is a risk that a church could challenge the access or use of prior audit information by the official responsible for determining reasonable belief, but that is in effect questioning whether the official's determination of reasonable belief was otherwise based upon adequate or reliable information related to the new allegation. In all cases where we are considering a follow-up church tax inquiry, we believe we will satisfy the requirements of section 7611 for opening a church tax inquiry if the information related to the new allegation is sufficient to support reasonable belief that an examination is warranted regardless of the church's prior audit history.

necessary" (the standard set in sections 7611(b)(1)(A) and (B)) to determine liability or church status. This requirement arguably sets a higher standard for enforcing a summons in a church case than in other summons enforcement proceedings because the IRS must show that the information is 'necessary' to demonstrate a failure of compliance.

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Section 7611(f) Five Year Rule

Any action involving a subsequent church inquiry needs to comply with the limitations on additional inquiries and examinations under section 7611(f). Section 7611(f) generally provides that a church inquiry or examination on the same or similar issues within 5 years of the earlier inquiry or examination needs to receive higher level approval before a subsequent inquiry can begin. Treas. Reg. § 301-7611 Q&A 16 provides that the higher signature level authority is the Assistant Commissioner (Employee Plans and Exempt Organization). Pursuant to Delegation Order 193 (Rev. 6) (11/08/2000), that authority is now delegated to the Division Commissioner (Tax Exempt and Government Entities).² Section 7611(f)(1)(A) provides an exception to this higher level signature requirement where the earlier inquiry or examination resulted in an adverse action (including revocation or notice of deficiency). However, it is important to note that section 7611(f)(1)(A) does not remove the need for a reasonable belief under section 7611(a)(2) to start the subsequent inquiry.

In determining whether a subsequent inquiry during the 5 year period discussed above involves the same or similar issues, Q&A 16 provides that "substantive factual issues involved in the two examinations, rather than legal classifications" govern whether a subsequent inquiry involves the "same or similar" issues. It follows from Q&A 16 that if the subsequent inquiry is on political campaign intervention, it is not a similar issue to the earlier political campaign intervention examination unless it is factually similar to the issue in the prior examination. It is our view that a subsequent inquiry is similar to the prior examination if they both involve a specific type of political campaign intervention, such as voter guides, a sermon, or a campaign contribution. It is not clear what other kinds of factual similarities would trigger the requirement for higher level approval. For example, if a church had been examined for implied advocacy for a candidate in a church publication, and a subsequent allegation was made in a different year that the church was engaging in implied advocacy for a different candidate during a sermon, a taxpayer might argue that there were similar issues even though the concrete activities are different. If EO Examinations has any doubt as to whether a subsequent church tax inquiry requires higher level approval where both the first and the second inquiries involve alleged political campaign intervention, and if the volume of such cases remains very low, it can elevate such a case involving subsequent inquiries during the five-year period to a higher level. Alternatively, Counsel is available to provide its opinion as to whether the issues are the same or different in specific cases.

Section 7611(f)(1)(B) also provides an exception from the higher level signature requirement for a subsequent inquiry where the earlier inquiry or examination resulted in

² After the Restructuring and Reform Act of 1998, Delegation Order 193 (Rev. 6) (11/08/2000) provides that actions previously delegated to Assistant Commissioners et al. by Treasury Regulations (par. 7) are now delegated to Division Commissioner et al. (par. 8).

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“a request by the Secretary for any significant change in the operational practices of the church.” The statute is silent as to whether the organization must have adopted the requested changes. However, it was likely assumed that if the church did not reassure the IRS on future compliance, the church’s exemption would have been revoked. It seems unlikely the authors of the statute would have anticipated closing an unagreed case with a written advisory. Therefore, we believe that the exception in section 7611(f)(1)(B) is best read as applying where IRS requested changes and the organization committed to make changes to its policies regarding political campaign intervention as part of the earlier inquiry or examination.

Where in the prior examination IRS concluded political campaign intervention occurred and requested changes, but the church disputed the IRS conclusion, and IRS closed the inquiry or examination with an advisory, it is our view that section 7611(f)(1)(B) does not apply. Although the language of the statute speaks only to the request for changes and is silent on the organization’s response, we believe the organization’s acquiescence is assumed. Therefore, we believe a higher level of review would be required if a subsequent inquiry were proposed under circumstances where the church disputed that it had violated the law in the period covered by the first exam. There may also be uncertainty as to whether the exception in section 7611(f)(1)(B) applies where the church already had language in their policies and procedures forbidding political campaign intervention and the IRS “requested” a clarification of the interpretation of political campaign intervention as applied to the specific incident or incidents that served as the cause for the inquiry or examination. It is not clear whether a request for a clarification is a request for a change. Again, if EO Examinations wants certainty in these cases, it will obtain the higher level approval for the subsequent examination.

In sum, the potential need for higher level approval arises whenever the following circumstances are present:

- both the initial and the subsequent allegations involve potential political campaign intervention;
- the subsequent inquiry would fall within the five-year period; and
- the prior examination did not result in revocation or assessment of tax.

Elevating the approval to the Division Commissioner will avoid the risk that a subsequent inquiry or examination will be challenged by the church as violating section 7611(f)(1). However, that level of approval is not required if the facts in the cases are not the same or similar.

Data Collection for a Possible Subsequent Inquiry

Before a subsequent inquiry can begin IRS needs a reasonable belief under section 7611(a) that the church is not exempt from tax or may be otherwise engaged in

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activities subject to tax. It is important to consider the scope of IRS' ability to collect any data beyond acting as a passive recipient of allegations sent to IRS by third parties. Treas. Reg. § 301-7611 Q&A 1 states that "[i]nformation received by the Internal Revenue Service at its request may not be used to form the basis of a reasonable belief to begin a church tax inquiry...." It is our view that this reference applies to active requests by IRS to a church or an individual connected to a church for documents or information that is otherwise not generally available to the public, but does not apply to the perusal of documents available to the public by IRS without request to the church or individuals connected with the church. We recognize that churches may argue that by taking affirmative steps to look for violations regarding whether a church is engaged in activities subject to tax the IRS is violating the underlying intent of section 7611. We find this argument unpersuasive. If the IRS is not able to consider the same information and material that is available to the general public, it would be limited to remaining passive and considering only that information that is referred to it by third parties, who may not necessarily be the most impartial or reliable sources. The IRS could not respond to information or allegations published or broadcast widely to hundreds of thousands of people in newspapers, on television or on radio. We view the policy of section 7611 as prohibiting random audits and audits based on speculation or the identity of an organization without any further information presenting a credible allegation of noncompliance with the requirements for tax exemption. We do not believe section 7611 is intended to force the IRS to be utterly passive in the face of information in the public domain.

We believe that review of publicly available documents including, but not limited to, newspapers, public data on campaign contributions, court documents, and web sites on the internet, does not violate section 7611 and can be used to develop a 'reasonable belief' under section 7611(a)(2). In our view, perusal of these types of sources to search for any mention of churches, or a specific church does not constitute a church tax inquiry, let alone a church tax examination. Therefore, we do not believe that review of publicly available material at our own initiative or as a measure taken in response to the result of a prior examination violates any provision of section 7611. We believe this is the case even though section 7611 was enacted prior to widespread use of the internet.

The internet has become one of the most utilized methods of making information available to the general public. As a practical matter, websites on the internet, including a church's website, are all publicly available information. Moreover, any organization, including any church that operates a website, has the ability to divide the website into sections with different types of access. For example, the church may have a part of the site that allows unrestricted access for the public and another part of the site that is restricted with secured access for members or employees. In our view, for purposes of section 7611, IRS viewing of the publicly available sections of any website would be no different than its perusal of any other publicly available document. Furthermore, we believe that viewing a church's website is entirely distinguishable from contacting the church for information. By creating the website the church has made the information on

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the website freely and publicly available to all just as if it had published a newspaper advertisement or church personnel had granted an interview to a newspaper. If however, the IRS contacts the church with questions or requests for documents or information, or the IRS contacts other persons with questions or requests for documents or information that are not publicly available, those contacts raise section 7611 issues. Similarly, viewing sections of a church's website that are not intended to be publicly available, for example, sections with restricted or secured access for members or employees, would also raise section 7611 issues.

For these reasons, we do not see any legal issues arising from having the examination function refer a church that was the subject of a prior examination to the Review of Operations Unit for follow-up in the coming election cycle as long as the follow-up is limited to reviewing publicly available material. In all cases, before commencing an inquiry, the IRS must comply with applicable section 7611 procedures, including the reasonable belief requirements of section 7611(a), and the requirements of section 7611(f) for higher level approval in certain cases, before beginning a subsequent inquiry.

Issue (2): Is the Director, Exempt Organizations Examinations "an appropriate high-level Treasury official" described in section 7611(a)(2)? Should we anticipate difficulties in sustaining this position if we do not revise our regulation which cites the abolished position of 'Regional Commissioner' as the appropriate official?

Section 7611(a)(2) requires that "an appropriate high-level Treasury official" have a reasonable belief that a church may not be exempt from federal income tax before the IRS may start a church tax inquiry. A church tax examination is legally valid under section 7611(b)(1) if and only if the church tax inquiry was legally valid. Thus, in order to establish that a church tax examination is legally valid, the IRS must be able to document that an appropriate high-level Treasury official had the necessary reasonable belief prior to the opening of the church tax inquiry on the church in question.

Section 7611(h)(7) provides that the term "appropriate high level Treasury official" means any delegate of the Secretary whose rank is no lower than that of a principal Internal Revenue officer for an internal revenue region. The designation of the Regional Commissioner (or higher treasury official) as the appropriate higher-level Treasury official for purposes of section 7611(a) is provided in the legislative history to section 7611. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1101 (1984). That designation was captured in regulations that are effective for all tax inquiries and examinations beginning after December 31, 1984. Treas. Reg. § 301.7611 Q&A 18.

Section 1001 of The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, (RRA 1998), provides that the Commissioner of Internal Revenue shall develop and implement a plan to reorganize the IRS. The plan shall "eliminate or substantially modify the existing organization of the Internal Revenue Service which is based on a national, regional, and district structure; [and] establish organizational units

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servicing particular groups of taxpayers with similar needs...." Under the reorganized structure, tax exempt and government entities are recognized as a particular group of taxpayers with similar needs.

Congress was aware that positions within the IRS would be eliminated by the reorganization it was directing the Commissioner to implement and accordingly, section 1001(b) of RRA1998 provides a savings provision. Section 1001(b) provides that "All orders, determinations, rules, regulations. . . and other administrative actions . . . which are in effect at the time this section takes effect . . . shall continue in effect according to their terms until modified, terminated, superseded, set aside or revoked in accordance with law . . ." This savings provision applies to keep in effect regulations that make reference to officers whose positions no longer exist. The legislative history of RRA 1998 at H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess. 195 (1998) explains that "[t]he legality of IRS actions will not be affected pending further appropriate statutory changes relating to such a reorganization (e.g., eliminating statutory references to obsolete positions)." Although the legislative history to the savings provision only refers to statutory changes, the provision refers to orders, determinations, rules, regulations and other administrative. The Service, therefore, interprets the savings provision liberally, applying it to regulations and other published rules.

After RRA 1998, the IRS issued Delegation Order 193 (Rev. 6) (11/08/2000) to specify who would take the place of various officials in performing delegated functions. Delegation Order 193 provides in part that actions previously delegated to Regional Commissioners et al. by Treasury Regulations (par. 7) are now delegated to Directors, Compliance Services Field et al. Although there is no further delegation order specifically addressing functions under section 7611,³ the IRM has been amended to designate the Director, Exempt Organizations Examinations (hereinafter, "Director"), as having final authority in all cases to determine whether to conduct a church tax inquiry and requiring the Director to sign the notice of examination. This position is recorded in IRM 4.76.7. Based on our understanding of the duties of the Director, the Service's decision to designate the Director to replace the Regional Commissioner as the IRS official responsible for determining whether to conduct a church inquiry is consistent with the policies underlying section 7611 and the accompanying regulations in effect in 1998.

Challenges to the Director's designation as "an appropriate high-level Treasury official" are likely to try to distinguish the Director from the Regional Commissioner based on the former Regional Commissioner's complete authority within a region and the Regional Commissioner's proximity to the Commissioner in the chain of authority. As cited in the RRA 1998 legislative history above, the restructuring of IRS was intended to change

³ The only delegation order specific to Church Tax Inquiries and Examinations is Delegation Order 137 (Rev. 3) (12/31/1996). Delegation Order 137 concerns the authority of certain officials to hold conferences described in IRC § 7611(b)(3)(A)(iii) and to execute agreements under IRC § 7611(c)(2)(C) to suspend the periods for completing church tax inquiries or examinations. Delegation Order 137 does not address who may authorize a church tax inquiry.

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focus from geographic location and concentrate on particular taxpayer groups. These objectives are achieved by assigning the duty of determining reasonable belief to an official who has national responsibility for tax exempt organizations, including churches, and oversees the examination function in which the need to determine reasonable belief arises. This designation of the Director enables the IRS to have nationwide consistency in the administration of section 7611 and is consistent with the statutory directives on the goals of the reorganization.

As a direct report, the Regional Commissioner had closer management proximity to the Commissioner, but the more appropriate criteria for identifying a comparable official is the official's scope of authority. Before amendment by RRA 1998, the Employee Retirement Income Security Act, Pub. L 93-406, section 1051(a) enacted section 7802(b) which created the position of Assistant Commissioner (Employee Plans and Exempt Organizations). At the same time that the legislative history of section 7611 indicated that Regional Commissioners should sign the section 7611(a) reasonable belief letter to begin a church tax inquiry, the suggestion was made that the Assistant Commissioner (Employee Plans and Exempt Organizations) approve any subsequent examination under the five year rule of section 7611(f). H.R. Conf. Rep. No. 861, 98th Cong., 2nd Sess. 1110 (1984). As the Assistant Commissioner's approval was required for opening new examinations within 5 years of a previous examination, Congress believed the national perspective of the Assistant Commissioner carried more weight than the geographic perspective of the Regional Commissioner when it came to the administration of section 7611 cases. Thus, for purposes of section 7611, the Regional Commissioner was not considered a higher official than the Assistant Commissioner, notwithstanding his position in the management chain as a direct report to the Commissioner.

The Director is at least an equivalent position to the Regional Commissioner for the purpose of approving a church inquiry or examination under IRC section 7611. The Regional Commissioner only had regional jurisdiction and in 1998, when the position was abolished, it was necessary to assign the responsibility for approving church tax inquiries to someone with comparable authority. The Commissioner could have assigned this responsibility to area managers because they have complete management authority within a geographic span comparable to the old Regional Commissioners. However, by designating the Director, who has national jurisdiction, as "an appropriate high-level Treasury official," the Service was, in fact, being more conservative than necessary. As noted above, the intent of the reorganization was to move IRS away from geographic divisions and focus upon particular groups of taxpayers with similar needs. The position of the Director is well suited for this purpose, having national jurisdiction over all the organizations covered by section 7611 and able to provide consistent application to the reasonable belief standard.

Currently, there is no significant litigation risk with respect to the delegation to Director. The arguments laid out above for considering the Director to be at an equal or higher level than the Regional Commissioner following the reorganization are sound.

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Nevertheless, whenever the section 7611 regulations are updated next, we recommend the regulations be updated to reflect this change. This is a ministerial change for clarity that would not make the current delegation to the Director vulnerable.

While the litigating risk may increase without an update to the regulations at some future date because courts may give less weight to the savings provision in section 1001(b) of RRA98 over time due to its temporal attributes, the regulations under section 7611 are no more vulnerable to this possibility than other regulatory provisions that refer to positions that have been eliminated.⁴ The Service has updated several orders, determinations, rules and regulations to reflect position changes resulting from the reorganization, but many significant orders, determinations, rules, regulations, and other administrative actions have not been modified following the reorganization and continue to reference positions eliminated as a result of the reorganization. The plan generally is to update the positions in these orders, rules, and regulations whenever the orders, rules, or regulations are next revised. Therefore, although an update is recommended, there is no urgency requiring the Service to consider a regulation project before other modifications to the regulations are needed.

⁴ The regulations include several references to district directors and other officials whose positions no longer exist. Treasury Regulation § 301.6212-1(a) authorizes a district director or director of a service center (or regional director of appeals) to send a notice of deficiency to a taxpayer if the official determines that there is a deficiency in respect of income, estate or gift tax imposed by subtitle A or B or an excise tax imposed by chapter 41, 42, 43, or 44. Similarly, Treasury Regulation § 301.6201-1(a) authorizes and requires the district director to make all inquiries necessary to the determination and assessment of all taxes, and Treasury Regulation § 301.6404-1(a) authorizes the district director or the director of the regional service center to abate any assessment, or any unpaid portion thereof, if the assessment is in excess of the correct tax liability. Although the position of district director was eliminated with the reorganization, successor positions, i.e., area directors and territory managers, continue to take actions pursuant to these regulations. We acknowledge that the area director and territory managers positions have similar management and tax administration authorities as those previously held by the district director, and, therefore, the "redelegation" of these duties is not completely analogous to the "redelegation" of the section 7611 authority, but, as with the church tax inquiry, these critical functions continue to be performed and are unaffected by the elimination of the position referenced in the regulation.

**DEPARTMENT OF JUSTICE PARTICIPATION ON THE INTERNAL
REVENUE SERVICE UNDERCOVER REVIEW COMMITTEE**

Disclosure of tax return information to a Department of Justice attorney serving on the Undercover Review Committee of the Internal Revenue Service is permissible under § 6103 of title 26 of the United States Code as a limited referral for legal advice.

October 8, 1996

**MEMORANDUM OPINION FOR THE ASSISTANT ATTORNEY GENERAL
TAX DIVISION**

This memorandum responds to your request for our legal opinion on what limitations, if any, are imposed by the provisions of § 6103 of the Internal Revenue Code on the participation by Department of Justice ("DOJ") attorneys on the Undercover Review Committee of the Internal Revenue Service ("IRS"). Letter for Walter Dellinger, Assistant Attorney General, Office of Legal Counsel, from Loretta C. Argrett, Assistant Attorney General, Tax Division (July 6, 1995) ("DOJ July 6, 1995 Letter"). Specifically, we have been asked to determine whether tax return information can be disclosed to DOJ attorneys sitting on the IRS Undercover Review Committee ("Committee") in investigations that have not been formally referred to DOJ by the IRS. As set forth below, we conclude that disclosure of tax return information to a DOJ attorney serving on the Committee is permissible under section 6103 as a limited referral for legal advice.

I. Background

A. Section 6103

Section 6103 of title 26 of the United States Code imposes restrictions on the disclosure of tax returns or tax return information. Only if authorized by statute can such information be disclosed. 26 U.S.C. § 6103(a). In pertinent part, § 6103(h)(2) and (3) provides for disclosure of tax returns or return information to DOJ attorneys. Section 6103(h)(2) states:

(2) **Department of Justice.** -- In a matter involving tax administration, a return or return information shall be open to inspection by or disclosure to officers and employees of the Department of Justice (including United States attorneys) personally and directly engaged in, and solely for their use in, any proceeding before a Federal grand jury or preparation for any proceeding (or investigation which may result in such a proceeding) before a Federal grand jury or any Federal or State court, but only if--

(A) the taxpayer is or may be a party to the proceeding, or the proceeding arose out of, or in connection with, determining the taxpayer's civil or criminal liability, or the collection of such civil liability in respect of any tax imposed under this title;

(B) the treatment of an item reflected on such return is or may be related to the resolution of an issue in the proceeding or investigation; or

(C) such return or return information relates or may relate to a transactional relationship between a person who is or may be a party to the proceeding and the taxpayer which affects, or may affect, the resolution of an issue in such proceeding or investigation.

Section 6103(h)(3) provides:

(3) **Form of request.** -- In any case in which the Secretary is authorized to disclose a return or return information to the Department of Justice pursuant to the provisions of this subsection--

(A) if the Secretary has referred the case to the Department of Justice, or if the proceeding is authorized by subchapter B of chapter 76, the Secretary may make such disclosure on his own motion, or

(B) if the Secretary receives a written request from the Attorney General, the Deputy Attorney General, or an Assistant Attorney General for a return of, or return information relating to, a person named in such request and setting forth the need for the disclosure, the Secretary shall disclose return or return information so requested.

A disagreement has arisen between the IRS and the Tax Division of DOJ as to what limitations, if any, are imposed by § 6103(h)(2) and (3) on the participation by a DOJ attorney on the Committee.

B. The Undercover Review Committee

The IRS has promulgated, in the form of guidelines, specific procedures for the review, approval, conduct, and oversight of undercover operations. As set forth in these guidelines, the IRS recognizes that although the undercover technique is lawful and valuable as an investigative tool, undercover operations can create legal problems. Internal Revenue Manual 910 at 9781-551 ("IRM").

Undercover operations conducted by the IRS are classified into two groups. Group I operations are deemed more sensitive in nature, and the approval of the Assistant Commissioner (Criminal Investigation) of the IRS must be obtained. These operations include those that exceed six months in duration and/or exceed the Director of Investigations' level of approval for confidential expenditures. IRM 922 at 9781-551. Group I operations also include any operation in which there is a reasonable chance that one or more of fourteen specified sensitive factors will arise. These factors include, inter alia, operations that will: result in significant civil claims against the United States; have an impact on investigations in numerous regions; involve public corruption crimes; involve an undercover person running the risk of being arrested or being required to give sworn

testimony or attending a meeting where the subject understood a privilege would exist. *Id.* at 9781-551 to 552.

Group II operations are those undercover activities that do not meet the Group I requirements. The IRS Director of Investigations is authorized to approve requests for Group II operations. *Id.* at 9781-552.

Requests for undercover operations must be submitted in writing, setting forth information necessary to evaluate the particular request. Each request must include in narrative form the evidence obtained to date that would lead a reasonable person to believe a violation of law has occurred. Not all undercover operations involve tax or tax-related crimes. Some investigations involve crimes such as money laundering.

The request must also establish that the undercover operation is the only efficient investigative alternative available. IRM 931 at 9781-553. We have been advised by the IRS that every submission to the Committee for a tax or tax-related investigation includes all information generated or collected by the IRS regarding the investigation, the identity of the taxpayer and the nature and plan of investigation and the potential charges, and tax return information for purposes of § 6103. Letter for Richard L. Shiffrin, Deputy Assistant Attorney General, Office of Legal Counsel, from Eliot D. Fielding, Associate Chief Counsel, Enforcement Litigation, Internal Revenue Service (Jan. 22, 1996) ("IRS Jan. 22, 1996 Letter").

All requests for Group I operations are reviewed by the Committee. The Committee also reviews significant deviations in ongoing Group I operations and all requests for recoverable funds which exceed an aggregate of \$50,000 in Group II operations. The Committee is advisory in nature and makes recommendations to the Assistant Commissioner (Criminal Division).

The Attorney General and the IRS Commissioner have agreed in a Memorandum of Understanding ("MOU"), signed in August 1995, on following specified procedures for the review and approval of certain undercover operations conducted by the IRS. According to the MOU, an attorney from either the Criminal Division or Tax Division of the Department of Justice will serve on the Committee in assessing Group I operations that exceed one year in duration and/or require approval of more than \$40,000 in confidential funds.

With the exception of the DOJ attorney, the Committee is comprised of IRS officials: the Director, National Operations Division; the Assistant Chief Counsel (Criminal Tax); and the Chief, Office of Special Investigative Techniques; or their designees. The Assistant Commissioner (Criminal Investigation) may invite other individuals to participate in the Committee. IRM 932 at 9781-554 (2); MOU at 3.

According to the MOU, the Committee shall meet on a regular basis to consider initial requests for qualifying Group I undercover operations or significant deviations to previously approved plans of action. No more than four operations will be scheduled for each meeting. Prior to each meeting, Committee members are to receive a sealed packet containing the undercover requests. The materials must be securely maintained and may not be copied. The materials must be returned after the Committee meeting. MOU at 3-4.

The IRS National Operations Division, Office of Special Investigative Techniques, is

responsible for the presentation of the undercover request packets to the Committee. Prior to the Office of the Special Investigative Techniques' receipt of the requests, however, each request has been reviewed and approved by the respective IRS Division Chief, District Director and Area Director of Investigations. MOU at 3.

After consideration of each request is completed, the Committee makes a recommendation to the Assistant Commissioner (Criminal Investigation) that the operation be approved, approved with conditions, or disapproved. The recommendation is based upon a majority vote of the Committee members. The Committee's recommendation, minutes from the Committee meeting and the undercover request is then sent to the Assistant Commissioner (Criminal Investigation) for final action. MOU at 4.

In the event the DOJ attorney disagrees with the Committee's recommendation for approval because of legal, ethical, prosecutive, or departmental policy considerations, the appropriate Assistant Attorney General shall consult with the Assistant Commissioner (Criminal Investigation). If the disagreement is not resolved, no further action shall be taken on the undercover request without the approval of the IRS Chief Compliance Officer.

The MOU states that the "undercover technique is a valuable law enforcement investigative tool" and is essential to the enforcement of tax and tax related statutes. MOU at 1. The MOU acknowledges that because the undercover tool is sensitive and potentially intrusive, care must be exercised to ensure that the technique is used properly. The parties agree that the participation of a DOJ attorney in the approval process for the sensitive operations is necessary "to ensure legal, ethical, and prosecutorial uniformity in the application of the undercover technique for Federal law enforcement." MOU at 2. The IRS has informed us that the "DOJ attorney would necessarily require access to tax data in order to permit a meaningful review of the details" of the operation. IRS Jan. 22, 1996 Letter at 10.

C. The Positions of the IRS and the Tax Division

The IRS and the Tax Division have informed us of their respective positions in several letter submissions, all of which we have reviewed and considered in reaching the conclusions set forth herein. Letter for Walter Dellinger, Assistant Attorney General, Office of Legal Counsel, from Stuart L. Brown, Chief Counsel, Internal Revenue Service (Aug. 21, 1995) ("IRS Aug. 21, 1995 Letter"); Letter for Walter Dellinger, Assistant Attorney General, Office of Legal Counsel, from Eliot D. Fielding, Associate Chief Counsel, Enforcement Litigation, Internal Revenue Service (Sept. 11, 1995); IRS Jan. 22, 1996 Letter; DOJ July 6, 1995 Letter; Letter for Walter Dellinger, Assistant Attorney General, Office of Legal Counsel, from Loretta C. Argrett, Assistant Attorney General, Tax Division (Aug. 25, 1995) ("DOJ Aug. 25, 1995 Letter"); Letter for Richard L. Shiffrin, Deputy Assistant Attorney General, Office of Legal Counsel, from Mark E. Matthews, Deputy Assistant Attorney General, Tax Division (Jan. 24, 1996) ("DOJ Jan. 24, 1996 Letter").

The IRS takes the position that the disclosure of tax information to a DOJ attorney serving on the Committee is not permissible under § 6103. The IRS believes that § 6103(h)(2) and (3) must be read in conjunction with one another because § 6103(h)(2) alone does not provide independent disclosure authorization. According to the IRS, even where the requirements of § 6103(h)(2) are satisfied, a disclosure is authorized only where the Secretary or his designee has referred a case to DOJ, the proceeding falls under subchapter B of chapter 76 or a written request is submitted by a DOJ official listed in § 6103(h)(3)(B).

In construing what constitutes a "referral" for purposes of § 6103(h)(3), the IRS asserts that an "institutional decision" must first be made by the IRS to request that DOJ provide advice or assistance. Once that decision has been made, a "referral" is appropriate in one of three forms. First, a "formal" referral (also known as a referral of "the case on the merits") is where the IRS requests that DOJ conduct a grand jury investigation, or prosecute, defend, or take some other affirmative action in court with respect to a case. IRS Aug. 21, 1995 Letter, attached memorandum at 15; IRS Jan. 22, 1996 Letter at 1-2.

Another type of referral is where a limited aspect of the case is referred by the IRS to DOJ for purposes of DOJ representing the IRS in court for a specific purpose, such as to obtain approval for an immunity order, to enforce a summons, or to obtain a search or arrest warrant or writ of entry. IRS Jan. 22, 1996 Letter at 2-4.

The third type of referral, and the one most relevant to the issue herein, is where the IRS makes tax return information disclosures to DOJ in seeking advice on issues arising during the investigative stage and prior to a formal referral of the case. IRS Jan. 22, 1996 Letter at 4-6. In this type of referral, the IRS asserts that DOJ advice may be sought only on a case-by-case basis by those officers with authority to make the referral. According to the IRS, the solicitation must be made of the DOJ division to which a formal referral would be submitted, and only after the IRS has made a preliminary determination that a formal referral may be appropriate.⁽¹⁾ In addition, the disclosures must be limited to the information necessary to obtain the legal advice sought on the specific case. *Id.* at 4-5.

The IRS relies upon the "Blue Book"⁽²⁾ on the Tax Reform Act of 1976 and various IRS publications as authority for its practice of referring a limited aspect of the case to DOJ or seeking advice prior to a formal referral. *Id.* at 3-4, n.4 & 7. The Blue Book states in relevant part:

For purposes of [6103(h)(3)], the referral of a tax matter by the IRS to the Justice Department would include those disclosures made by the IRS to the Justice Department in connection with the necessary solicitation of advice and assistance with respect to a case prior to formal referral of the entire case to the Justice Department for defense, prosecution, or other affirmative action.

Staff of Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 322 (Comm. Print 1976) ("Blue Book").

The IRS rejects the notion that DOJ's participation on the Committee would constitute any of the referral types permitted by § 6103. The IRS argues that the disclosures to the DOJ attorney would not qualify as the type of pre-formal referral "advice" contemplated by the Blue Book because certain prerequisites to soliciting advice from DOJ are not satisfied. Specifically, the IRS claims that an "institutional decision" to seek DOJ advice is lacking and that no decision has been made on a "case-by-case" basis after a preliminary determination that a formal referral may thereafter be appropriate. In addition, IRS officials submitting requests to the Committee are not necessarily authorized to "refer" matters to DOJ for purposes of § 6103 and the DOJ attorney serving on the Committee would not necessarily be from the division to which a formal referral would be made.

The Tax Division agrees with the IRS that § 6103(h)(2) and (3) must be read in conjunction with one another. The Tax Division characterizes the only issue in dispute as

centering on what constitutes a "referral" under § 6103(h)(3). The Tax Division agrees with the IRS that a § 6103 referral includes a formal referral of the case and a limited referral for the purpose of seeking DOJ assistance in court or advice during the investigative stages of cases. The Tax Division acknowledges that a limited referral terminates once the advice or assistance has been rendered. The Tax Division disagrees, however, with the IRS as to whether disclosures to the DOJ attorney serving on the Committee constitute the type of limited referrals permitted by § 6103. Relying upon the plain meaning of the statute, the Blue Book, and the practices of the IRS, the Tax Division claims that the disclosures to the DOJ attorney are permissible under the statute as a limited referral for purposes of seeking advice. See DOJ Aug. 25, 1995 Letter; DOJ Jan. 24, 1996 Letter.

II. Analysis

We believe that the IRS and the Tax Division are correct that § 6103(h)(2) and (3) must be read in conjunction with one another. Section 6103(h)(3) provides in relevant part that "[i]n any case in which the Secretary is authorized to disclose a return or return information to the Department of Justice pursuant to the provisions of this subsection," the Secretary may make such disclosure if the Secretary has referred a case to DOJ, the proceeding falls under subchapter B of chapter 76, or a written request is submitted by an authorized DOJ official. In its plain meaning, the quoted language refers to a disclosure authorized by § 6103(h)(2).

The primary guide to statutory interpretation is the plain meaning of the text. As stated by the Supreme Court in United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 242 (1989):

The plain meaning of legislation should be conclusive, except in the "rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters." Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982). In such cases, the intention of the drafters, rather than the strict language, controls.

This is not the "rare case[]" where the result that follows from the statute's text is "demonstrably at odds" with its underlying congressional purpose. See Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982). The legislative history supports the conclusion we have reached from a plain reading of the statute.

In explaining the provisions relating to disclosures to DOJ representatives in tax cases, the Senate Committee on Finance stated:

The Justice Department would continue to receive returns and return information with respect to the taxpayer whose civil or criminal tax liability was at issue.

. . . .

Except in those instances where a tax matter was referred by the IRS to the Department of Justice, and tax refund cases under Subchapter B of Chapter 76, the Department of Justice would be required to make a written request (by the Attorney General, the Deputy Attorney General, or an Assistant Attorney

General) for the inspection or disclosure of returns and return information, setting forth the reasons for such disclosure or inspection.

S. Rep. No. 94-938, at 325-26 (1976). The conference agreement adopted a shortened version of this explanation in its report. "The Justice Department will continue to receive returns and return information with respect to the taxpayer whose civil or criminal tax liability is at issue. Written request is required in cases other than refund cases and cases referred by the IRS." Staff of House Comm. on Ways and Means, 94th Cong., 2d Sess., *Summary of Conference Agreement on the Tax Reform Act of 1976*, at 44 (Comm. Print 1976). See also H.R. Conf. Rep. No. 94-1515, at 477 (1976); S. Conf. Rep. No. 94-1236, at 477 (1976).

Courts addressing the issue have adopted the same plain meaning of § 6103(h)(2) and (3). In *United States v. Chemical Bank*, 593 F.2d 451, 457 (2d Cir. 1979), the Second Circuit found that DOJ attorneys may obtain tax returns and return information pursuant to § 6103(h)(2) "only on compliance with" § 6103(h)(3). Similarly, the Third Circuit found that in tax cases "there are two possible routes under which disclosure of tax returns and return information can be made" to DOJ attorneys -- compliance with either § 6103(h)(3)(A) or § 6103(h)(3)(B). *United States v. Bachelier*, 611 F.2d 443, 447 (3d Cir. 1979). See also *United States v. Robertson*, 634 F. Supp. 1020, 1027 n.9 (E.D. Cal. 1986) ("Section 6103(h)(3) sets forth two alternative procedures by which the Department of Justice may inspect return information when [§ 6103(h)(2)] is satisfied . . ."), *aff'd*, 815 F.2d 714 (9th Cir.), *cert. denied*, 484 U.S. 912 (1987).

We now turn to the issue in dispute, whether disclosure of tax return information to a DOJ attorney serving on the Committee is permissible under § 6103 as a limited referral for advice. Section 6103 provides that the IRS may make disclosures of tax information to DOJ attorneys if the case has been "referred" to DOJ. We agree with the IRS and the Tax Division that referrals under § 6103 include a formal referral of the entire case, as well as a limited referral for purposes of seeking DOJ assistance in court or advice during the investigative stages.

Nothing in the plain meaning of the statute or in its legislative history suggest that Congress intended that the term "referred" be narrowly construed. Section 6103 states, in relevant part, that tax information may be disclosed to DOJ employees for use in the grand jury or other proceeding, or in an "investigation which may result in such a proceeding." 26 U.S.C. § 6103(h)(2). This language clearly contemplates disclosures to DOJ not only when a tax matter is far enough along for presentment to the grand jury or in some court proceeding, but where disclosures are needed at the investigative stage. We know from the practices of the IRS and DOJ, as discussed below, that disclosures at the investigative stage are often made in seeking legal advice from DOJ attorneys prior to a formal referral of the entire case. These pre-formal referral practices play a critical role in the effective enforcement of tax statutes.

The legislative history confirms that pre-formal referral disclosure is permissible as a § 6103 referral. As the IRS has stated:

the legislative history of [Section] 6103 indicates that Congress intended a broad interpretation of the term [referred] and acceptance of the definition traditionally used by the Service and the Department of Justice.

IRM, (22)53, at 1272-298.2. The legislative history reveals that Congress did not intend to limit DOJ's access to tax information that was necessary in enforcing criminal tax statutes. See S. Rep. No. 94-938, at 324-25; Staff of House Comm. on Ways and Means, 94th Cong., 2d Sess., Summary of Conference Agreement on the Tax Reform Act of 1976, at 44-45 (Comm. Print 1976); see also United States v. Bacheler, 611 F.2d at 449 ("Section 6103 recognized the need of the Justice Department for continued access to tax returns and return information in carrying out its statutory responsibility in the civil and criminal tax areas and did not seek to change the rules pertaining to the disclosure of returns and return information of the taxpayer whose civil and criminal tax liability is at issue."). And, we know from the agencies' practices that disclosures prior to formal referral are essential to prosecuting tax crimes. The legislative history reveals that in adopting the statute, Congress was concerned with protecting individuals against misuses of tax information by the government. See Beresford v. United States, 123 F.R.D. 232 (E.D. Mich. 1988); McSurely v. McAdams, 502 F. Supp. 52 (D.D.C. 1980). For example, Congress sought to address DOJ's use of tax information in nontax cases. See S. Rep. No. 94-938, at 316-17; Staff of House Comm. on Ways and Means, 94th Cong., 2d Sess., Summary of Conference Agreement on the Tax Reform Act of 1976, at 45 (Comm. Print 1976); see also McLarty v. United States, 741 F. Supp. 751, 755 (D. Minn. 1990), reconsideration granted on other grounds, 784 F.Supp. 1401 (D. Minn. 1991).

In addition, the Blue Book specifically states that a referral includes disclosures made in connection with "the necessary solicitation of advice and assistance with respect to a case prior to formal referral of the entire case to the Justice Department for defense, prosecution, or other affirmative action." Blue Book at 322. Although some courts have held that the Blue Book is not part of the statute's "legislative history" per se, see Flood v. United States, 33 F.3d 1174, 1178 (9th Cir. 1994); Estate of Wallace v. Commissioner, 965 F.2d 1038, 1050 n.15 (11th Cir. 1992); Todd v. Commissioner, 862 F.2d 540, 541-42 (5th Cir. 1988); Hutchinson v. Commissioner, 765 F.2d 665, 669-70 (7th Cir. 1985); Redlark v. Commissioner, 141 F.3d 936 (9th Cir. 1998); Zinniel v. Commissioner, 89 T.C. 357, 365-66 (1987), courts agree that the Blue Book is a valuable aid in understanding and interpreting the federal tax code, see Condor Int'l, Inc. v. Commissioner, 98 T.C. 203, 227 (1992), aff'd in part and rev'd in part, 78 F.3d 1355 (9th Cir. 1996); Estate of Wallace, 965 F.2d at 1050 n.15; Todd, 862 F.2d at 542-43; McDonald v. Commissioner, 764 F.2d 322, 336 n.25 (5th Cir. 1985); Allison v. United States, 701 F.2d 933, 940 n.9 (Fed. Cir. 1983); Hutchinson, 765 F.2d at 669-70; Estate of Ceppi v. Commissioner, 698 F.2d 17, 19 (1st Cir. 1983), cert. denied, 462 U.S. 1120 (1983); Bank of Clearwater v. United States, 7 Cl. Ct. 289, 294 (1985). Indeed, the Supreme Court observed that the Blue Book constituted a "compelling contemporary indication" of legislative intent. Federal Power Comm'n v. Memphis Light, Gas & Water Div., 411 U.S. 458, 472 (1973).

The IRS does not dispute the relevance of the Blue Book as to the issue raised herein. Indeed, an IRS training manual entitled "Disclosure Litigation Training Reference," states in relevant part:

As for prereferral advice, although no court has addressed the issue, a referral for purposes of section 6103(h)(3) may, in appropriate circumstances, include disclosures made by the IRS to Justice in connection with the necessary solicitation of advice and assistance with respect to a case prior to the formal referral (citing the Blue Book).

Office of Chief Counsel, IRS, Disclosure Litigation Training Reference 45 (July 1994).

In sum, we believe a § 6103 referral does include those occasions where the IRS solicits DOJ advice during the investigative stage, but prior to a formal referral of the case.⁽³⁾ We now turn to the issue whether DOJ's participation on the Committee would fall within this type of referral category.

The IRS claims that the solicitation of advice from the DOJ attorney on the Committee does not qualify as a § 6103 referral because the undercover proposals do not satisfy certain prerequisites. The Tax Division takes the contrary position, citing current practices of the IRS in seeking pre-formal referral advice from DOJ attorneys as analogous to the advice sought from the Committee attorney. These practices include the following:

Advice concerning IRS summons for records and/or testimony. IRS agents or District Counsel attorneys often contact DOJ civil trial or appellate attorneys in the Tax Division for advice relating to the defensibility of the procedures or scope of an IRS summons. Disclosure of tax information and often the identity of the taxpayer are essential to rendering the opinion requested.

Case development and strategy. On a regular basis, Tax Division lawyers receive telephone calls from IRS District Counsel attorneys seeking advice about the course of legal action that should be pursued in certain factual situations to build a strong case against the defendant. Full disclosure is made in seeking this type of advice. In some instances, representatives from the IRS Criminal Investigation Division meet with Tax Division managers to discuss a whole class of cases focused on a particular market segment. Tax information has been disclosed so that the Tax Division could assess the likelihood that the cases would be prosecuted.

Coordination of multi-district litigation. In IRS investigations that cross judicial districts, IRS District Counsel attorneys may disclose details of the cases to DOJ in seeking advice as to whether all of the cases would be prosecuted and to facilitate the coordination of those prosecutions.

Appellate issues. IRS personnel frequently contact the Tax Division appellate attorneys about specific issues pending in DOJ cases that are similar to ones arising in IRS investigations. To fully discuss the legal implications, IRS personnel often disclose tax information to the DOJ attorney.

Cases requiring prompt DOJ action. In exigent circumstances where prompt DOJ action is necessary, IRS personnel will make disclosures to DOJ so that DOJ attorneys can begin working on the case. The IRS describes these circumstances as part of the referral procedure and not a request for prereferral advice. IRS Jan. 22, 1996 Letter at n.2. The Tax Division asserts that the disclosures are made before any formal referral of the case has been made.

DOJ prosecution policies. The Tax Division and the IRS describe another situation where pre-formal referral solicitation occurs. In determining whether DOJ's dual prosecution policy applies to preclude a particular federal prosecution, certain procedures must be followed by the IRS and DOJ. In compliance with these requirements, tax information must be disclosed. The IRS describes this procedure as rarely used during the past several years.

Consensual monitoring of conversations. The Tax Division and the IRS acknowledge

that pre-formal referral disclosures are made in compliance with DOJ policy that IRS agents seek DOJ approval prior to engaging in any consensual monitoring during an investigation. The DOJ policy is set forth in a 1983 Attorney General Memorandum signed by William French Smith and in the United States Attorney's Manual, Memorandum to Heads and Inspectors General of Executive Departments and Agencies, from William French Smith, Attorney General, Re: Procedures for Lawful, Warrantless Interceptions of Verbal Communications (Nov. 7, 1983); USAM 9-7.302 (July 1, 1992). The IRS requires compliance with the DOJ policy. IRM 9389. As explained in the Internal Revenue Manual, the purpose of the policy is "to avoid any abuse or any unwarranted invasion of privacy." Id. at 9389.1 at 9-228.4. The Tax Division explained that the policy has the additional purposes of ensuring that the interception be carried out in a way that will withstand challenge in court and that a uniform approach to monitoring be utilized throughout the country. DOJ Jan. 24, 1996 Letter at 6.

We agree with the Tax Division that the current practices are analogous to and legally indistinguishable from DOJ's participation on the Committee.⁽⁴⁾ We also agree that disclosures to the DOJ attorney on the Committee would be permissible referrals under § 6103. DOJ's involvement on the Committee is necessary "to ensure legal, ethical, and prosecutorial uniformity in the application of the undercover technique for Federal law enforcement." MOU at 2. The role played by the DOJ attorney would include assisting in the development of a uniform approach to the use of the undercover technique and to ensure that prosecutive issues are addressed at the earliest stage. The attorney could help ensure that the investigation would withstand challenge in court, by advising on entrapment and double jeopardy defenses, as well as other issues. To fulfill the role of providing the desired advice and assistance, the DOJ attorney would need full access to the relevant tax information. We understand that the disclosures, however, would be limited to the information necessary to obtain the advice sought on the specific proposal and that such information would be returned upon completion of the assignment.

The nature of Group I operations creates the necessity for the solicitation of DOJ advice in approving the proposals. A Group I undercover operation is a sensitive and potentially intrusive technique, and care must be exercised to ensure that it be used properly. MOU at 2. A flawed operation could create significant legal impediments to a tax prosecution. If done correctly, however, the technique is a valuable law enforcement investigative tool and is essential to the enforcement of tax and tax related statutes. MOU at 1. IRS policies associated with these operations underscore the legitimate legal concerns associated with the practice.

Under these circumstances, we are compelled to conclude that DOJ's participation on the Committee falls within the rubric of the pre-formal referral advice contemplated by § 6103, as articulated in the Blue Book and applied in other practices by the IRS and DOJ. We do not find persuasive the contrary arguments made by the IRS. Specifically, the IRS claims that the disclosures are not permissible because no "institutional decision" to refer a specific question to DOJ exists. Nor has a preliminary determination been made that a formal referral may thereafter be appropriate. The IRS also states that the proposals to the Committee would not necessarily be submitted by an IRS official with authority to make a § 6103 referral. Nor would the DOJ attorney on the Committee necessarily be from the DOJ division to which a formal referral would be made.

First, assuming § 6103 requires that solicitations for advice must be made on a case-by-

case basis or after an "institutional decision" has been made, as well as a preliminary determination that a formal referral may be appropriate, we believe that referring requests to the Committee for approval of Group I operations would satisfy these standards. The qualifying requirements for Group I operations necessarily limit the types of requests made to the Committee. Determining that a matter satisfies the prerequisites for a proposed undercover operation constitutes a case-by-case determination. Indeed, before proposals are submitted to the Committee, several IRS officials must review and approve the proposals. We understand that the number of undercover requests submitted to the Committee are few in relation to the total number of IRS investigations and that no more than four operations are considered at any one Committee meeting.

In addition, the very nature of Group I operations and the associated approval process would suggest that the IRS views these type of investigations as ones that may be appropriate for referral to DOJ for prosecution. And, the assistance proffered by the DOJ attorney would be limited in nature based upon the issues posed by the particular operation and relevant tax information. These circumstances, that is the special role of the Committee, the policies associated with referring qualifying proposals to the Committee for approval, the particular nature of Group I undercover investigations, and the IRS decision to enter into an MOU for DOJ participation, would suggest that an "institutional decision" has been made to seek DOJ advice in a particular matter. Simply put, we cannot agree that these facts support IRS' claim that disclosures to the DOJ attorney would be tantamount to giving DOJ "free and unfettered" access to tax information in a whole class of cases.

Even if, however, the submissions to the Committee were correctly characterized as a referral of "a class of cases," we do not believe § 6103 precludes such referrals. Some of the IRS' current practices of consulting with DOJ attorneys prior to a formal referral could also be characterized as referrals of whole classes of cases. For example, as discussed above, IRS representatives occasionally meet with DOJ attorneys to discuss whole classes of cases, wherein tax information is disclosed in seeking legal advice. Similarly, the IRS practice of complying with the DOJ consensual monitoring policy could be characterized as a referral of a whole class of cases. In these practices, as well as the proposed Committee work, the solicitations for advice are essential to the successful prosecutions of tax violations. For example, as to the consensual monitoring cases, the solicitations help "to avoid any abuse or any unwarranted invasion of privacy," IRM 9389.1 at 9-228.4, and to build a legally stronger investigation. DOJ Jan. 24, 1996 Letter at 6. No one can dispute that uniformity in tax investigations and prosecutions is critical to the success of the federal tax enforcement program. See USAM 6-4.000 (Mar. 1, 1994).

In sum, we do not believe § 6103 was intended to preclude DOJ from providing advice in cases that as a class present legitimate legal concerns. The objectives behind the current practices, as well as DOJ's participation on the Committee, are entirely consistent with the statute's legislative history and Blue Book provision. The legislative history shows that § 6103 was not intended to interfere with DOJ's access to tax information that is necessary in enforcing the tax laws. See S. Rep. No. 94-938, at 324-25; Staff of House Comm. on Ways and Means, 94th Cong., 2d Sess. Summary of Conference Agreement of the Tax Reform Act of 1976, at 44-45 (Comm. Print 1976); see also Bachelor, 611 F.2d at 449. And, the Blue Book explicitly states that the IRS may make disclosures to DOJ "in connection with the necessary solicitation of advice."⁽⁵⁾ Blue Book at 322.

Finally, we are not persuaded by IRS' claim that DOJ's full participation on the

Committee is impermissible because the "referrals" are not necessarily made by IRS officials with authority to do so, or that the DOJ attorney would not be from the division to which a formal referral would be made. We agree that the "referral" must be made by IRS personnel with the authority to do so. We also believe, however, that this prerequisite can be satisfied. To the extent persons involved in submitting requests to the Committee are not currently authorized to "refer" matters to DOJ for purposes of § 6103, the IRS orders or practices can be amended to guarantee that the persons referring the matters to the Committee have the appropriate authority. We are unaware of any authority for the remaining alleged prerequisite, that the DOJ attorney must be from the division to which a formal referral would be made, nor has any been called to our attention. Moreover, the current practices of the IRS in soliciting DOJ advice, as discussed above, do not appear to be consistent with the existence of such a requirement. In any event, if such a prerequisite is desired, it could easily be complied with by redesignating, as necessary, which DOJ attorney would sit on the Committee for specific proposals.

CHRISTOPHER H. SCHROEDER
Acting Assistant Attorney General
Office of Legal Counsel

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1. According to the IRS, the question of which officials have authority to refer matters to DOJ depends upon the type of investigation involved. IRS documents specify who these officials are. Disclosures to DOJ are generally made by IRS District and Regional Counsel, and the Assistant Commissioner of Criminal Investigation. IRM (22)55.1, at 1272-298.2; see also IRS Jan. 22, 1996 Letter at 4-5, Tabs C & L.
 2. For further discussion of the Blue Book see *infra* at _____.
 3. Although no court has decided the issue presented herein, at least one court has broadly construed what constitutes a "referral" for purposes of § 6103. See United States v. Bachelier, 611 F.2d 443 (3d Cir. 1979). Courts have also acknowledged the importance of DOJ and IRS working together in investigating and prosecuting tax crimes. See *id.*; United States v. Chemical Bank, 593 F.2d 451 (2d Cir. 1979).
 4. Although the IRS now raises a question as to the propriety of its 20 year compliance with DOJ policy relating to consensual monitoring (see IRS Jan. 22, 1996 Letter at 10), we think the practice is permissible under the scope of § 6103.
 5. We construe "necessary" here to mean solicitation that will further federal efforts in the tax enforcement program.

not issued to Taxpayer by the same company in the same calendar year. The result in this case would be the same if, instead of individually issued MECs, the Original Contracts and New Contracts were evidenced by certificates that were issued under a group contract or master contract and that were treated as separate contracts for purposes of §§ 817(h), 7702, and 7702A.

HOLDING

If a taxpayer that owns multiple modified endowment contracts (MECs) issued by the same insurance company in the same calendar year exchanges some of those MECs for new MECs issued by a second insurance company, the new contracts are not required to be aggregated with the remaining original contracts under § 72(e)(12).

DRAFTING INFORMATION

The principal author of this revenue ruling is Melissa S. Luxner of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Ms. Luxner at (202) 622-3970 (not a toll-free call).

Section 430.—Minimum Funding Standards for Single-Employer Defined Benefit Pension Plans

Procedures with respect to applications for requests for letter rulings on substitute mortality tables under section 430(h)(3)(C) of the Code and section 303(b)(3)(C) of the Employee Retirement Income Security Act of 1974 are set forth. See Rev. Proc. 2007-37, page 1433.

Section 501.—Exemption From Tax on Corporations, Certain Trusts, etc.

26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary or educational purposes, or for the prevention of cruelty to children or animals.

Exempt organizations; political campaigns. This ruling provides 21 examples illustrating the application of the facts and circumstances to be considered to determine whether an organization exempt from

income tax under section 501(a) of the Code as an organization described in section 501(c)(3) has participated in, or intervened in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Rev. Rul. 2007-41

Organizations that are exempt from income tax under section 501(a) of the Internal Revenue Code as organizations described in section 501(c)(3) may not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

ISSUE

In each of the 21 situations described below, has the organization participated or intervened in a political campaign on behalf of (or in opposition to) any candidate for public office within the meaning of section 501(c)(3)?

LAW

Section 501(c)(3) provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable or educational purposes, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in section 501(h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Section 1.501(c)(3)-1(c)(3)(i) of the Income Tax Regulations states that an organization is not operated exclusively for one or more exempt purposes if it is an "action" organization.

Section 1.501(c)(3)-1(c)(3)(iii) of the regulations defines an "action" organization as an organization that participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office. The term "candidate for public office" is defined as an individual who offers himself, or is proposed by others, as a contestant for

an elective public office, whether such office be national, State, or local. The regulations further provide that activities that constitute participation or intervention in a political campaign on behalf of or in opposition to a candidate include, but are not limited to, the publication or distribution of written statements or the making of oral statements on behalf of or in opposition to such a candidate.

Whether an organization is participating or intervening, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office depends upon all of the facts and circumstances of each case. For example, certain "voter education" activities, including preparation and distribution of certain voter guides, conducted in a non-partisan manner may not constitute prohibited political activities under section 501(c)(3) of the Code. Other so-called "voter education" activities may be proscribed by the statute. Rev. Rul. 78-248, 1978-1 C.B. 154, contrasts several situations illustrating when an organization that publishes a compilation of candidate positions or voting records has or has not engaged in prohibited political activities based on whether the questionnaire used to solicit candidate positions or the voters guide itself shows a bias or preference in content or structure with respect to the views of a particular candidate. See also Rev. Rul. 80-282, 1980-2 C.B. 178, amplifying Rev. Rul. 78-248 regarding the timing and distribution of voter education materials.

The presentation of public forums or debates is a recognized method of educating the public. See Rev. Rul. 66-256, 1966-2 C.B. 210 (nonprofit organization formed to conduct public forums at which lectures and debates on social, political, and international matters are presented qualifies for exemption from federal income tax under section 501(c)(3)). Providing a forum for candidates is not, in and of itself, prohibited political activity. See Rev. Rul. 74-574, 1974-2 C.B. 160 (organization operating a broadcast station is not participating in political campaigns on behalf of public candidates by providing reasonable amounts of air time equally available to all legally qualified candidates for election to public office in compliance with the reasonable access provisions of the Communications Act of

1934). However, a forum for candidates could be operated in a manner that would show a bias or preference for or against a particular candidate. This could be done, for example, through biased questioning procedures. On the other hand, a forum held for the purpose of educating and informing the voters, which provides fair and impartial treatment of candidates, and which does not promote or advance one candidate over another, would not constitute participation or intervention in any political campaign on behalf of or in opposition to any candidate for public office. See Rev. Rul. 86-95, 1986-2 C.B. 73 (organization that proposes to educate voters by conducting a series of public forums in congressional districts during congressional election campaigns is not participating in a political campaign on behalf of any candidate due to the neutral form and content of its proposed forums).

ANALYSIS OF FACTUAL SITUATIONS

The 21 factual situations appear below under specific subheadings relating to types of activities. In each of the factual situations, all the facts and circumstances are considered in determining whether an organization's activities result in political campaign intervention. Note that each of these situations involves only one type of activity. In the case of an organization that combines one or more types of activity, the interaction among the activities may affect the determination of whether or not the organization is engaged in political campaign intervention.

Voter Education, Voter Registration and Get Out the Vote Drives

Section 501(c)(3) organizations are permitted to conduct certain voter education activities (including the presentation of public forums and the publication of voter education guides) if they are carried out in a non-partisan manner. In addition, section 501(c)(3) organizations may encourage people to participate in the electoral process through voter registration and get-out-the-vote drives, conducted in a non-partisan manner. On the other hand, voter education or registration activities conducted in a biased manner that favors (or opposes) one or more candidates is prohibited.

Situation 1. *B*, a section 501(c)(3) organization that promotes community involvement, sets up a booth at the state fair where citizens can register to vote. The signs and banners in and around the booth give only the name of the organization, the date of the next upcoming statewide election, and notice of the opportunity to register. No reference to any candidate or political party is made by the volunteers staffing the booth or in the materials available at the booth, other than the official voter registration forms which allow registrants to select a party affiliation. *B* is not engaged in political campaign intervention when it operates this voter registration booth.

Situation 2. *C* is a section 501(c)(3) organization that educates the public on environmental issues. Candidate *G* is running for the state legislature and an important element of her platform is challenging the environmental policies of the incumbent. Shortly before the election, *C* sets up a telephone bank to call registered voters in the district in which Candidate *G* is seeking election. In the phone conversations, *C*'s representative tells the voter about the importance of environmental issues and asks questions about the voter's views on these issues. If the voter appears to agree with the incumbent's position, *C*'s representative thanks the voter and ends the call. If the voter appears to agree with Candidate *G*'s position, *C*'s representative reminds the voter about the upcoming election, stresses the importance of voting in the election and offers to provide transportation to the polls. *C* is engaged in political campaign intervention when it conducts this get-out-the-vote drive.

Individual Activity by Organization Leaders

The political campaign intervention prohibition is not intended to restrict free expression on political matters by leaders of organizations speaking for themselves, as individuals. Nor are leaders prohibited from speaking about important issues of public policy. However, for their organizations to remain tax exempt under section 501(c)(3), leaders cannot make partisan comments in official organization publications or at official functions of the organization.

Situation 3. President *A* is the Chief Executive Officer of Hospital *J*, a section

501(c)(3) organization, and is well known in the community. With the permission of five prominent healthcare industry leaders, including President *A*, who have personally endorsed Candidate *T*, Candidate *T* publishes a full page ad in the local newspaper listing the names of the five leaders. President *A* is identified in the ad as the CEO of Hospital *J*. The ad states, "Titles and affiliations of each individual are provided for identification purposes only." The ad is paid for by Candidate *T*'s campaign committee. Because the ad was not paid for by Hospital *J*, the ad is not otherwise in an official publication of Hospital *J*, and the endorsement is made by President *A* in a personal capacity, the ad does not constitute campaign intervention by Hospital *J*.

Situation 4. President *B* is the president of University *K*, a section 501(c)(3) organization. University *K* publishes a monthly alumni newsletter that is distributed to all alumni of the university. In each issue, President *B* has a column titled "My Views." The month before the election, President *B* states in the "My Views" column, "It is my personal opinion that Candidate *U* should be reelected." For that one issue, President *B* pays from his personal funds the portion of the cost of the newsletter attributable to the "My Views" column. Even though he paid part of the cost of the newsletter, the newsletter is an official publication of the university. Because the endorsement appeared in an official publication of University *K*, it constitutes campaign intervention by University *K*.

Situation 5. Minister *C* is the minister of Church *L*, a section 501(c)(3) organization and Minister *C* is well known in the community. Three weeks before the election, he attends a press conference at Candidate *V*'s campaign headquarters and states that Candidate *V* should be reelected. Minister *C* does not say he is speaking on behalf of Church *L*. His endorsement is reported on the front page of the local newspaper and he is identified in the article as the minister of Church *L*. Because Minister *C* did not make the endorsement at an official church function, in an official church publication or otherwise use the church's assets, and did not state that he was speaking as a representative of Church *L*, his actions do not constitute campaign intervention by Church *L*.

Situation 6. Chairman *D* is the chairman of the Board of Directors of *M*, a section 501(c)(3) organization that educates the public on conservation issues. During a regular meeting of *M* shortly before the election, Chairman *D* spoke on a number of issues, including the importance of voting in the upcoming election, and concluded by stating, "It is important that you all do your duty in the election and vote for Candidate *W*." Because Chairman *D*'s remarks indicating support for Candidate *W* were made during an official organization meeting, they constitute political campaign intervention by *M*.

Candidate Appearances

Depending on the facts and circumstances, an organization may invite political candidates to speak at its events without jeopardizing its tax-exempt status. Political candidates may be invited in their capacity as candidates, or in their individual capacity (not as a candidate). Candidates may also appear without an invitation at organization events that are open to the public.

When a candidate is invited to speak at an organization event in his or her capacity as a political candidate, factors in determining whether the organization participated or intervened in a political campaign include the following:

- Whether the organization provides an equal opportunity to participate to political candidates seeking the same office;
- Whether the organization indicates any support for or opposition to the candidate (including candidate introductions and communications concerning the candidate's attendance); and
- Whether any political fundraising occurs.

In determining whether candidates are given an equal opportunity to participate, the nature of the event to which each candidate is invited will be considered, in addition to the manner of presentation. For example, an organization that invites one candidate to speak at its well attended annual banquet, but invites the opposing candidate to speak at a sparsely attended general meeting, will likely have violated the political campaign prohibition, even if the

manner of presentation for both speakers is otherwise neutral.

When an organization invites several candidates for the same office to speak at a public forum, factors in determining whether the forum results in political campaign intervention include the following:

- Whether questions for the candidates are prepared and presented by an independent nonpartisan panel,
- Whether the topics discussed by the candidates cover a broad range of issues that the candidates would address if elected to the office sought and are of interest to the public,
- Whether each candidate is given an equal opportunity to present his or her view on each of the issues discussed,
- Whether the candidates are asked to agree or disagree with positions, agendas, platforms or statements of the organization, and
- Whether a moderator comments on the questions or otherwise implies approval or disapproval of the candidates.

Situation 7. President *E* is the president of Society *N*, a historical society that is a section 501(c)(3) organization. In the month prior to the election, President *E* invites the three Congressional candidates for the district in which Society *N* is located to address the members, one each at a regular meeting held on three successive weeks. Each candidate is given an equal opportunity to address and field questions on a wide variety of topics from the members. Society *N*'s publicity announcing the dates for each of the candidate's speeches and President *E*'s introduction of each candidate include no comments on their qualifications or any indication of a preference for any candidate. Society *N*'s actions do not constitute political campaign intervention.

Situation 8. The facts are the same as in *Situation 7* except that there are four candidates in the race rather than three, and one of the candidates declines the invitation to speak. In the publicity announcing the dates for each of the candidate's speeches, Society *N* includes a statement that the order of the speakers was determined at random and the fourth candidate declined the Society's invitation to speak. President *E* makes the same statement in

his opening remarks at each of the meetings where one of the candidates is speaking. Society *N*'s actions do not constitute political campaign intervention.

Situation 9. Minister *F* is the minister of Church *O*, a section 501(c)(3) organization. The Sunday before the November election, Minister *F* invites Senate Candidate *X* to preach to her congregation during worship services. During his remarks, Candidate *X* states, "I am asking not only for your votes, but for your enthusiasm and dedication, for your willingness to go the extra mile to get a very large turnout on Tuesday." Minister *F* invites no other candidate to address her congregation during the Senatorial campaign. Because these activities take place during official church services, they are attributed to Church *O*. By selectively providing church facilities to allow Candidate *X* to speak in support of his campaign, Church *O*'s actions constitute political campaign intervention.

Candidate Appearances Where Speaking or Participating as a Non-Candidate

Candidates may also appear or speak at organization events in a non-candidate capacity. For instance, a political candidate may be a public figure who is invited to speak because he or she: (a) currently holds, or formerly held, public office; (b) is considered an expert in a non political field; or (c) is a celebrity or has led a distinguished military, legal, or public service career. A candidate may choose to attend an event that is open to the public, such as a lecture, concert or worship service. The candidate's presence at an organization-sponsored event does not, by itself, cause the organization to be engaged in political campaign intervention. However, if the candidate is publicly recognized by the organization, or if the candidate is invited to speak, factors in determining whether the candidate's appearance results in political campaign intervention include the following:

- Whether the individual is chosen to speak solely for reasons other than candidacy for public office;
- Whether the individual speaks only in a non-candidate capacity;
- Whether either the individual or any representative of the organization

- makes any mention of his or her candidacy or the election;
- Whether any campaign activity occurs in connection with the candidate's attendance;
- Whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present; and
- Whether the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

Situation 10. Historical society *P* is a section 501(c)(3) organization. Society *P* is located in the state capital. President *G* is the president of Society *P* and customarily acknowledges the presence of any public officials present during meetings. During the state gubernatorial race, Lieutenant Governor *Y*, a candidate, attends a meeting of the historical society. President *G* acknowledges the Lieutenant Governor's presence in his customary manner, saying, "We are happy to have joining us this evening Lieutenant Governor *Y*." President *G* makes no reference in his welcome to the Lieutenant Governor's candidacy or the election. Society *P* has not engaged in political campaign intervention as a result of President *G*'s actions.

Situation 11. Chairman *H* is the chairman of the Board of Hospital *Q*, a section 501(c)(3) organization. Hospital *Q* is building a new wing. Chairman *H* invites Congressman *Z*, the representative for the district containing Hospital *Q*, to attend the groundbreaking ceremony for the new wing. Congressman *Z* is running for reelection at the time. Chairman *H* makes no reference in her introduction to Congressman *Z*'s candidacy or the election. Congressman *Z* also makes no reference to his candidacy or the election and does not do any political campaign fundraising while at Hospital *Q*. Hospital *Q* has not intervened in a political campaign.

Situation 12. University *X* is a section 501(c)(3) organization. *X* publishes an alumni newsletter on a regular basis. Individual alumni are invited to send in updates about themselves which are printed in each edition of the newsletter. After receiving an update letter from Alumnus *Q*,

X prints the following: "Alumnus *Q*, class of 'XX is running for mayor of Metropolis." The newsletter does not contain any reference to this election or to Alumnus *Q*'s candidacy other than this statement of fact. University *X* has not intervened in a political campaign.

Situation 13. Mayor *G* attends a concert performed by Symphony *S*, a section 501(c)(3) organization, in City Park. The concert is free and open to the public. Mayor *G* is a candidate for reelection, and the concert takes place after the primary and before the general election. During the concert, the chairman of *S*'s board addresses the crowd and says, "I am pleased to see Mayor *G* here tonight. Without his support, these free concerts in City Park would not be possible. We will need his help if we want these concerts to continue next year so please support Mayor *G* in November as he has supported us." As a result of these remarks, Symphony *S* has engaged in political campaign intervention.

Issue Advocacy vs. Political Campaign Intervention

Section 501(c)(3) organizations may take positions on public policy issues, including issues that divide candidates in an election for public office. However, section 501(c)(3) organizations must avoid any issue advocacy that functions as political campaign intervention. Even if a statement does not expressly tell an audience to vote for or against a specific candidate, an organization delivering the statement is at risk of violating the political campaign intervention prohibition if there is any message favoring or opposing a candidate. A statement can identify a candidate not only by stating the candidate's name but also by other means such as showing a picture of the candidate, referring to political party affiliations, or other distinctive features of a candidate's platform or biography. All the facts and circumstances need to be considered to determine if the advocacy is political campaign intervention.

Key factors in determining whether a communication results in political campaign intervention include the following:

- Whether the statement identifies one or more candidates for a given public office;
- Whether the statement expresses approval or disapproval for one or more candidates' positions and/or actions;
- Whether the statement is delivered close in time to the election;
- Whether the statement makes reference to voting or an election;
- Whether the issue addressed in the communication has been raised as an issue distinguishing candidates for a given office;
- Whether the communication is part of an ongoing series of communications by the organization on the same issue that are made independent of the timing of any election; and
- Whether the timing of the communication and identification of the candidate are related to a non-electoral event such as a scheduled vote on specific legislation by an officeholder who also happens to be a candidate for public office.

A communication is particularly at risk of political campaign intervention when it makes reference to candidates or voting in a specific upcoming election. Nevertheless, the communication must still be considered in context before arriving at any conclusions.

Situation 14. University *O*, a section 501(c)(3) organization, prepares and finances a full page newspaper advertisement that is published in several large circulation newspapers in State *V* shortly before an election in which Senator *C* is a candidate for nomination in a party primary. Senator *C* represents State *V* in the United States Senate. The advertisement states that S. 24, a pending bill in the United States Senate, would provide additional opportunities for State *V* residents to attend college, but Senator *C* has opposed similar measures in the past. The advertisement ends with the statement "Call or write Senator *C* to tell him to vote for S. 24." Educational issues have not been raised as an issue distinguishing Senator *C* from any opponent. S. 24 is scheduled for a vote in the United States Senate before the election, soon after the date that the advertisement is published in the newspapers. Even though the advertisement appears shortly before the election and iden-

ties Senator *C*'s position on the issue as contrary to *O*'s position, University *O* has not violated the political campaign intervention prohibition because the advertisement does not mention the election or the candidacy of Senator *C*, education issues have not been raised as distinguishing Senator *C* from any opponent, and the timing of the advertisement and the identification of Senator *C* are directly related to the specifically identified legislation University *O* is supporting and appears immediately before the United States Senate is scheduled to vote on that particular legislation. The candidate identified, Senator *C*, is an officeholder who is in a position to vote on the legislation.

Situation 15. Organization *R*, a section 501(c)(3) organization that educates the public about the need for improved public education, prepares and finances a radio advertisement urging an increase in state funding for public education in State *X*, which requires a legislative appropriation. Governor *E* is the governor of State *X*. The radio advertisement is first broadcast on several radio stations in State *X* beginning shortly before an election in which Governor *E* is a candidate for re-election. The advertisement is not part of an ongoing series of substantially similar advocacy communications by Organization *R* on the same issue. The advertisement cites numerous statistics indicating that public education in State *X* is underfunded. While the advertisement does not say anything about Governor *E*'s position on funding for public education, it ends with "Tell Governor *E* what you think about our under-funded schools." In public appearances and campaign literature, Governor *E*'s opponent has made funding of public education an issue in the campaign by focusing on Governor *E*'s veto of an income tax increase the previous year to increase funding of public education. At the time the advertisement is broadcast, no legislative vote or other major legislative activity is scheduled in the State *X* legislature on state funding of public education. Organization *R* has violated the political campaign prohibition because the advertisement identifies Governor *E*, appears shortly before an election in which Governor *E* is a candidate, is not part of an ongoing series of substantially similar advocacy communications by Organization *R* on the same issue, is not timed to

coincide with a non election event such as a legislative vote or other major legislative action on that issue, and takes a position on an issue that the opponent has used to distinguish himself from Governor *E*.

Situation 16. Candidate *A* and Candidate *B* are candidates for the state senate in District *W* of State *X*. The issue of State *X* funding for a new mass transit project in District *W* is a prominent issue in the campaign. Both candidates have spoken out on the issue. Candidate *A* supports funding the new mass transit project. Candidate *B* opposes the project and supports State *X* funding for highway improvements instead. *P* is the executive director of *C*, a section 501(c)(3) organization that promotes community development in District *W*. At *C*'s annual fundraising dinner in District *W*, which takes place in the month before the election in State *X*, *P* gives a lengthy speech about community development issues including the transportation issues. *P* does not mention the name of any candidate or any political party. However, at the conclusion of the speech, *P* makes the following statement, "For those of you who care about quality of life in District *W* and the growing traffic congestion, there is a very important choice coming up next month. We need new mass transit. More highway funding will not make a difference. You have the power to relieve the congestion and improve your quality of life in District *W*. Use that power when you go to the polls and cast your vote in the election for your state senator." *C* has violated the political campaign intervention as a result of *P*'s remarks at *C*'s official function shortly before the election, in which *P* referred to the upcoming election after stating a position on an issue that is a prominent issue in a campaign that distinguishes the candidates.

Business Activity

The question of whether an activity constitutes participation or intervention in a political campaign may also arise in the context of a business activity of the organization, such as selling or renting of mailing lists, the leasing of office space, or the acceptance of paid political advertising. In this context, some of the factors to be considered in determining whether the organization has engaged in political campaign intervention include the following:

- Whether the good, service or facility is available to candidates in the same election on an equal basis,
- Whether the good, service, or facility is available only to candidates and not to the general public,
- Whether the fees charged to candidates are at the organization's customary and usual rates, and
- Whether the activity is an ongoing activity of the organization or whether it is conducted only for a particular candidate.

Situation 17. Museum *K* is a section 501(c)(3) organization. It owns an historic building that has a large hall suitable for hosting dinners and receptions. For several years, Museum *K* has made the hall available for rent to members of the public. Standard fees are set for renting the hall based on the number of people in attendance, and a number of different organizations have rented the hall. Museum *K* rents the hall on a first come, first served basis. Candidate *P* rents Museum *K*'s social hall for a fundraising dinner. Candidate *P*'s campaign pays the standard fee for the dinner. Museum *K* is not involved in political campaign intervention as a result of renting the hall to Candidate *P* for use as the site of a campaign fundraising dinner.

Situation 18. Theater *L* is a section 501(c)(3) organization. It maintains a mailing list of all of its subscribers and contributors. Theater *L* has never rented its mailing list to a third party. Theater *L* is approached by the campaign committee of Candidate *Q*, who supports increased funding for the arts. Candidate *Q*'s campaign committee offers to rent Theater *L*'s mailing list for a fee that is comparable to fees charged by other similar organizations. Theater *L* rents its mailing list to Candidate *Q*'s campaign committee. Theater *L* declines similar requests from campaign committees of other candidates. Theater *L* has intervened in a political campaign.

Web Sites

The Internet has become a widely used communications tool. Section 501(c)(3) organizations use their own web sites to disseminate statements and information.

They also routinely link their web sites to web sites maintained by other organizations as a way of providing additional information that the organizations believe is useful or relevant to the public.

A web site is a form of communication. If an organization posts something on its web site that favors or opposes a candidate for public office, the organization will be treated the same as if it distributed printed material, oral statements or broadcasts that favored or opposed a candidate.

An organization has control over whether it establishes a link to another site. When an organization establishes a link to another web site, the organization is responsible for the consequences of establishing and maintaining that link, even if the organization does not have control over the content of the linked site. Because the linked content may change over time, an organization may reduce the risk of political campaign intervention by monitoring the linked content and adjusting the links accordingly.

Links to candidate-related material, by themselves, do not necessarily constitute political campaign intervention. All the facts and circumstances must be taken into account when assessing whether a link produces that result. The facts and circumstances to be considered include, but are not limited to, the context for the link on the organization's web site, whether all candidates are represented, any exempt purpose served by offering the link, and the directness of the links between the organization's web site and the web page that contains material favoring or opposing a candidate for public office.

Situation 19. *M*, a section 501(c)(3) organization, maintains a web site and posts an unbiased, nonpartisan voter guide that is prepared consistent with the principles discussed in Rev. Rul. 78-248. For each candidate covered in the voter guide, *M* includes a link to that candidate's official campaign web site. The links to the candidate web sites are presented on a consistent neutral basis for each candidate, with text saying "For more information on Candidate *X*, you may consult [URL]." *M* has not intervened in a political campaign because the links are provided for the exempt purpose of educating voters and are presented in a neutral, unbiased manner that

includes all candidates for a particular office.

Situation 20. Hospital *N*, a section 501(c)(3) organization, maintains a web site that includes such information as medical staff listings, directions to Hospital *N*, and descriptions of its specialty health programs, major research projects, and other community outreach programs. On one page of the web site, Hospital *N* describes its treatment program for a particular disease. At the end of the page, it includes a section of links to other web sites titled "More Information." These links include links to other hospitals that have treatment programs for this disease, research organizations seeking cures for that disease, and articles about treatment programs. This section includes a link to an article on the web site of *O*, a major national newspaper, praising Hospital *N*'s treatment program for the disease. The page containing the article on *O*'s web site contains no reference to any candidate or election and has no direct links to candidate or election information. Elsewhere on *O*'s web site, there is a page displaying editorials that *O* has published. Several of the editorials endorse candidates in an election that has not yet occurred. Hospital *N* has not intervened in a political campaign by maintaining the link to the article on *O*'s web site because the link is provided for the exempt purpose of educating the public about Hospital *N*'s programs and neither the context for the link, nor the relationship between Hospital *N* and *O* nor the arrangement of the links going from Hospital *N*'s web site to the endorsement on *O*'s web site indicate that Hospital *N* was favoring or opposing any candidate.

Situation 21. Church *P*, a section 501(c)(3) organization, maintains a web site that includes such information as biographies of its ministers, times of services, details of community outreach programs, and activities of members of its congregation. *B*, a member of the congregation of Church *P*, is running for a seat on the town council. Shortly before the election, Church *P* posts the following message on its web site, "Lend your support to *B*, your fellow parishioner, in Tuesday's election for town council." Church *P* has intervened in a political campaign on behalf of *B*.

HOLDINGS

In situations 2, 4, 6, 9, 13, 15, 16, 18 and 21, the organization intervened in a political campaign within the meaning of section 501(c)(3). In situations 1, 3, 5, 7, 8, 10, 11, 12, 14, 17, 19 and 20, the organization did not intervene in a political campaign within the meaning of section 501(c)(3).

DRAFTING INFORMATION

The principal author of this revenue ruling is Judith Kindell of Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, contact Ms. Kindell at (202) 283-8964 (not a toll-free call).

Section 707.—Transactions Between Partner and Partnership

26 CFR 1.707-1: Transactions between partner and partnership.

Partnership property; transfer. This ruling concludes that a transfer of partnership property to a partner in satisfaction of a guaranteed payment under section 707(c) of the Code is a sale or exchange under section 1001, and not a distribution under section 731.

Rev. Rul. 2007-40

ISSUE

Is a transfer of partnership property to a partner in satisfaction of a guaranteed payment under section 707(c) a sale or exchange under section 1001, or a distribution under section 731?

FACTS

Partnership purchased Blackacre for \$500x. *A*, a partner in *Partnership*, is entitled to a guaranteed payment under section 707(c) of \$800x. Subsequently, when the fair market value of Blackacre is \$800x and *Partnership*'s adjusted basis in Blackacre is \$500x, *Partnership* transfers Blackacre to *A* in satisfaction of the guaranteed payment to *A*.

Mr. SCHIFF. I thank the chairman for his indulgence of someone from Boston; and I look forward to, within 30 days, hearing back from you either in writing or if you want to meet instead.

I would like to have the church involved, since it has most directly impacted them; and I will provide you with a waiver that they provided as well as their written request. And I thank you.

Mr. SERRANO. Thank you. The problem is not indulging over the 5 minutes. It is that Boston comment that keeps haunting me.

Mr. SCHIFF. I realize that, Mr. Chairman. You are Mets, not Yankees, right? Or you are Yankees, not Mets?

Mr. SERRANO. I really think, Mr. Schiff, that you should talk to Mr. Hinchey and cut your losses just about now.

Mr. Alexander.

ECONOMIC STIMULUS REBATE CHECKS

Mr. ALEXANDER. Thank you, Mr. Chairman.

Commissioner, I don't know if this will come as comfort to you, but in my congressional district you are still just like a lot more than immigration.

When you say one has filed their tax statement, that doesn't necessarily mean that they owe money; is that correct?

Mr. SHULMAN. I—

Mr. ALEXANDER. There were many people who filed income taxes but don't owe anything?

Mr. SHULMAN. Oh, absolutely.

Mr. ALEXANDER. So of this number of people that have filed, if some owe money but have not yet paid, do we still expect them to get a stimulus check? The rule is you have to file a return.

Mr. SHULMAN. Yes, we do. I think until you are delinquent on your taxes and it is clear that you owe us, that once you file you get a stimulus check, unless you are in dispute and it has not been established that you owe us money.

Mr. SERRANO. That is a good question. If someone files an extension and we still don't know at that point if they owe, does that hold up their ability to get a check or does that take them out of the running to get a check?

Mr. SHULMAN. Well, it doesn't take you out of the running. You actually have to file your return to get your stimulus payment. So if you file an extension, the government owes you a stimulus payment once you file your return.

Mr. SERRANO. Your return?

Mr. SHULMAN. Your return.

Mr. SERRANO. This answers another question. So not everybody will get a check at the end of May?

Mr. SHULMAN. What is that? Oh, no, you need to file.

Mr. SERRANO. So some checks will go out throughout the year?

Mr. SHULMAN. Absolutely.

Mr. SERRANO. Okay, that is good to know. There is hope for all of us here. We don't qualify.

IRS TAXPAYER SERVICES FUNDING

The fiscal year '09 budget proposes to increase funding for enforcement by 7.1 percent. But funding for taxpayer services is flat. Why is this, Mr. Commissioner? If services plus enforcement equals

compliance, why shouldn't both categories be increased, especially as the tax-paying population continues to increase? Couldn't the IRS make use of an increase in taxpayer services funding, especially as it continues to implement a taxpayer-assistance blueprint?

Mr. SHULMAN. I know that the people at the IRS have been continuing to work on the taxpayer-assistance blueprint.

Another thing I should point out is modernization funding isn't for widgets and servers and guys with propellers on their heads. It is to support enforcement and services. So part of the modernization funding actually supports services.

I think the most important thing happening in modernization is trying to get real-time information into the hands of the people at the IRS who are helping people on the phone. So when you send in information in a real-time fashion you have to have the right information in their hand.

And so, again, I am still getting my arms around the budget issues. I would say some of the modernization budget really is going to help with services. I think on the enforcement and services I would really need to understand better.

This is a budget I inherited. I support full funding of it because our team has said it would help move the IRS forward. I think some of the very specific issues are trying to target areas where we know there is noncompliance. There is only so much money in the pot, and we needed to adjust it and make resource allocation decisions accordingly. And so my belief, from what I know now, is this budget will move us forward and will allow us to focus on both service and enforcement.

I think there is always room for a very legitimate debate about how much you are putting in one till or the other. My goal is to get the right amount of money for both service and enforcement year in and year out to pursue our dual mission.

Mr. SERRANO. This makes me think about my initial comment about you having something in common with the Immigration Department. Mr. Hinchey can attest to this. There are many people who support border protection; and there are others who feel like we do, that, yes, border protection is important but also make it easier for those people waiting in line to become citizens who have been waiting for years to become citizens, balance it off.

Here is the same thing. We want enforcement, but we also want you to supply tax services so that there is a balance, so it doesn't look only that you are going after a problem but rather helping people figure out the system. And that is where the discussion will always be on what money we are allocating, what you are asking for and what you are putting into it.

EARNED INCOME TAX CREDIT DELAYS

Let's talk a little bit about the Earned Income Tax Credit delays. At previous hearings I have raised the issue of IRS delays in processing many Earned Income Tax Credit refunds. This hurts those hard-working, low-income Americans who legitimately claim a credit. Do you have updated data on, one, the number of legitimate EITC claims that experience delays each year; two, how long, on average, are these delays; and, three, what is the IRS doing to fur-

ther minimize the number of the legitimate EITC claims that experience delays?

Mr. SHULMAN. If you would let me come back to you with the data, I don't have it at my fingertips.

I will tell you I have sat down and talked with our team about the Earned Income Tax Credit. I think everyone at the IRS recognizes it is an incredibly important program for the Federal Government and for the taxpayers it serves. We have an extensive outreach program on the Earned Income Tax Credit.

I think, regarding the delays, my understanding is new procedures were put in place to expedite getting out legitimate Earned Income Taxpayer Credit refunds. Anytime there is a question about it being a questionable claim, we apply due process to quickly resolve issues and avoid delaying legitimate payments.

When I met with the team, it was very clear to me that they were trying to balance fraud prevention and fairly administering a refundable credit, which is susceptible to fraud, with making sure that low-income taxpayers, who often don't have the same resources to wrestle with their government, are getting very quick service.

They are trying to balance both of these issues. I know the people are very dedicated to that, and I will remain dedicated to it. And if you let me come back to you with the numbers, I'd appreciate it.

[The information follows:]

QUESTIONABLE REFUND PROGRAM (QRP), EARNED INCOME TAX CREDIT (EITC)

April 8, 2008—Response to GAO's question about our processes to ensure that legitimate EITC claims are given to the taxpayer expeditiously if selected for QRP.

The IRS makes every effort to ensure legitimate refunds are not unnecessarily delayed. Improvements to the Questionable Refund Program since 2006 include notification to taxpayers when refunds are held and implementation of a systemic release of refunds when the IRS has been unable to verify the refund is false within 70 days.

Criminal Investigation (CI) uses the Electronic Fraud Detection System (EFDS) to identify returns claiming false income and credits, i.e., withholding and Earned Income Tax Credit (EITC), and where appropriate criminally investigates perpetrators who create the schemes. Last year more than 200,000 returns were verified as false with refunds claiming \$1.4 billion.

EFDS screens all refund returns and flags suspicious returns for review. Refunds on approximately 400–500 thousand (includes both EITC and non-EITC returns) of the 100 million refund returns filed (½%) are delayed up to two weeks while CI reviews the returns. CI completes the verification within 14 days on average and remaining refunds (not verified false) are systemically released at 70 days. When income is verified as false, IRS disallows the income and resulting false credits, including EITC.

TAX PREPARERS

Mr. SERRANO. Okay. Let me ask you a related question. Some folks, like the ranking member, prepare their own taxes, but the folks who do the EITC for the most part go to someone, and at times it may be a tax service. That is totally legitimate. It seems that around this time of the year I see, in neighborhoods like the South Bronx, every store front that is empty has a tax place open up. When you look at these alleged claims of abuse and fraud, is there anything within your power, the agency's power, to look at the folks preparing those returns, also?

Mr. SHULMAN. Well, some of the fraud that you see, from what I understand, is people processing lots of returns and sending in false information, et cetera.

Mr. SERRANO. When you say "people," you mean like a tax place?

Mr. SHULMAN. Well, there are two types of preparer issues I am trying to get to. There is the preparer who doesn't sign the return, and the circular—I think it is 230—that oversees activities of certain preparers. So we do have some outreach there. And then there are people who are just preparing returns and claiming to be the taxpayer in order to get refunds, and perpetrating clear fraud that we can easily and obviously reach into.

I think this is one of the discussions I had with the Finance Committee about our ability to enforce the law vis-a-vis preparers, not just taxpayers. I think, given the number of people that avail themselves of preparers, it is clearly an issue we are spending more time on now, seeing what our options are, to make sure the taxpayer and the person they work with are——

Mr. SERRANO. Do you have the ability to enforce law there?

Mr. SHULMAN. We do with accountants, lawyers, enrolled agents, but not with all preparers; and that is the ongoing discussion.

Mr. SERRANO. Because the law doesn't cover all preparers? Is that the reason?

Ms. STIFF. We actually do have a program that allows us to screen preparers for IT concerns.

Mr. SERRANO. But is there a law that allows you to go after these storefront operations, with all due respect to them, that open up in the poorer neighborhoods?

Ms. STIFF. If there is tax fraud, the law does give us the ability; and we do that every year. We actually prosecute several hundreds of these a year.

Mr. SHULMAN. We will come back with the statistics.

Mr. SERRANO. Okay. One of the advantages of having a tax accountant, if you will, is that if I have a problem he's going to go with me. But Mrs. Rivera, who went to a place and she might have been given some information as to what was available to her that actually wasn't available to her, now she's alone because these places don't show up to give her support when she has to go face you folks; and that is something that we have to keep a look on.

Mr. SHULMAN. As you know, I come from——

Mr. SERRANO. Mrs. Rivera is just a name I picked out. It is like Jones. I don't want anybody to go look for Mrs. Rivera.

Mr. SHULMAN. I come from an agency responsible for regulating an industry, the financial industry, so I am pretty familiar with overseeing professionals who deal with ordinary Americans; and so this is something that I am committed to really grappling with.

Mr. SERRANO. I would like us to stay in touch about that. That is an issue that concerns me.

I have no proof of any wrongdoing, in all honesty, but I just see that in every available storefront in my district, somebody opens up a tax preparer office, and people stand outside handing out fliers for customers to come in. The whole thing about the payday loans—there is just something that doesn't feel right to me. It may be that everything is fine, but I would like to stay in touch to see if everything is, in fact, fine.

COORDINATED CASE AUDITS

Let me ask one last question before I turn it over to my colleagues. Audits of larger corporations—now you know that liberals like me have to finally ask this question, right? A new study released by the Transactional Records Access Clearinghouse at Syracuse University and reported in the New York Times shows that the number of coordinated industry case audits, the in-depth audits of the largest corporations, declined from 428 in fiscal year 2002 to 353 in fiscal year 2007. This is despite the fact that coordinated industry case audits uncovered \$24 billion in unpaid taxes in 2007. Why such a sharp decline in coordinated case audits?

Mr. SHULMAN. I looked at the TRAC data and had a chance to discuss this with our large business division. Let me make a couple comments, if I could, about this.

First, I have made it very clear, and said this in the only speech I have given and in statements, that focusing on large corporate taxpayers, making sure that they pay their fair due, is going to be a focus of mine as Commissioner. I really think, for the integrity of our system, that Americans expect large corporations to be good corporate citizens, which means paying the amount of taxes due.

Regarding the TRAC data, I think it is one view and an interesting view for me to see as a new person coming in, but it doesn't paint the full picture of what has happened in the large corporate area. Enforcement revenue is up, which means the IRS has been doing something right in the large corporate area.

Second, and it is a program that I support, the IRS has taken a number of large corporations, like 70 some odd corporations, and moved them to a program called the Compliance Assurance Program, which means they are in with the large corporation before they file their return negotiating all of the taxes due so that when the number goes in there is not going to be an audit and there is not going to be a dispute. And a lot of the CAP data was showing the disputed amount. This brings in money to the FISC, and so that is not reflected in the TRAC data.

Mr. SERRANO. It sounds like a preemptive rehab program.

Mr. SHULMAN. Well, I think it is along the lines that I mentioned to Mr. Schiff. The more we can be clear up front, that is a good way to administer the tax law and be clear with our guidance. And so we are trying to do some innovative things, which I applaud.

Third, there was a conscious decision to shift some of the people who can deal with sophisticated large business audits to tax shelters, promoters of tax shelters, and to get some more coverage in the mid market.

So those are management decisions that are made every day at the IRS. I am not going to tell you that everyone got it right in the past or I am always going to get it right, but trying to get that balance right was important, and those decisions were made.

And then, finally, just around large cases, I would be remiss if I didn't say this. I talked in my opening statement about the fight for talent that we are going to have with the private sector and on having to work on our workforce. In a Sarbanes-Oxley environment, in a pretty heavy regulatory environment, the people working large cases are very attractive to people in the private sector;

and I think we are going to have to stay focused on keeping our best people here. It is not going to be the easiest thing in the world for us to do. And so I think this was one slice. I think we will be focused on large corporations, and we will use a variety of tools to do that.

Mr. SERRANO. Well, that is very encouraging, and I thank you for those comments, and I thank you for that initiative. We will stay in touch on that, but it is encouraging to know that you understand the issues here for what they are and want to do something about them.

Mr. Regula.

Mr. REGULA. I thought about how I went by an auto dealer the other day. They had a sign out: We will do your tax returns. Obviously, what they want to do is do the tax returns so they get the refund and sell you an automobile while they get that refund for you.

Mr. SERRANO. Really?

Mr. REGULA. I assume they have somebody doing it at the dealership. But it is interesting that they are into tax returns.

Mr. SERRANO. Don't ever get your tax returns done by your auto dealer. That is the only advice I can give.

NARCOTICS TRAFFICKING

Mr. REGULA. A couple questions. I notice the oversight board recommended a \$24 million increase to enhance investigations of narcotics trafficking, and I think back that Al Capone was convicted by using the IRS code, rather than for killing people or whatever else he was involved in. Are you doing an adequate job of using the tools that you have on narcotics, in the narcotics area?

Mr. SHULMAN. You know, I am not familiar with the narcotics area. Our Criminal Investigation division works on everything from counterterrorism to anti money laundering to narcotics to pursuing all of the criminal tax violations. I think we are asking for sustained funding for that division. I think that is important.

PROTECTING TAXPAYER DATA

Mr. REGULA. Another area of concern is identity theft. I think with the use of credit cards there's a growing problem with that. Do you feel that the IRS is adequate in its protection of very sensitive information that is contained on tax returns?

Mr. SHULMAN. Um—

Mr. REGULA. And that is, again, a subject I assume is somewhat new to you at this point.

Mr. SHULMAN. Protecting taxpayer data or protecting personal data is new to me at the IRS. We did examinations of brokerage firms in the past, and we had brokerage firm information, sensitive information. So I am familiar with the issues of data protection.

What I would say is the IRS doesn't do it perfectly. There have been some recent reports that have pointed that out. This is hard for everyone to do. I know the IRS has made some progress. It has encrypted all laptops, which is a step forward. It is in the process of centralizing all of its information technology access, which will allow us to have clear protection, and we are reviewing everyone inside the agency who has access control.

So we are basically saying, the presumption is you don't have access to a system until you prove that you need it; and every division is working through that right now.

I also have a strong belief that data protection is as much about a culture as it is about firewalls and encryption and all the sophisticated language that we use.

And something I am proud of, which we are launching right now, is Operation RED. We are taking every single IRS employee, all 100,000 plus, off-line for at least 2 hours so they may have discussions with their managers about what data comes in. What are you doing about it to protect it every day? It's not just about the procedures, because everyone is always getting e-mails about procedures, but to have a real discussion about it and to try to make it top of mind for every employee. They have a sacred trust with the American people and need to protect this data.

My second week I actually filmed a video that every single employee is going to see, with me talking about how seriously I take this issue. I actually think that the IRS has a long tradition, because of taxpayer privacy rights, thinking about this issue, but since technology has changed we just need to be all over this.

So I have every indication to believe when I came in Linda and Richard understood this issue and were focused on it and we are going to keep pushing. It is very hard to do. The private sector and the government are wrestling with these issues, but we are going to do what we can to make sure we are taking very seriously the protection of taxpayer data.

Mr. REGULA. Thank you.

TAXPAYER ADVOCATE SERVICE FUNDING

The taxpayer advocate program has worked in Ohio in my area very effectively on behalf of people that use the service, and I notice there is a proposed reduction of \$7.5 million below the current year. Do you think, in your opinion, the budget request is adequate to do the job on the Taxpayer Advocate Service?

Mr. SHULMAN. Let me say a couple of things. One, I think the Taxpayer Advocate Service is an asset to the IRS and a good thing for the American people. I met twice with the current Taxpayer Advocate and plan to work with her going forward.

I think these budgets are always a balance. The IRS has billions of dollars focused on taxpayer service. We do a lot of taxpayer service. The Taxpayer Advocate does some things. I wasn't there when this budget was put forward, but that balance was trying to be met.

What I do know is over the last 2 years the Taxpayer Advocate Service budget has risen 9 percent. The IRS budget as a whole has risen about 7 percent. So I think it is important that we fund it well. I can't speak to the specifics beyond that.

Mr. REGULA. Well, I can only say my experience in Ohio works very well. It does provide the taxpayers a place to go for help if needed.

Thank you, Mr. Chairman.

Mr. SERRANO. Thank you.

Mr. Hinchey.

Mr. HINCHEY. Thank you very much Mr. Chairman.

Mr. Shulman, thank you very much. It has been an interesting session here; and I very much appreciate the candor and the way in which you are effectively trying to deal with the situation, even though you have only been there a short period of time.

One of the things I want to say, again, in gratitude and appreciation, is the way that the IRS has set up these helping operations, these offices, phone operations, to help people, particularly senior citizens, retired people who are interested in trying to qualify for the help that is coming in as a result of the stimulus package—my understanding is that just in New York alone there were 37 operations set up across the State. I think that was a very good thing to do, and I very much appreciate that being done.

TAXPAYER COMPLAINTS AGAINST PRIVATE COLLECTION AGENCIES

I want to talk a little bit more about the privatization action that is taking place; and I know that this is going to be the major focus of your attention, to make sure that it is working right and to even consider excluding it, as some of us have recommended.

There were, according to my understanding, something in the neighborhood of five dozen taxpayer complaints against private collection agencies, including violations of taxpayer privacy laws. So there is a certain amount of uncertainty or unhappiness about that.

I wonder if, not now but as a result of maybe some of the people who are with you here, they might be able to give us the number of actual complaints that came in as a result of the privacy operations and maybe even the amount of fines imposed, if there were any, on private collection agencies for taxpayer violations and the number of validated penalty cases and the overall number of taxpayer complaints that were filed against the private collection agencies.

[The information follows:]

Of the 108,905 cases placed with the private collection agencies (PCA's) through March 2008, the IRS has received 102 complaints, with 17 of these received from or on behalf of taxpayers and the remainder self-reported by the PCA's. All complaints are investigated by both the IRS and the PCA's, with a validity determination made by a Contract Concerns Review Panel. There have been 5 validated complaints (0.005%). There are three categories of complaints, classified based upon the severity of the incident. Type One validated complaints involve inappropriate PCA employee behavior (rudeness, poor attitude). Type Two complaints involve intimidation, heavy-handed behavior, or similar activity rising above the level of a Type One complaint and bordering on a statutory violation. Type Three complaints involve a violation of statute or applicable law.

There have been two validated Type One complaints which were not serious enough to warrant monetary fines; however, corrective actions were implemented. Three validated Type Three complaints have resulted in monetary fines totaling \$10,000.

Any validated complaint, IRS or contractor, is one too many. We are committed to improving the protection of taxpayer rights throughout all IRS programs.

AUTOMATED COLLECTION SYSTEM FUNDING

Mr. HINCHEY. Also, the Appropriations Act of '08, this appropriations bill requires the IRS to spend \$7,350,000 to increase personnel in the automated collections system. I wonder if—I don't expect it now, but if you could look into that and inform us where the IRS is in implementing that provision and whether or not the managers statement which accompanied the bill urging the IRS to take the \$7.35 million in funding from the private tax collection

program, whether or not that actually occurred. That was in the managers amendment asking that that \$7.35 million, which was put in the appropriations bill to upgrade the automated collection system, if that could be taken out of the private collection system. [The information follows:]

We are on track to spend the \$7.35 million increase for the Automated Collection System (ACS) functions as required by the FY 2008 Consolidated Appropriations Act. We allocated the funding evenly between our Wage and Investment (W&I) and Small Business Self-Employed (SB/SE) functions and will be spent on new hires, overtime and support costs.

In total, this funding equates to 126.5 FTE for ACS operations. We allocated 83.8 FTE to ACS and ACS Support hiring, and 42.7 FTE to overtime. We hired in eleven of the fourteen call sites and three of the four support sites. We started hiring in February 2008 and will complete the remaining hires June 2008. We based the new hire allocation on the sites' capacity levels and ability to recruit and deliver the training. We are using the overtime to provide training support and to work ACS inventory and correspondence.

The following worksheet provides a breakdown by FTE and Dollars.

	FTE new hire	New hire cost	Overtime	Overtime cost	Total FTE	Total dollars
SBSE ACS	37.2	\$2,008,800.00	12	\$873,600.00	49.2	\$2,882,400.00
SBSE ACS Support	9.3	502,200.00	4	291,200.00	13.3	793,400.00
WI ACS	46.5	2,511,000.00	16	1,164,800.00	62.5	3,675,800.00
WI ACS Support	29.8	1,442,863.00	21.4	1,498,000.00	51.2	2,940,863.00
WI ACS Support	7.5	363,137.00	5.3	371,000.00	12.8	734,137.00
WI Subtotal	37.3	1,806,000.00	26.7	1,869,000.00	64.0	3,675,000.00
Grand Total	83.8	4,317,000.00	42.7	3,033,800.00	126.5	7,350,800.00

EXXON MOBIL

Mr. HINCHEY. And just finally, I would be very interested to learn what the tax amount was on the \$40.6 billion that was earned by Exxon Mobil last year. I don't expect the answer now, Mr. Chairman, but if that number could be provided to us at some point soon we would appreciate it.

[The information follows:]

The Congressman is referring to the earnings reported by ExxonMobil for the year ending 12-31-07. Returns for last year won't be filed until September 2008, so the IRS does not have the data requested at this time. In addition, the IRS cannot respond to the request at the present time, since the IRS is prohibited from disclosing taxpayer information requested without proper authorization, pursuant to disclosure rules and privacy laws.

Mr. HINCHEY. Again, I want to thank you very much for doing this job and the confidence that we have in how much better this operation is going to work. Thank you very much.

Mr. SHULMAN. Thank you.

Mr. SERRANO. On a personal note, I bet you that it was a large amount that they paid but probably a lower percentage than Mrs. Rivera paid in my district on her \$25,000, maybe.

One of the dangerous things, Commissioner, to do at a hearing like this is to praise you as much as we have.

Mr. SHULMAN. It feels dangerous.

Mr. SERRANO. But there seems to be a sense in this committee that you are very interested in doing this in a very fair and balanced way. Does that sounds like a news station or something? And we appreciate that, and we hope that that continues. And we also commit ourselves to trying to help you in any way we can to do your job. And so I have a few questions that I will submit for the record.

Mr. REGULA. Same here.

Mr. SERRANO. And so will you and so will you.

And we thank you for your testimony today. We thank you for taking Mr. Hinchey's tax return personally to handle for him, and we stay committed to helping you. And I personally thank you for no Boston Red Sox comments, as my colleagues like to make.

Thank you so much. The hearing is adjourned.

Questions for the Record
Submitted by Chairman José E. Serrano

1. Recent IRS research indicates there is a segment of the taxpaying population that will likely always need face-to-face service. Low-income taxpayers, taxpayers with limited English proficiency, and elderly taxpayers are all more likely than other taxpayers to prefer assistance provided by IRS walk-in sites. Yet current IRS walk-in sites are within thirty minutes drive time of only 60 percent of the U.S. population. Is the IRS open to increasing the total number of walk-in sites to assist more of the taxpayers who need them?

Answer: The IRS agrees that a segment of the taxpayer population such as low-income taxpayers, taxpayers with limited English proficiency, and elderly taxpayers are more likely to prefer the face-to-face service that is offered at Taxpayer Assistance Centers (TAC). The goal is to ensure that TACs are located in the most optimal locations to assist more of the taxpayers who need face-to-face assistance. To meet this goal, in February 2008 the IRS launched the Geographic Coverage Initiative. The initiative's objectives are to develop a geographic footprint that focuses on identifying optimal TAC locations; create a data collection system that includes demographics; maximize both filing season and year-round service delivery; expand assistance options to consider alternative locations, such as volunteer-partner sites or mobile units; and expand tax law topics based on geographic need. A critical component of this analysis includes the utilization of the IRS Office of Program Evaluation and Risk Analysis' Geographic Coverage Rate Model. This model will improve the coverage rate of all segments of the taxpayer population who prefer face-to-face service delivery by determining where best to locate these sites.

2. How much progress is being made in designing a long-term taxpayer services plan, pursuant to the Taxpayer Assistance Blueprint, and is the IRS in agreement with the Taxpayer Advocate and the IRS Oversight Board on how best to shape taxpayer services going forward?

Answer: As required by the joint explanatory statement accompanying the Treasury's FY 2008 Appropriations Act, on May 13, 2008 the IRS delivered its first annual report for the House and Senate Appropriations Committees on progress in implementing the Taxpayer Assistance Blueprint. This report included the perspectives of the Board and the National Taxpayer Advocate.

3. The IRS has been working on the problem of identity theft, most recently by establishing a new office of Privacy, Information Protection, and Data Security. However, the Treasury Inspector General for Tax Administration has noted

recently that the IRS Criminal Investigation Division investigates identity theft crimes only if they are committed in conjunction with other criminal offenses having a large tax effect. Does the IRS plan to have the Criminal Investigation Division take a larger role in investigating identity theft cases?

Answer: The IRS' Criminal Investigation Division (CI) aggressively pursues identity theft crimes in relation to the enforcement of criminal tax violations. The IRS believes this pursuit is important to its ability to send a strong deterrent message and to encourage voluntary compliance. The IRS continues to emphasize the critical nexus between identity theft and the motive of violating the Internal Revenue Code. Generally this nexus is seen most frequently in the investigations of refund crime schemes.

The IRS will continue to strive to maximize the deterrent effect resulting from the prosecution of criminal tax violations and related identity theft conduct wherever possible.

The IRS charges individuals with fraud and identity theft under Title 18 USC 1028 (Fraud and related activity in connection with identification documents, authentication features, and information) when appropriate, usually along with substantive tax and/or money laundering violations. The Department of Justice's (DOJ) Tax Division must approve all Title 18 USC 1028 prosecution recommendations made by the IRS in conjunction with tax administration. The DOJ generally will authorize prosecution of Title 18 USC 1028 only when a conviction will enhance the overall investigation by significantly affecting incarceration. The IRS has been encouraged to include identity theft charges in their prosecution recommendations where appropriate. During 2007, the IRS recommended 58 prosecutions where Title 18 USC 1028 was included as a charge. The 58 prosecution recommendations involved 6830 victims whose identities had been stolen.

To enhance the IRS' fight against identity theft, CI continues to work with the Office of Privacy, Information Protection, and Data Security to develop an action plan to protect taxpayers from identity theft in their transactions with the IRS, including the investigation of criminal conduct and prosecution of those individuals who are violating the law. The IRS continues to maintain a focus on the area of identity theft utilizing all currently available tools. Recognizing that limitations exist, the IRS is also evaluating the opportunity for pursuing potential legislative changes that could enhance its ability to prosecute individuals involved in identity theft crimes consistent with available resources.

IRS CI will continue to partner with other law enforcement agencies (i.e., Federal Bureau of Investigation, Social Security Administration, US Postal Inspection

Service, Immigration Customs Enforcement, Secret Service, etc.) in criminal cases that involve identity theft.

4. How much funding does the IRS expect to derive from user fees in fiscal year 2009? How does the IRS plan to use the funds to supplement the fiscal year 2009 budget? Please provide a breakdown, by appropriations account, of how the IRS plans to apply the user fee collections.

Answer: The IRS projects that it will collect \$170 million in user fees in FY 2009. The IRS plans to spend \$178 million, and it will all be used to fund base activities. This amount includes \$127 million to supplement the Taxpayer Services account and \$51 million to supplement the Operations Support account. The carryover user fee balances from earlier years will allow the IRS to spend slightly higher than the projected FY 2009 receipts.

5. Since the goal of 80% e-filing of tax returns by 2007, as specified in the IRS Reform and Restructuring Act, has not been achieved, how has this impacted the IRS submission processing consolidation strategy? Has it caused delays or changes in IRS submission processing consolidation plans? If future e-filing growth is slower than anticipated, will this impact the future submission processing consolidation plans of the IRS, and if so, how?

Answer: The IRS is committed to continuing analysis to validate the present strategy. Despite the projections being below the goal, ongoing analyses confirm the consolidation plan will provide sufficient capacity to process all projected paper returns efficiently.

The timetable was not solely based on the 80-percent goal; rather, it was based on actual e-file receipts to date, as well as realistic projections over the course of the consolidation timeline. For example, the latest data show that taxpayers e-filed 58 percent of returns in 2007, and are projected to e-file 65 percent in 2009 and 69 percent in 2011, all well below the 80 percent goal. Should the IRS' ongoing analysis alter the assumptions on which the IRS based these decisions, it is prepared to revisit the plans. This was the case in 2005, when data analysis resulted in the addition of Austin to Kansas City and Fresno as final 2012 end-state sites for paper individual returns processing.

When the IRS identified Austin, Kansas City and Fresno as end-state sites, it based the decision on the sites' combined capacity to process the projected 46 million paper returns at end-state in 2012. Kansas City and Fresno are the two largest sites, with the capacity to process 18 million individual returns apiece; Austin would process the remaining balance of 10 million estimated individual paper returns. Current

projections for paper individual returns now show that there will be approximately 42.3 million paper returns filed in 2012. Based on those projections, the IRS does not anticipate either Fresno or Kansas City will need to process more than 16.5 million paper returns in any year between now and end-state, and Austin's capacity can handle the remaining balance. However, the IRS has the ability to add workload to any of the three end sites if paper volumes end up higher than projected.

Since the IRS began implementing the strategy for consolidating submission processing sites in 2002, it has conducted multiple analyses to validate the continued ability to process paper returns and the planned order of consolidations, based on comparative costs using productivity, real estate, and strategic human resource data. The IRS conducts a yearly state mapping exercise to realign workload based on projected return volumes and capacities at the processing sites, computing centers, and lockbox banks. The IRS also examines resource allocation decisions made in the past to determine if the assumptions justifying past decisions still remain true and, if they do not, whether it should alter course.

The IRS strives to optimally allocate resources – the right people, the right funding levels – for all of its taxpayer service and compliance functions; therefore, the IRS is committed to on-going analysis to review those allocations, including the allocations for submission processing, across the IRS.

6. An August 2007 report of the Treasury Inspector General for Tax Administration cited several unanticipated developments at the Fresno, CA submission processing site due to increased return volume, including delays in processing returns and a possible staffing shortfall. The report further notes that the IRS is currently having difficulty hiring a sufficient number of qualified workers at the site and that according to the IRS' own methodology, it will be unable to hire enough staff if it reaches its projected workload in Fresno. Is the agency concerned that further consolidation of submission processing centers might only serve to exacerbate some of the capacity and staffing issues such as those at the Fresno center? Has the agency developed any contingency plans to minimize any negative impact resulting from further submission processing consolidation?

Answer: The IRS believes the August 2007 Treasury Inspector General for Tax Administration (TIGTA) report cited concerns about Fresno's ability to process higher volumes of returns due to potential problems involving United States Postal Service (USPS) support and recruitment at the Fresno Submission Processing (SP) Center.

To resolve any issues or problems that occurred in prior filing seasons with the USPS, the IRS sent correspondence to the Postmaster General and subsequently held meetings with key members of the national USPS staff. The USPS reported they were prepared to handle the future projected increased volumes of returns. As a result, the experience with the USPS in 2007 was very positive, with only two isolated one-day instances of mail delays during the two week peak processing period. The IRS reported this experience in its response to the TIGTA report. The USPS support thus far during 2008 has also been very good. Currently, the IRS does not anticipate future USPS-related problems at any of the submission processing sites, but the IRS will continue to monitor closely the support provided by the USPS and will react in a timely manner to resolve any future issues that might arise.

In 2005, the IRS validated the consolidation strategy and determined it would be more effective to modify the consolidation plan and retain Austin as a third end-state submission processing site. This modification provided for additional capacity and redundancy of operations. When the IRS identified Austin, Kansas City and Fresno as end-state sites, it based the decision on the sites' combined capacity to process the projected 46 million paper returns at end-state in 2012. Kansas City and Fresno are the two largest sites, with the capacity to process 18 million individual returns apiece; Austin would process the remaining balance of 10 million estimated individual paper returns.

When the IRS chose Fresno as an end-state site, one of the factors for selection was the ability to recruit new employees due to the employment rates in the area. The IRS estimated the employment needs in Fresno using a higher number of individual return filings. Based on the updated projections showing there will be only approximately 42.3 million returns filed in 2012, the IRS should be able to recruit and hire a sufficient number of employees to process the anticipated number of paper returns. The IRS does not anticipate either Fresno or Kansas City will need to process more than 16.5 million returns in any year between now and end-state and Austin's capacity can handle the remaining balance. However, the IRS has the ability to add workload to any of the three end sites if paper volumes end up higher than projected.

The IRS has conducted on-going analysis to assure the current end-state footprint of three Submissions Processing sites to process individual returns and two sites (Cincinnati and Ogden) to process business returns will allow the IRS to continue to deliver successful filing seasons. The IRS is committed to continuing analysis to validate the present strategy.

7. How many employees at the two private collection agencies with IRS contracts are currently working on the private debt collection program? How many IRS employees are assigned to oversee and administer the program?

Answer: The private collection agencies (PCA's) currently have more than 250 employees working on their contract with the IRS, including approximately 99 front-line employees and managers directly working on accounts. The IRS currently has 40 FTE's working on the Private Debt Collection (PDC) program which translates to a head count of 54 full- and part-time employees who administer and oversee the program.

8. Section 108 of Division D of the Consolidated Appropriations Act (P.L. 110-161) requires the IRS to spend not less than \$7,350,000 to increase above fiscal year 2007 levels the number of FTE's and related support activities performing Automated Collection System functions. Please provide an update on the implementation of this provision.

Answer: The IRS plans to spend the \$7.35 million increase for the Automated Collection System (ACS) functions as required by the FY 2008 Consolidated Appropriations Act. The IRS allocated the funding between the Wage and Investment (W&I) and Small Business Self-Employed (SB/SE) functions to be spent on new hires, overtime and support costs.

In total, this funding equates to 126.5 FTE for ACS operations — 83.8 FTE for ACS and ACS Support hiring and 42.7 overtime FTE (to provide training support and to work ACS inventory and correspondence). Hiring, which began in February 2008, will be complete by June 2008 in eleven of the fourteen call sites and three of the four support sites. The IRS based the new hire allocation on the sites' capacity levels and ability to recruit and deliver the training.

9. The Transactional Records Access Clearinghouse reports that on March 3, 2008, the IRS filed suit in federal court, seeking a court order to bar the Transactional Records Access Clearinghouse from having access, under the Freedom of Information Act, to audit statistics that it has been receiving from the agency since 1976. Is this true, and if so, why is the IRS seeking this court order?

Answer: Contrary to the Syracuse University Transaction Records Access Clearinghouse's (TRAC) recently released report, the government has not filed a motion to bar TRAC or Ms. Long, the co-Director of TRAC who brought a suit under the Freedom of Information Act (FOIA), from requesting data in the future. However, the Government is seeking a modification of a more than 30-year

old consent order which it entered in 1976, prior to the effective date of I.R.C. § 6103 and before the Electronic FOIA Amendments. The consent order requires IRS to release specific reports that it no longer creates and some of which even Ms. Long could not identify.

The IRS certainly respects the transparency to which the Freedom of Information Act (FOIA) speaks. But the FOIA also balances the important value of transparency against governmental and privacy interests, such as taxpayer privacy. When parties disagree as to how that balance is to be achieved, looking to the courts is an option for resolution. The IRS has asked the court to consider how the agency might provide to Ms. Long the audit statistics and other enforcement-related data she seeks without unduly compromising taxpayer privacy interests. Even while the matter — captioned as *Long v. IRS*, No. C74-724 (W.D. Wash) — is pending before Judge Marsha Pechman, the IRS continues, as it has for the past year, to provide Ms. Long with nine separate monthly reports that cover the examination functions for the operating divisions, as well as Criminal Investigation, Collection, and Customer Service statistical data. In order to satisfy Ms. Long, the IRS has presented an exhaustive list of information it would make available to her, in an effort to have the court enter a new order under which the parties would work on a going-forward basis. The proposed order would establish Ms. Long's right to receive reports currently used by IRS management in an orderly, regular, and predictable fashion, while at the same time protecting taxpayer privacy as I.R.C. § 6103 requires. In addition, the IRS also hopes to establish an orderly mechanism that would be followed if the IRS discontinues these reports and Ms. Long desires access to others.

10. In written testimony, the IRS notes that the fiscal year 2007 level of examinations is three-quarters more than the fiscal year 2001 level. How much of this increase consists of in-person, face-to-face audits, and how much of the increase consists of correspondence audits?

Answer: As noted in the testimony, the IRS substantially increased individual income tax examinations in FY 2007 over the FY 2001 level. In fact, FY 2007 individual examinations increased 89 percent over the 2001 level. Seventeen percent of this increase was accomplished through face-to-face audits and 83 percent through correspondence. The number of correspondence examinations increased over 500,000, or 103 percent, and the number of face-to-face examinations increased over 100,000, or 54 percent. See table below for more detail.

INDIVIDUAL	Examined Returns 2001 ¹	Examined Returns 2007 ²	Increase in Examinations from 2001	Percentage Increase in Examinations by type since 2001
Correspondence	529,241	1,073,224	543,983	103%
In Person/Face to Face	202,515	311,339	108,824	54%
Total	731,756	1,384,563	652,807	89%
¹ Data from 2001 IRS Data Book, Table 10, Page 15				
² Data from 2007 IRS Data Book, Table 9, Page 23				

11. In written testimony, the IRS notes that the audit coverage rate has increased from 0.6 percent in fiscal year 2001 to one percent in fiscal year 2007. How much of the increase consists of in-person, face-to-face audits, and how much of the increase consists of correspondence audits?

Answer: Between 2001 and 2007 the coverage rate increased from 0.58 percent to 1.03 percent (a 78 percent increase). This increase in the coverage rate consists of a 90 percent increase in the coverage rate for correspondence examinations and a 44 percent increase in the coverage rate for face-to-face examinations. See tables below for more detail.

INDIVIDUAL	Examined	2001¹ Returns Filed	Coverage
Correspondence	529,241		0.42%
In Person/Face to Face	202,515		0.16%
Total	731,756	127,097,400	0.58%

INDIVIDUAL	Examined	2007² Returns Filed	Coverage
Correspondence	1,073,224		0.80%
In Person/Face to Face	311,339		0.23%
Total	1,384,563	134,542,879	1.03%

INDIVIDUAL	Percentage Increase in coverage
Correspondence	90%
In Person/Face to Face	44%

¹ Data from 2001 IRS Data Book, Table 10, Page 15

² Data from 2007 IRS Data Book, Table 9, Page 23

12. The IRS Commissioner noted that the IRS is currently auditing one out of every eleven taxpayers with incomes of \$1 million per year or more. What percentage of these audits are in-person, face-to-face audits, and what percentage are correspondence audits?

Answer: For FY 2007, 39 percent of the examinations of taxpayers with incomes of \$1 million or more were audited face-to-face and 61 percent of these examinations were conducted through correspondence examinations. The examination method is determined based upon the return complexity and issues identified. See table below for more detail.

Individual Taxpayer Incomes > 1M	Number of exams	Percentage
Correspondence	19,123	61%
In Person/Face to Face	12,259	39%
Total	31,382	

Data from 2007 IRS Data Book, Table 9, Page 23

Questions for the Record from Mr. Regula

- 1. The IRS has a vast amount of very sensitive taxpayer information. In a January 2008 report, GAO stated that the “IRS is at increased risk of unauthorized disclosure, modification, or destruction of financial and taxpayer information”. In the fiscal year 2008 bill, the Committee funded your requested \$21 million increase for computer security.**

- Is enough being done to address IT security?**

Answer: Data security is a rapidly evolving issue, in both the private and public sectors. Ensuring information technology security and protection of taxpayer information is a high priority at the IRS. Security is an essential ingredient in all work processes and systems. When new systems are designed and developed, the information security requirements will be identified at the start, and tracked and tested with the same rigor as core business requirements. The other key aspect of information system security is constant online monitoring. Maintaining the latest versions of systems and ensuring security patches are implemented timely is critical. A comprehensive monitoring program of all IT assets in the enterprise is essential for success.

The IRS is working constantly to address IT security and it is an area of continued attention. Title III of the E-Government Act, entitled Federal Information Security Management Act (FISMA), requires each federal agency to develop, document, and implement an agency-wide information security program to provide information security for the information systems that support the operations and the assets of the agency. As required by FISMA, the IRS has implemented an agency-wide information technology security program, which includes the following key elements:

- Periodic assessments of risk;
- Policies and procedures based on risk assessments;
- Subordinate plans for providing adequate information security for networks, facilities, information systems, or groups of information systems as appropriate;
- Security awareness training to inform personnel (including contractors) of the information security risks associated with their activities and their responsibilities in complying with IRS policies and procedures designed to reduce these risks;
- Periodic testing and evaluation of the effectiveness of information security policies, procedures, practices and security controls;

- A process for planning, implementing, evaluating, and documenting remedial actions to address any deficiencies in the information security policies, procedures and practices of the IRS;
- Procedures for detecting, reporting and responding to security incidents; and
- Plans and procedures to ensure continuity of operations for information systems that support the operations and assets.

• **Are additional resources needed in this area?**

Answer: The way the IRS transacts business, operates, and conducts core tax administration has changed. These activities now rely on an interdependent network of information technology infrastructures in cyberspace. At the same time, threats from cyberspace have risen dramatically and are growing increasingly more complex, harder to detect and prevent. In order for the IRS to keep abreast of the latest threats from cyberspace, more strategic and tactical investments will have to be made to protect against the debilitating disruption of the operation of the IRS' information systems or breaches of the sensitive personally identifiable information entrusted to us by the American taxpaying public. The current budget request allows us to tackle these cyberthreats in 2009, and we will continue to assess cybersecurity needs in the future.

2. I understand that 75 percent of the tax gap is estimated to be associated with small businesses and the self employed. The budget request includes an increase of \$168 million and 1,608 FTE to improve enforcement in this area.

- **Is it realistic that the IRS can recruit, hire and train this many new staff in one year to do enforcement solely on small businesses and the self employed?**

Answer: The FY 2009 *Reduce the Tax Gap for Small Business/Self-Employed* initiative includes the following FTE:

	FTE	Dollars
SB/SE Field Exam	676	\$73
SB/SE Field Collection	582	\$57
SB/SE Fraud/BSA	33	\$3
SB/SE Campus Compliance	100	\$10
WAGE Campus Compliance	50	\$4
Appeals	67	\$9
Counsel	62	\$8
Taxpayer Advocate	38	\$3
Total Initiative	1,608	\$168

Dollars in Millions

The IRS realizes this growth will be challenging, but is confident these projected hiring levels can be effectively and efficiently absorbed without negatively affecting existing programs. The factors listed below reflect IRS' ability to absorb the growth requested:

1. **Hiring in Waves.** In years where there is significant attrition and initiative hiring, SB/SE plans and executes these hires in separate large hiring waves.
2. **Campus Hiring.** In campus locations, the IRS routinely maintains hiring certification rosters allowing quick identification of new hires
3. **Internal Hiring.** While a significant portion of new hires comes from outside the IRS, the internal portion is not insignificant (28 percent for Revenue Agents/Revenue Officers/Tax Compliance Officer combined hires in FY 2007 were internal) and should be a positive factor in our ability to hire.
4. **Adjust the Workplan.** Workplans are developed to provide program guidance and direction on the utilization of resources and delivery of programs. All phases of new hire training are incorporated into the workplans and build in training cases and support from instructors. Adjustments are made to the workplans as resources and hiring plans change.

In addition, in FY 2006, the last year in which SB/SE received initiative funding, the IRS successfully hired approximately 2,600 front-line enforcement employees (initiative and attrition hires). Based on this experience and current plans, the IRS is confident that the employees associated with these FTE could be successfully recruited, hired and trained in FY 2009.

- **How much non-compliance do you believe is intentional and how much is due to a lack of understanding the tax code?**

Answer: The IRS does not currently know precisely how much noncompliance is the result of intentional acts by taxpayers and how much is the result of honest errors because it is very difficult, even in an intensive audit, to know for certain what motivated a taxpayer's behavior. For example, a taxpayer who intentionally overstated charitable contributions could plausibly claim in an audit he lost the receipts. Conversely, a taxpayer may convincingly state he was unaware of the substantiation requirements for charitable contributions. That said, however, two clues suggest that intentional noncompliance may be greater than innocent mistakes or confusion. First, one would generally expect taxpayers in the aggregate to make innocent or unintentional mistakes that result in underpayments and overpayments of tax in roughly equal amounts and frequencies. However, data from returns randomly selected for audit consistently show that far more tax is understated than is overstated (evidenced both by amounts and frequencies), suggesting that intentional noncompliance is larger than unintentional noncompliance. Second, a large portion

of the tax gap relates to unreported business income by individual taxpayers, particularly understated gross receipts. The IRS tries to distinguish intentional from inadvertent noncompliance so that the Service can provide the right kinds of interventions for each type of taxpayer.

Questions for the Record

IRS Commissioner Douglas Shulman

Congressman Bud Cramer

Question: I understand that the IRS will now begin distributing the 2008 stimulus checks. For some filers, these payments/checks may be coming close to or at the same time as their refunds for their 2007 returns. Were there any efforts made by the IRS to combine the 2007 refund with the 2008 stimulus payment?

Answer: Following the statutory requirements, the IRS did not combine tax year 2007 refunds with the 2008 stimulus payments. The IRS is making stimulus payments subsequent to processing 2007 returns because to compute the allowable payment, the IRS first must process the tax return. In addition, since the stimulus program was put into place after the IRS had completed the complicated and extensive computer programming changes necessary for the 2008 filing season, the IRS needed to ensure that none of the programming necessary for issuing stimulus payments in any way delayed or otherwise affected the ability to process returns accurately and issue refunds.

Question: I understand that the Volunteer Income Tax Assistance (VITA) Program offers free tax help to low- to moderate-income (generally, \$40,000 and below) people who cannot prepare their own tax returns. Unfortunately, I understand that for the FY09 IRS budget request, there is a decrease in the VITA program. What is the reasoning for the VITA decrease?

Answer: The FY 2008 Appropriations Act included funding for a new VITA matching grant demonstration program for tax return preparation assistance, in addition to the core VITA program for which resources are derived from the larger Service appropriation. Congress provided \$8 million to establish this new grant program, and allowed the funds to be expended over two years; therefore, the VITA grant funds provided in FY 2008 are available until September 30, 2009. The 2009 Filing Season is the first available spending opportunity due to the timing of the Appropriation. As a result, the IRS expects to issue these grants for the 2009 filing season. The FY09 budget fully supports the current VITA program, which provides training materials and instructors to train volunteers on federal income tax preparation.

Congressman Maurice Hinchey's Questions for the Record

Question #1

Please provide a 5 year summary from 2002-2006 in tabular form showing taxes paid by the following oil/gas companies: ExxonMobil, BP, Royal Dutch/Shell, ChevronTexaco and ConocoPhillips.

Please specify what the paid taxes represent as a percentage of the companies' gross revenues, gross profits, income before taxes and net income after taxes.

Answer: The IRS cannot submit a response at the present time since the IRS is generally prohibited by 26 USC § 6103 from disclosing return information of identified taxpayers. If the Congressman receives a disclosure waiver under IRC 6103(f)(4) from either the Chief of Staff, Joint Committee on Taxation or the Chairman of the Ways and Means Committee, the IRS could provide a more detailed response with the requested data to the Congressman as an agent under IRC 6103(f)(4).

Question #2

Can you provide an update on the amount of fines imposed on the private collection agencies for taxpayer violations, the number of validated penalty cases and the overall number of taxpayer complaints filed against the private collection agencies to date?

Answer: Of the 108,905 cases placed with the private collection agencies (PCAs) through March 2008, the IRS has received 102 reported concerns, with 17 of these received from or on behalf of taxpayers and the remainder self-reported by the PCAs. All concerns are investigated by both the IRS and the PCAs, with a validity determination made by a Contract Concerns Review Panel. There have been 5 validated complaints, which is equivalent to 0.005 percent of all cases.

There are three categories of complaints, classified based upon the severity of the incident. Type One complaints involve inappropriate PCA employee behavior (rudeness, poor attitude). Type Two complaints involve intimidation, heavy-handed behavior, or similar activity rising above the level of a Type One complaint and bordering on a statutory violation. Type Three complaints involve a violation of statute or applicable law.

There have been two validated Type One complaints, which were not serious enough to warrant monetary fines; however, the IRS has implemented corrective actions. Three validated Type Three complaints have resulted in monetary fines totaling \$10,000. Monetary penalties for validated complaints range from \$2,500 - \$75,000 per incident.

The amount of the penalty is dependent upon the type of complaint validated and the number of occurrences for each complaint type at a PCA.

**Congressman Adam Schiff
Questions for the Record
Financial Services Subcommittee
April 15, 2008
Commissioner Douglas Shulman**

Lack of a Bright Line Standard

The IRS's Political Activities Compliance Initiative (PACI) evaluates speech by 501(c)(3) organizations based on "all the facts and circumstances" of the case. Because IRS privacy regulations do not allow the details of past cases to be released, organizations find themselves guessing at where the line between legitimate advocacy for causes (causes which are inextricably tied to the theology of the church, in the case of All Saints), and political interference which endangers tax exempt status.

For example, IRS regulations include a temporal judgment, in which statements uttered from the pulpit a month before an election may be considered political interference while the exact same statement uttered a year before an election may be entirely permissible.

Some charitable organizations, such as All Saints Church in Pasadena, have publicly contested an IRS investigation and finding of wrongdoing. But by and large, these matters are settled out of the public eye. It seems very likely that many churches and organizations are going to refrain from issue advocacy because of the lack of clarity in the law. I know you agree that "clear guidance" is essential, so I am interested to know your thoughts on this matter.

- o Do you believe that the current "all the facts and circumstances" test establishes a clear line for organizations?

Answer: Section 501(c)(3) of the Code prohibits political intervention by organizations described in that subsection. To qualify for exemption from federal income tax under that provision, the organization may not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office. In making the determination of whether an organization has intervened in a political campaign, the IRS considers all the facts and circumstances, including those that mitigate against a finding that the organization has intervened. While the statutory facts and circumstances test does not lend itself to clear lines, the IRS has issued formal guidance that provides clear lines in many areas of interest or concern to the sector and to the IRS, including through the use of numerous examples to address many of

the most common fact patterns. However, the examples do not and cannot cover all conceivable fact patterns, and for other possible instances the IRS provides specific factors it will consider to assess whether an organization has violated the statutory prohibition.

- **Given that the timing of a statement may be a factor in an IRS ruling of interference, wouldn't it be appropriate to issue clear guidance on when stricter scrutiny of statements begins?**

Answer: As the IRS has in the past, it will continue to talk to the public about additional guidance, including guidance on the outlined factors. Obviously, timing is a key factor. However, the timing of a communication is only one factor in determining whether there is intervention in a political campaign. All the relevant facts and circumstances must be considered. So while timing is important, it is not dispositive. For example, Situation 14 of Rev. Rul. 2007-41 illustrates a situation in which a communication made shortly before an election that identifies a candidate and takes a position on an issue does not constitute intervention in a political campaign. Thus, while the IRS will consider this situation for future guidance, it may be hard to come up with a bright line on timing. To the extent the IRS determination results in the revocation of exempt status, or the denial of an application for exempt status, such determinations are made publicly available under IRC 6110, with deletions to protect the organization's taxpayer privacy rights.

- **Do you think the fact that the Supreme Court invalidated a similarly vague "facts and circumstances" test for the FEC in the Wisconsin Right to Life case suggests that the current IRS standard is constitutionally suspect?**

Answer: The Wisconsin Right to Life decision concerned the application of the Federal Election Campaign Act of 1971, which specifically regulates speech and has a long history of being limited by the courts. With regard to section 501(c)(3), the courts have held that tax exemption is not a right, but a matter of legislative grace for which Congress may impose conditions, and have upheld the restriction on lobbying (see Regan v. Taxation with Representation of Washington) and the prohibition on political campaign intervention (see Branch Ministries, Inc. v. Rossotti).

Investigation of All Saints and Deadlines for Resolving Cases

I understand that the Political Activities Compliance Initiative set certain goals for how rapidly cases are resolved. It is absolutely crucial that investigations come to a quick resolution, otherwise churches and charities will face the

challenge of speaking, not to mention raising funds, with the threat of losing tax exempt status hanging over their heads.

Yet I have here letters from the IRS to All Saints Church. The first was received on June 9th, 2005 notifying them the IRS's "reasonable belief" that a violation had been committed. The second is from September 10th 2007 finally notifying the church that the investigation has been closed, while still maintaining that a violation occurred. It is worth mentioning that the investigation into All Saints was the least serious type of investigation, "Type A" investigation, in which the speech in question was not repeated and no funds were expended in support of any candidate.

- **Is there any firm deadline for when the IRS must complete investigation of a violation and close a case?**

Answer: The enforcement objective of the Political Activities Compliance Initiative (PACI) has been and continues to be to pursue and resolve credible allegations of political campaign intervention as expeditiously as practical. The time to conduct any particular inquiry depends on a number of factors, including the number and complexity of issues and whether the organization is a church.

For organizations other than churches, the statute of limitations imposed by section 6501 of the Tax Code operates as a constraint on the length of examinations. Generally, this limitation requires that any tax for a year be assessed within three years of the date the return for the year was filed, or the due date of the return if it was timely filed. This period may be extended with the consent of the organization.

A case involving a church must be conducted according to the special restrictions and within the specific time limits of section 7611 of the Code. Section 7611 imposes special limitations and certain procedural protections on when and how the IRS may conduct civil tax examinations of churches. Section 7611 provides for a two-stage process when IRS pursues a potential violation by an organization that claims to be a church or a convention or association of churches. The initial stage is the church tax inquiry. It provides the first opportunity for the IRS to present the allegation and for the church to respond. Dialogue at the inquiry stage may permit a speedy resolution of the issues. If the IRS cannot resolve the case at the inquiry stage within 90 days of when it begins the inquiry (unless extended by mutual consent), it must close the case or proceed to the second stage, the notice of church tax examination. The notice of examination, which cannot be sent earlier than 15 days after the notice of church tax inquiry, must contain certain provisions, including the offer of a conference with IRS officials to discuss the concerns. The IRS cannot begin an examination sooner than 15 days after the notice of examination and the holding of the conference, if the

organization requests it. Section 7611 provides that a church tax examination must be completed within two years of the date of the examination notice, although the running of this period may be suspended due to judicial proceedings, failure of the organization to comply with reasonable requests for records, or other information or by mutual agreement of the IRS and the organization.

- **If not, do you agree that it is appropriate to institute one? Do you agree that an investigation stretching on longer than two years, through an entire election cycle, is likely to chill free expression?**

Answer: As noted, in the case of churches, section 7611 gives the IRS strict timelines. It is difficult to project how fast the IRS can close an examination, recognizing the need to balance the importance of resolving cases as quickly as possible with timeliness and the organization's need to respond fully. Moreover, the actual length of any given examination will vary, determined not only by the actions of the IRS, but also by those of the organization.

The Need for Additional Guidance for Charitable Organizations

In June 2007, the IRS released Ruling 2007-41, providing guidance and examples for 501(c)(3) organizations on permissible and impermissible political activities. The ruling was welcome, in that it represented the first guidance in more than 20 years. The ruling also makes explicit that "501(c)(3) organizations may take positions on public policy issues, including issues that divide candidates in an election for public office."

However, the examples provided in the IRS ruling do not address the complicated situations that arise for many charities and churches when attempting to abide by the rules on political speech. While useful, the reality in many cases is that the determination is likely to be much more subjective and determined by a variety of factors. I am very concerned that vague guidance and little or no case history will have a chilling effect on tax exempt organizations exercising constitutionally protected free speech rights.

- **Do you feel that the current guidance available to tax exempt charitable organizations on political speech is sufficient?**

Answer: Revenue Ruling 2007-41 discusses facts and circumstances to be considered in this area and illustrates the application of the political campaign prohibition with 21 examples. While these 21 examples do not address every situation, the revenue ruling does provide meaningful guidance on the factors to be analyzed, including in the area of "political speech." For example, there are factors

surrounding whether a communication is issue advocacy, political campaign intervention, or both. The revenue ruling notes that key relevant factors include the following:

- Whether the statement identifies one or more candidates for a given public office;
- Whether the statement expresses approval or disapproval for one or more candidates' positions and/or actions;
- Whether the statement is delivered close in time to the election;
- Whether the statement makes reference to voting or an election;
- Whether the issue addressed in the communication has been raised as an issue distinguishing candidates for a given office;
- Whether the communication is part of an ongoing series of communications by the organization on the same issue that are made independent of the timing of any election; and
- Whether the timing of the communication and identification of the candidate are related to a non-electoral event such as a scheduled vote on specific legislation by an officeholder who also happens to be a candidate for public office.

The IRS also recognizes the value of providing more guidance in this area, and is committed to working with the charitable community to identify areas for additional guidance. To the extent an IRS determination results in the revocation of exempt status, or the denial of an application for exempt status, such determinations are made publicly available under IRC 6110, with deletions to protect the organization's taxpayer privacy rights.

- **Will you be providing a more detailed treatment of what 501(c)(3) organizations may do and say without violating IRS regulations?**

Answer: While more can and will be done, the IRS has been and remains committed to improving its efforts in communicating the rules relating to the statutory prohibition on campaign intervention and educating the public. As noted, the IRS came out with a detailed revenue ruling in the area last year. As previously indicated, more detailed guidance will be considered as the sector comes forward with suggestions.

Below is a timeline of previous educational activities. Since 2004, in addition to numerous speeches on political campaign intervention, the IRS has made presentations concerning political campaign intervention at its Small and Mid-Size Exempt Organization Workshops and at the IRS Tax Forums. Additionally, the IRS has provided the following:

- April 2004 – IRS issues News Release IR-2004-59, reminding charities that they may not intervene in a political campaign;
- June 2004 – IRS issues News Release IR-2004-79, concerning letter sent to national political parties concerning the section 501(c)(3) political campaign prohibition;
- June 2004 – IRS sends letter to national political parties;
- July 2004 – IRS sends email to religious groups providing information about political campaign prohibition, including Publication 1828;
- November 2004 – IRS issues Fact Sheet 2004-14 describing the Political Activity Compliance Initiative (PACI);
- February 2005 – TIGTA issues its report on the IRS PACI program which the IRS makes available on its website;
- February 2006 – IRS issues News Release IR-2006-36 concerning the PACI program;
- February 2006 – IRS releases report on the PACI program;
- February 2006 – IRS issues Fact Sheet 2006-17 using 21 examples to illustrate the application of the political campaign prohibition;
- February 2006 – IRS provides article concerning political campaign intervention for IRS Congressional Newsletter;
- March 2006 – IRS provides Tax Talk Today session on the web concerning political campaign intervention;
- April 2006 – IRS provides article for FEC newsletter, the Record;
- June 2006 – IRS issues News Release IR-2006-87, reminding charities that they may not intervene in a political campaign;
- September 2006 – IRS provides Phone Forum on political campaign intervention;
- January 2007 – StayExempt.org released – including segment on political campaign intervention;
- June 2007 – IRS releases report on PACI program;
- June 2007 – IRS releases Rev. Rul. 2007-41, providing precedential guidance using 21 examples to illustrate the application of the political campaign prohibition;
- November 2007 – IRS issues News Release IR-2007-190, reminding charities that they may not intervene in a political campaign;
- March 2008 – IRS provides article for FEC newsletter, the Record; and
- April 2008 – IRS sends letter to national political parties.

Most recently, on April 17, 2008, the IRS issued News Release IR-2008-61 stating that it was continuing the PACI program for the 2008 election cycle, accompanied by a program letter to Exempt Organization employees. The program letter explains the PACI objectives for 2008 and emphasizes the IRS' priority both to educate the public

and tax-exempt community about the law pertaining to political campaign intervention and to maintain a meaningful enforcement presence in this area. The program letter indicates that the IRS intends to issue a report on the PACI program by March 31, 2009 that will include (i) recommendations arising from this year's election cycle for the future direction of the PACI program, (ii) an assessment of the effectiveness of the limited statutory tools available to address instances of political intervention, and (iii) an identification of troubling trends, as well as seeking the assistance of the charitable community to identify areas requiring additional guidance.

The IRS makes all of this information available to the public on the IRS website.

- o **If so, when? If not, why do you not feel it is necessary?**

Answer: As indicated, last year in advance of this campaign cycle, the IRS released detailed guidance on the political campaign prohibition that includes 21 examples. The IRS developed Revenue Ruling 2007-41 over a period of years, beginning with the release of the draft publication for churches (ultimately released as Publication 1828, Tax Guide for Churches and Religious Organization) and continuing with the release of Fact Sheet FS-2006-17. As noted in the April 17, 2008 news release, the IRS will continue its efforts to educate the public and the relevant community, and provide guidance, on the section 501(c)(3) prohibition on political campaign intervention and will seek the assistance of the charitable community to identify areas requiring additional guidance.

WEDNESDAY, APRIL 16, 2008.

SECURITIES AND EXCHANGE COMMISSION

WITNESS

CHRISTOPHER COX, CHAIRMAN

CHAIRMAN SERRANO'S OPENING STATEMENT

Mr. SERRANO. Good morning. The subcommittee will come to order.

But before I do, Mr. Regula, I would like to ask you a question in public because you have been a chairman much longer than I have.

When the Pope calls a meeting of Cardinals, am I supposed to show up?

Mr. REGULA. Absolutely.

Mr. SERRANO. Just checking.

Mr. REGULA. Let him know ahead of time, so he can deal with the problem.

Mr. SERRANO. Get used to me, right?

I welcome you to this hearing on the Financial Services and General Government Subcommittee. Today the subcommittee will hear from the Chairman of the Securities and Exchange Commission, the Honorable Christopher Cox. Always nice to see a former colleague with us.

Chairman Cox, welcome to the hearing. We are pleased to have this opportunity to discuss the fiscal year 2009 budget with you.

The SEC is responsible for promoting investor protection and education as well as for overseeing the integrity of capital markets. These responsibilities are essential so that businesses have access to capital so they can grow, add jobs and contribute to the Nation's economic strength.

The Commission's budget request for fiscal year 2009 is \$913 million, which is \$7 million above the enacted fiscal year 2008 spending authority level. Part of this funding will be provided through \$42 million of prior year balances, resulting in an appropriated level of \$871 million. This modest funding increase is allocated toward the 2009 Federal pay raise as well as promotions and merit pay increases.

However, this funding increase will not be enough to pay for all of the agency's salary needs at its authorized personnel level. To meet its salary requirements, the Commission is proposing to decrease its authorized number of full-time employees down to its actual fiscal year 2007 levels.

This troubles me, as recent market trends have raised legitimate questions about the overall integrity of the market. It seems that a reduction in workforce at the SEC would send a signal that the government is not committed to the important goals of improving

market structure and transparency. We want to be sure that you have enough people to accomplish your mission, and I will be interested in your comments on the staffing at the Commission.

The SEC has been in the news a lot recently resulting from the Treasury plan for regulatory reform. This plan would dramatically change the structure of the SEC by merging it with the Commodity Futures Trading Commission. The subcommittee looks forward to hearing the Commission's response to this plan.

And we welcome you today it, and we will remind you that your statement will be fully put in the record. You have said this yourself so many times, and we ask you to keep your verbal comments to 5 minutes so that we can drill you and grill you and put you through all kinds of terrible things.

But a man who has never put anyone through anything terrible is Mr. Regula, our ranking member.

MR. REGULA'S OPENING STATEMENT

Mr. REGULA. Thank you, Mr. Chairman.

And as you know, Chairman Cox, recent events have put you in the eye of the storm. And people are having some misgivings as to whether there is adequate regulation in the market to protect the average investor. Bear Stearns of course is a classic where you go to \$172 a share—thousand a share down to \$2, ultimately \$10.

But I am sure you are challenged always to strike a somewhat delicate balance between regulating and letting the market work in a free way, which historically we have done. So I will be interested in your insights as to how we address that problem. I know that you have a somewhat limited budget number.

And how do we go about restoring confidence? We went through this with Enron, Global Crossing, Arthur Andersen; the result was a doubling of your budget.

As people understood it, the fragility of these institutions and now the temptation is to say, okay, we will just double the budget, and somehow this solves subprime and all the other problems go with it. So I am very interested in your comments. I think the chairman did a good job of summarizing the challenges that confront the Subcommittee.

Mr. SERRANO. Thank you. You are on.

CHAIRMAN COX'S TESTIMONY

Mr. COX. Thank you very much, Chairman Serrano.

Ranking Member Regula, Representative Kilpatrick, members of the subcommittee who are not here but represented undoubtedly by staff. I want to thank you for the opportunity to testify today about the President's 2009 budget request for the SEC.

To answer directly your question, in return for the SEC's not quite \$1 billion budget, the taxpaying public is getting significant value. The SEC oversees the nearly \$44 trillion in securities trading every year on America's public equity markets; the disclosures of almost 13,000 public companies; the activities about 11,000 investment advisors; nearly 1,000 fund complexes and 5,700 broker dealers. And the Commission is active on a number of other fronts:

working to protect investors, promote capital formation and foster healthy markets.

The SEC is pursuing wrongdoers in all corners of the securities markets while applying enforcement resources to the areas of greatest risk for investors. The Enforcement Division's subprime working group is aggressively investigating possible fraud market manipulation and breaches of fiduciary duty. The SEC is also investigating insider trading; wrongdoing in the municipal bond market, Internet and microcap; fraud and scams against seniors.

In our most recent year, we brought the highest number of corporate penalty cases and the second highest number of all enforcement cases in the agency's 74-year history. In the current fiscal year, the Commission has already broken the record for the largest penalty ever assessed against an individual defendant when the former CEO of United Health paid over \$600 million to settle charges related to options backdating.

Through our Office of Compliance, Inspections and Examination, the SEC is aggressively using a risk-based approach to our program of regular examination of securities firms. Those examinations are focused on the firms' controls over valuations; their controls to prevent insider trading; the procedures they have in place to protect seniors in our markets; and the adequacy of the firms' compliance programs to prevent violations of the securities laws.

The SEC is also working closely with our fellow regulators to promote the fairness and stability of the markets. Under a recently concluded Memorandum of Understanding with the CFTC, we have established a formal cooperative process to better regulate today's increasingly interconnected markets.

The SEC has immediately acted to implement the new authority from Congress in the Credit Rating Agency Act. Under this new authority, the Commission is conducting inspections of rating agencies to evaluate whether they are adhering to their published methodologies for determining ratings and managing conflicts at interest. Very soon this year, the Commission will formally consider new rules to regulate credit rating agencies that build on the lessons learned from the subprime market turmoil.

To anticipate future problems, we are more than doubling the size of the SEC's Office of Risk Assessment. It will help staff throughout the Commission look around corners and over the horizon to identify potentially dangerous practices before they impact large numbers of investors and the economy as a whole.

The failure of Bear Stearns has brought to the fore the regulatory gap in the supervision of investment banks. Although Federal law provides for the supervision of commercial banks, no such scheme exists for the largest investment banks. The Commission created the Consolidated Supervised Entities program to fill this gap. Without this voluntary program, there would have been no consolidated information available to regulators, including the New York Fed, when Bear Stearns precipitously lost liquidity in mid-March. While the CSC program is at present voluntary and receives no dedicated funding from Congress, we understand that Congress may be acting to fill this gap.

The Commission has also taken additional steps to safeguard investors and protect the integrity of the markets in short selling

transactions, by proposing a rule that would specify that abusive naked short selling is a fraud.

Since the SEC first received authority under the Sarbanes-Oxley Act to use Fair Funds, we have returned a total of more than \$3.7 billion to wronged investors. We expect to distribute another \$1 billion in the next 6 months alone.

The SEC is also building on its growing success in returning funds to harmed investors by creating the Office of Collections and Distributions to professionalize this task. We are also using a new computer tracking system, called Phoenix, to speed up the return of funds to investors and a new agency-wide enforcement database called The Hub.

The SEC's efforts in the international arena have by necessity been a key focus of my chairmanship. The world's regulatory and enforcement authorities are finding that we have to collaborate if we hope to protect our own investors. Accordingly, the SEC is working closely with our international counterparts to monitor the markets and pursue fraudsters wherever they may run. We are also exploring the idea of mutual recognition among a very few high-standards countries with robust regulatory and enforcement regimes.

In recognition of the interconnectedness of global markets, the SEC will continue to expand our own expertise in IFRS and explore additional ways that U.S. investors might benefit from increased comparability using a high-quality international standard.

After years of experience through the SEC's voluntary interactive data pilot program, the Commission will consider a rule in 2008 that requires the use of interactive data to give investors the ability to easily find and compare key data about the companies and the funds in which they invest.

There are other investor-friendly improvements in store for mutual fund disclosure. In the coming months, the SEC will consider authorizing mutual funds to issue a summary prospectus that will present key facts about the fund up front with more detailed information available for investors on the Internet or in paper on request. These improvements build on the resounding success of our comprehensive enhancements to the disclosure of executive compensation, which took effect last year.

Mr. Chairman, these are only some of the highlights of what the SEC has recently been focused on and what we have planned for the coming year. The agency's mandate is as broad as it is important to America's investors and to our markets.

The budget request for fiscal year 2009 will allow the SEC to continue to aggressively pursue each of these ongoing initiatives on behalf of investors as well as to address new risk areas as they emerge. The request will allow the SEC to fully maintain our current program of strong enforcement; of risk-based examinations and inspections; our disclosure review program for America's public companies and mutual funds; and our extensive rulemaking agenda across a wide array of regulatory topics.

I want to thank you for this opportunity to discuss the SEC's appropriation for fiscal year 2009, and, on behalf of the over 3,600 men and women at the SEC, I want to thank you and this sub-

committee for the support that you have so well provided over so many years for these vital efforts.

I look forward to continuing to work with you. And I would be happy to answer your questions.

[The information follows:]



**TESTIMONY
OF**

**CHRISTOPHER COX, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION**

**CONCERNING
FISCAL YEAR 2009 APPROPRIATIONS REQUEST**

**BEFORE THE SUBCOMMITTEE ON FINANCIAL SERVICES
AND GENERAL GOVERNMENT**

COMMITTEE ON APPROPRIATIONS

U.S. HOUSE OF REPRESENTATIVES

APRIL 16, 2008

**U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549**

Fiscal Year 2009 Appropriations Request

Testimony
Before the Subcommittee on Financial Services and General Government
Committee on Appropriations
U.S. House of Representatives

April 16, 2008

By
Christopher Cox
Chairman
U.S. Securities and Exchange Commission

Chairman Serrano, Ranking Member Regula, and Members of the Subcommittee:

Thank you for the opportunity to testify today about the President's fiscal year 2009 budget request for the Securities and Exchange Commission.

As you know, until this year the Congress had not increased the SEC's budget for three years. If the President's budget request for another increase this year is approved, then after years of flat budgets, the SEC will have received a roughly four percent increase over two years. After taking inflation and pay increases into account, this budget for FY 2009 would permit the SEC to keep staffing on par with levels in FY 2007—at about 3,470 full-time equivalents.

In return for the SEC's not-quite-\$1 billion budget, the tax-paying public gets significant value. The SEC oversees the nearly \$44 trillion in securities trading annually on U.S. equity markets; the disclosures of almost 13,000 public companies; and the activities of about 11,000 investment advisers, nearly 1,000 fund complexes, and 5,700 broker-dealers. By way of illustration, let me outline some of what the agency achieved during FY 2007.

Review of Fiscal Year 2007

For the SEC's Enforcement Division, which polices the markets and helps keep investors' money safe, FY 2007 was truly a notable year. The Division's results are impressive both in number of cases filed — the second highest in Commission history — and in their substance, covering a range of topics of critical importance to investors.

Among many highlights, the Division halted multiple scams targeting the retirement savings of senior citizens, bringing 30 enforcement actions involving fraud against seniors. The Commission brought one of the most significant insider trading cases in 20 years. We filed options backdating cases against executives at companies in a range of industries, to stamp out that notorious abuse. Even non-investors benefited from the Commission's efforts: our anti-spam initiative was credited with a 30-percent reduction in the volume of stock market spam

emails in an independent industry review. In all, the SEC forced wrongdoers to give up more than \$1 billion in illegal profits and pay more than \$500 million in financial penalties.

The SEC's examination program seeks to identify compliance issues at brokerage firms and investment advisers and ensure that problems are corrected before they could harm investors. In FY 2007, SEC examiners in our Office of Compliance, Inspections and Examinations conducted more than 2,400 examinations of investment advisers and investment companies, broker-dealers, transfer agents, and self-regulatory organizations. Overall, 75 percent of investment adviser and investment company examinations and almost 82 percent of broker-dealer examinations revealed some type of deficiency or control weakness. Importantly, most examinations resulted in improvements in the firms' compliance programs. Where appropriate, inspection results were referred for enforcement action.

In FY 2007, we also initiated a new program for broker-dealer chief compliance officers that seeks to help them improve their compliance programs, called the *CCOutreach BD* program. This program has been a great success, involving hundreds of participants.

On the regulatory front, the Commission reformed the implementation of Section 404 of the Sarbanes-Oxley Act, to fulfill the congressional intent that the law's objectives be achieved without waste and inefficiency. These reforms included Commission approval of a new auditing standard to ensure that 404 audits are conducted in a more cost-effective way, and that they focus on areas that truly matter to investors. The Commission also adopted Section 404 guidance for management, who previously had to rely on the rules intended for auditors. Currently, the staff is undertaking a study to determine whether as a result of these reforms Section 404 is in fact being implemented in a manner that is efficient and that will be cost-effective for smaller reporting companies. The study will be completed before small companies are required to have their first audit under Section 404. In addition, during 2007 the Commission approved a series of reforms to help smaller companies gain faster and easier access to the financial markets when they need it.

One of the most significant disclosure initiatives in the Commission's history was our new comprehensive disclosure regime for executive compensation, which took effect in 2007. The complete and readily accessible information about executive pay that this initiative has opened up to investors has provided a valuable new insight into corporate governance in the nation's public companies.

Also in 2007, the SEC broke an eight-year logjam by publishing final rules to implement the Gramm-Leach-Bliley Act's bank-broker provisions. This will benefit investors who utilize banks as well as brokers to help achieve their financial objectives. And we approved the merger of the NYSE and NASD's regulatory arms, with the goal of creating a single set of rules and eliminating the regulatory gaps between markets that often made enforcement difficult.

The Commission also significantly intensified its contacts with its counterparts across the globe. As Chairman, I executed agreements with the College of Euronext Regulators, the German Federal Financial Supervisory Authority, and the UK's Financial Services Authority and Financial Reporting Council, all aimed towards enhancing information-sharing on enforcement

and supervisory matters. The SEC also moved to help our markets better integrate with the rest of the world by authorizing foreign firms to use IFRS as published by the International Accounting Standards Board in preparing their disclosures in the U.S. market, thereby facilitating capital formation in the United States capital markets.

Administratively, we undertook major reforms to improve the effectiveness of the SEC's operations. In 2007, the SEC significantly augmented its investor education and advocacy functions. To reinvigorate the agency's emphasis on the needs of retail investors, we created the Office of Policy and Investor Outreach which will assess the views of individual investors and help inform the agency's policymaking. A new Office of Investor Education will promote financial literacy and help investors gain the tools they need to make informed investment decisions.

In 2007, the SEC took major steps to foster the widespread use of interactive data in corporate disclosures. Interactive data will empower investors to easily obtain and compare information about their investments in ways that previously only financial pros could.

Overall in FY 2007, the SEC had one of the most productive years in its history, aggressively pursuing wrongdoing and tackling fundamental reforms in the securities markets, all on behalf of America's investors.

Fiscal Year 2008 to Date

Already in FY 2008, the Commission has been active on a number of fronts working to protect investors, promote capital formation, and foster healthy markets. And our agenda in the coming months is no less ambitious.

Oversight of the Markets

The failure of Bear Stearns has brought to the fore the regulatory gap in the supervision of investment banks. Although federal law provides for supervision of commercial banking by bank regulatory agencies, no such scheme exists for the largest investment banks. Because the law fails to provide for supervision of even the largest globally active firms on a consolidated basis, the Commission created the Consolidated Supervised Entities (CSE) program to fill this gap. Without this voluntary program there would not have been any consolidated information available to regulators, including the Federal Reserve Bank of New York, when Bear Stearns precipitously lost liquidity in mid-March 2008. This program, which is necessary to monitor for, and act quickly in response to, any financial or operational weaknesses that might place regulated entities or the broader financial system at risk, is providing the basis for significant new collaboration with the Federal Reserve. While the CSE program is at present voluntary, and receives no dedicated funding from Congress, we understand that Congress may be acting to fill this gap. This will help us to better integrate the information we receive under this program with the broader systemic risk objectives of the Federal Reserve.

Building on the new statutory authority from Congress that became effective in June 2007, the SEC has launched a new program to oversee credit rating agencies. This is also a

vitaly important topic in light of recent market events. Under this new authority, the Commission is conducting inspections of rating agencies to evaluate whether they are adhering to their published methodologies for determining ratings and managing conflicts of interest. Given the recent problems in the subprime market, the SEC has been particularly interested in whether the rating agencies' involvement in bringing mortgage-backed securities to market impaired their ability to be impartial in their ratings. We will shortly propose additional rules building on the lessons learned from the subprime market turmoil. These proposals may include, among other things, requiring better disclosure of past ratings, so as to facilitate competitive comparisons of rating accuracy; enhancing investor understanding of the differences in ratings among different types of securities; regulating and limiting conflicts of interest; reducing reliance on ratings per se, as opposed to the underlying criteria that ratings are thought to represent; and disclosing the role of third-party due diligence in assigning ratings. This will continue to be an area of emphasis for the Commission in the coming fiscal year.

Through our Office of Compliance, Inspections and Examinations, the SEC is continuing to follow a risk-based approach to overseeing securities firms, including registered advisers, investment companies, broker-dealers, transfer agents, clearing agencies, securities markets, and self-regulatory organizations. Among other examination areas of focus are controls over valuations, controls to prevent insider trading, protections provided to seniors in our markets, and the adequacy of firms' compliance programs to prevent, detect and correct violations of the securities laws.

The SEC is also working closely with our fellow regulators to promote the fairness and stability of the markets. Under a recently concluded Memorandum of Understanding with the Commodity Futures Trading Commission, we have established a durable process to better address the regulatory issues that in today's increasingly interconnected markets don't respect regulatory boundaries drawn up decades ago.

To anticipate future problems, I announced in February 2008 a program to more than double the size of the SEC's Office of Risk Assessment, created under the leadership of my predecessor, Chairman Bill Donaldson. With additional staff experts and the right surveillance tools, the newly expanded Office will help staff throughout the Commission look around the corners and over the horizon to identify potentially dangerous practices before they impact large numbers of investors and the economy as a whole.

Enforcement

The SEC is continuing to pursue wrongdoers in all corners of the securities markets, while also applying enforcement resources to the areas that pose the greatest risks to investors.

The Enforcement Division's subprime working group is aggressively investigating possible fraud, market manipulation, and breaches of fiduciary duty. Among the issues we are looking at is whether financial firms made proper disclosures about their holdings and their valuations, whether insiders used non-public information to gain from the recent market volatility, and whether naked short sellers illegally manipulated the market.

The Enforcement Division is also investigating insider trading among large institutional traders; wrongdoing in the municipal bond market; Internet and microcap fraud; and scams against seniors.

The SEC is also building upon its growing success in returning funds to harmed investors. Since the agency first received authority under the Sarbanes-Oxley Act of 2002 to use Fair Funds to compensate victims, we have returned a total of more than \$3.7 billion to wronged investors. We expect to distribute another \$1 billion in the next six months alone. To further professionalize the agency's execution in this area, I have created the Office of Collections and Distributions, which is led by a Director who reports to the Executive Director and the Chairman. As part of this initiative, the agency has deployed a new computer tracking system, called Phoenix, which with additional enhancements this year will help to speed the return of investors' money and maintain appropriate internal controls.

Another major productivity enhancement in the Enforcement Division is "The Hub," an agency-wide database that gives all enforcement staff access to the entire inventory of investigations. By giving line staff a window into this deep knowledge base, and permitting senior management to direct the resources of the national enforcement program quickly and effectively when necessary, The Hub is significantly increasing the effectiveness of our enforcement dollars. Additional features being rolled out in the coming months will help Division staff more readily access performance information, coordinate more effectively with the Office of Compliance, Inspections and Examinations, and better manage their investigative documents throughout the enforcement lifecycle.

International Enforcement and Regulatory Issues

The SEC's efforts in the international arena, which have markedly increased in recent years, have by necessity been a key focus of my Chairmanship. The time is long past when the SEC, or any financial regulator, can feel safe that by scrutinizing just the activities within its national borders, it can comprehend all the potential dangers ahead. In a world where capital flows freely across borders, problems or issues in one corner of the globe rarely stay there. The world's regulatory and enforcement authorities are finding that we have to collaborate if we hope to protect our own investors. Accordingly, the SEC is working closely with our international counterparts to monitor the markets and pursue fraudsters wherever they may run. We are also exploring the idea of mutual recognition among a very few high-standards countries with robust regulatory and enforcement regimes.

In recognition of the interconnectedness of global markets, the SEC will continue to expand our own expertise in IFRS, and explore additional ways that U.S. investors might benefit from increased comparability using a high-quality international standard. The continued integration of our own domestic accounting standards and IFRS will enhance the quality of both, while improving the reliability, clarity, and comparability of financial disclosure for American investors.

Disclosure

The SEC is committed to making public company disclosure more useful to investors. Under the leadership of the Office of Interactive Disclosure, the SEC is building upon our recent successes in constructing a foundation for the widespread use of interactive data. After years of experience through the SEC's voluntary pilot program, the Commission will consider a rule in 2008 that requires the use of interactive data by reporting companies, as well as other proposals to expand interactive data reporting by mutual funds and other market participants. These efforts will be aimed at giving investors the ability to easily find and compare key data about the companies and funds in which they invest.

There are other investor-friendly improvements in store for mutual fund disclosure. Too many investors today throw away their mutual fund disclosures instead of reading them. Too often, the prospectuses are laden with legalese that makes them nearly impenetrable for the average person. In the coming months, the SEC will consider authorizing mutual funds to issue a summary prospectus that will be more user-friendly for investors. If adopted, the summary document would succinctly present key facts about the fund up front, with more detailed information available for investors on the Internet or in paper upon request. The agency also is preparing help for investors at the time they buy a mutual fund to learn about fees, expenses, and conflicts of interest.

Another important initiative relates to the \$2.5 trillion worth of municipal securities currently outstanding, about two-thirds of which is owned either directly or indirectly by retail investors. Despite its size and importance, this market has many fewer protections for investors than exist in the corporate market. For example, investors often find it difficult even to get their hands on the disclosure documents for the municipal securities they own. To address this shortcoming, the Commission is working to authorize the creation of an online computer database, a so-called muni-EDGAR, which would give investors in municipal securities electronic access to disclosures filed in connection with their investments. I have also urged our authorizing committees in the House and in the Senate to update the SEC's authority in this area.

Investor Protection

The Commission has very recently taken additional steps to safeguard investors and protect the integrity of the markets during short selling transactions by proposing a rule that would specify that abusive "naked" short selling is a fraud. In a naked short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period for trades. As a result, the seller fails to deliver stock to the buyer when delivery is due. This is known as a "failure to deliver." Sellers sometimes intentionally fail to deliver securities to the buyer as part of a scheme to manipulate the price of a security, or possibly to avoid borrowing costs associated with short sales. This is just the latest sign of the Commission's continuing focus on abuses in this area.

The Commission is also working to protect Americans' pension fund investments. In March 2008, the Commission issued a special report reminding public pension funds of their responsibilities under the federal securities laws, and warning them that they assume a greater

risk of running afoul of anti-fraud and other provisions if they do not have adequate compliance policies and procedures in place to prevent wrongdoing in their money management functions.

To protect investor privacy and to help prevent and address security breaches at the financial institutions the SEC regulates, the Commission proposed new rules that provide more detailed standards for information security programs. The proposed rules provide more specific requirements for safeguarding information and responding to information security breaches. The Commission also extended these privacy protections to other entities registered with the Commission.

The Commission has also proposed an expedited process to speed up the availability to the investing public of exchange-traded funds (ETFs). ETFs are similar to traditional mutual funds, but issue shares that trade throughout the day on securities exchanges. The proposed rules would eliminate a barrier to entry for new participants in this fast-growing market, while preserving investor protections. The Commission also proposed enhanced disclosure for ETF investors who purchase shares in the secondary markets.

Mr. Chairman, these are only some of the highlights of what the agency has recently been focused on, and what we have planned for the coming year. The SEC's mandate is as broad as it is important to America's investors and our markets. On behalf of the agency, let me thank you for the support that you and this Committee have so well provided for these vital efforts.

Conclusion

The budget request for fiscal year 2009 will allow the SEC to continue to aggressively pursue each of these ongoing initiatives on behalf of investors, as well as to address new risk areas as they emerge. As I mentioned, the request will allow the SEC to fully maintain our current program of strong enforcement, examinations and inspections, disclosure review, and regulation.

The request also will cover merit raises for SEC staff, as the agency transitions to a new performance evaluation system. This new five-level rating system has been developed in conjunction with the National Treasury Employees' Union to provide more individualized feedback to staff, based on clear performance criteria. The system has been piloted in our Office of Human Resources, and will next be extended to the agency's senior managers. The rest of the agency's employees are scheduled to transition into the program next year.

I want to thank you for this opportunity to discuss the SEC's appropriation for fiscal year 2009. I look forward to working with you to meet the needs of our nation's investors, and I would be happy to answer any questions you may have.

TREASURY REGULATORY REFORM PLAN

Mr. SERRANO. Thank you so much for your testimony.

As we all know, Chairman Cox, last month the Treasury Department issued its plan to dramatically overhaul the entire financial regulatory structure. One of the key proposals highlighted in this plan is the merging of the SEC and the Commodity Futures Trading Commission, CFTC.

Chairman Cox, was the Commission consulted during the development of this plan? Has your agency developed an official response in favor or against the Treasury plan?

Mr. COX. The Treasury plan was the Treasury plan. It was not a product of the President's Working Group on Financial Markets, of which the SEC is a member. It was, rather, the effort of the Department, and I think the Secretary personally, to set out a vision for how things might be different in the future and to challenge the status quo. I think, in part to achieve that objective, it was deliberately not a consultative process. It was not a committee process. The SEC was certainly aware that this was going on. And we have discussed in other fora the possibility of better integrating the balkanized financial regulatory structure in the United States. But, to directly answer your question, this was a Treasury product, and the SEC was not part of its preparation.

With respect to the specifics of a CFTC-SEC combination, it has been advanced by people over a number of years. For example, former Chairman Arthur Levitt wrote an op-ed in *The Wall Street Journal*, I believe it was last year, urging this combination. Since the Treasury report, he has said that there is a right way and a wrong way in his view to do this and that it matters greatly how it is done. But I would simply observe, as a former Member here, that there are serious jurisdictional challenges for Congress in what is obviously a legislative and not an executive initiative. If that merger were to occur, it would have to be done by legislation.

From an authorizing standpoint, jurisdiction over the SEC rests with the Financial Services Committee in the House. Jurisdiction over the CFTC has existed with the Agriculture Committee for many years through many administrations. That jurisdictional divide has presented a significant barrier to consideration of legislation of that kind.

Mr. SERRANO. So you feel that it has to be a congressional decision?

Mr. COX. Indeed, I would say that about the entirety of the Treasury proposal. There is one item in the entire blueprint that is susceptible of being accomplished by executive action, and that is an initiative of the President's Working Group. That can be done by executive order. Everything else is entirely a legislative proposal.

Mr. SERRANO. All right. It is interesting, just for the information of the members of the committee—Mr. Regula knows this already—but the only difference between the Senate Financial Services Appropriations subcommittee and our subcommittee is that the commodities in our jurisdiction exists in the Agriculture Subcommittee of Appropriations. Whereas Mr. Durbin's committee, Senator Durbin's committee in the Senate includes it already. That is the main

difference. So it has an effect on this subcommittee. But certainly that is not what we should base the decision on.

So unless I didn't hear right, you didn't tell me you are supporting the merger.

Mr. COX. Well, I think—

Mr. SERRANO. Or has it reached that point yet? It has been presented by Treasury.

Mr. COX. Well, I think, first, the merger of the CFTC and the SEC is something that is far beyond the capacity of the Chairman of the SEC or the SEC as an agency or the executive branch in its entirety to accomplish. It is solely up to the Congress to do that. So, I mean, I suppose I can tell you that I think it would be very wise for the Congress to take a look at how better to integrate our financial services regulation. But beyond that, unless the Congress wants to initiate this, it is not possible for me, as Chairman, to undertake it.

I will tell you that I have recently executed a Memorandum of Understanding with the CFTC that takes the landscape as it presently exists and makes it work. It puts a little grease in the gears so that, while they do their job under their statutes, their rules and their approach, and we do ours under ours, it makes sense. But as you know, options and derivatives can compete head to head.

Mr. SERRANO. Right. But just one last comment on this. If it reaches a point where it is before Congress and you are asked about this, what would be your answer?

Mr. COX. It would be entirely dependent on the how. But I would be at a very broad level supportive of closer integration, not just of regulations and derivatives and options, but commercial and investment banking across the board. We have in this Nation a lot of different regulators for things in the marketplace that become very much intertwined.

FTE ISSUES AT THE SEC

Mr. SERRANO. Chairman Cox, since fiscal year 2008, the SEC has had some form of performance-based pay system. The goal of these performance-based systems is to stimulate retention and recruitment so that the highly qualified workers at the SEC and the best and brightest college graduates that the Commission recruits are not as enticed by the greener pastures of the private sector.

In recent years, however, the SEC has not fully budgeted for the increases needed to adequately pay the salary increases that were earned by their employees. In fact, the SEC has seen an uptick in attrition during this time period. This year's budget request only includes a 2 percent increase over what was approved in 2008. It is very unlikely that this level will provide the Commission's employees the pay increase they deserve.

So my question is, at a time when we need a strong workforce at the SEC to maintain and improve the integrity of the securities markets, why is the agency putting itself in the difficult situation of risking the loss of its best employees in order to save a few dollars?

Mr. COX. Mr. Chairman, for the coming year, the budget that we are submitting assumes that the SEC will offer merit raises and COLAs equal to an average of about 4.5 percent. And that puts us

at parity with other financial regulators against whom we compete in the Federal Government.

We also offer a competitive compensation package across the board. We offer some things that others don't. We provide health and vision and dental benefits, the latter two which the SEC pays for in its entirety, that others do not. We just opened a Cadillac of a child care center, which I am very proud of. It has been one of my initiatives as Chairman. That really contributes to the quality of life for employees with families at the SEC. And we have currently been rated one of the top places to work in the Federal Government, number three in the last year.

So I think that we are doing everything necessary to make sure that the SEC continues to set the pace for being the best place to work in the Federal Government.

Mr. SERRANO. Well, obviously, we respect your comments and your knowledge on the issue. But I have to tell you that on this side of where we are sitting today, there seems to be a sense that maybe not enough is being done to protect your workforce and to retain the folks you have now and to make sure you can recruit the people you need. And again, as we get into this situation that we are already in to a certain extent, you will be looked at, the Commission will be looked at, to provide assistance and commentary in how we deal with this crisis. I was going to say looming crisis, but the crisis may be here already. So please understand that it is not our intent to banter you about the issue, but there is a sense on this side of the table that we are running the risk of losing good people and not getting the opportunity to bring some bright folks into the Commission.

Mr. COX. Well, that is why you have me here to ask me questions and share the data. I will just start by observing that we are, in terms of turnover, at 25 percent lower rates of turnover than were common during the 1990s. Turnover is now, you know, historically low. And from 2006 to 2007, the most recent year, it went down. So I think we are in very, very good shape. Experientially, in terms of whom one can attract to work at the SEC, the quality of people that come to our agency and that dedicate their lives and their careers to it is just absolutely striking and extraordinary. So we have absolutely the best people at the SEC that the country can offer. And you know, this is sometimes not the case in the Federal Government where you have to compete against the private sector. But, not only do we go toe to toe with the private sector, but when people do leave the SEC, they are recruited to the very top ranks of the private sector and not because of their contacts with government but because of their skill and experience.

Mr. SERRANO. Thank you.

Mr. Regula.

Mr. REGULA. Thank you, Mr. Chairman.

And I do note that you have been rated very high as a desirable place to work. And I think you have some unique authority on matters of benefits and wages as compared to other government agencies, which has enabled the SEC to attract top-rate employees.

SUBPRIME MORTGAGES

Question, what was the role, if any, of the SEC in the recent meltdown of the subprime activities which caused bank stocks to take a real hit? And it certainly has, to some extent, eroded investor confidence. Was there an SEC role? If so, what was it?

Mr. COX. Most certainly. We are not the frontline regulators for lenders, of course. And that is where the problem started, with a deterioration in underwriting standards for loans, which you are all too familiar with from your work.

Mr. REGULA. But that started at the root. The cause was a collateralization of these subprime mortgages were made into financial instruments.

Mr. COX. Yes, the securitization of those loans then had that problem bleed into the securities markets. The rating of the packages by the rating agencies was a contributor to this problem. Congress wisely, with uncommon foresight—usually we find that we are passing remedial legislation after the fact when it is too late—just completed work on the Credit Rating Agency Act and gave the SEC the authority to go in and regulate. So we don't need to write new legislation. We have brand-new legislation. We worked very, very fast so that, at the first opportunity, we put rules in place and then started inspecting these rating agencies. We have been in with the credit rating agencies examining them for some months now. That will inform our rule writing this year. So that is a piece of it that the SEC did not have but now does, and we are using that authority very, very aggressively.

With respect to the large investment banks, as I mentioned, our Consolidated Supervised Entities program was being put together when I first came to the Commission. It is a voluntary program. It doesn't exist in law. I believe it should. But thank God that that program existed because then, when the Fed needed to go into Bear Stearns and look at what was going on, there was a history of at least a few years of Bear Stearns having to compute at the consolidated level for the whole entity, not just the regulated broker-dealer subsidiary that we have authority over, their Basel capital ratios and so on.

SEC AND FEDERAL RESERVE AUTHORITIES

Mr. REGULA. Does the Fed and SEC have corollary authority? Or do they each have a niche in this regulatory structure?

Mr. COX. Well, the Fed is traditionally a bank regulator.

Mr. REGULA. Right.

Mr. COX. And post-Gramm-Leach-Bliley, we have a regulatory gap. We don't have in law a program of consolidated supervision for investment banks, and we need one.

Mr. REGULA. You will in the future?

Mr. COX. That is up to the Congress. We have a program, just to be very clear, at the SEC, the Consolidated Supervised Entities program, that we created as it were out of thin air. It is built on the slender reed of an exemption from the net capital rule. The reason that I think there was largely take-up among the major investment banks in this voluntary program is that, if the United States did not offer something like this, Europe was going to. Probably

what the firms would have done, although we won't know for sure, in that circumstance is that they would have perhaps ring-fenced their operations in Europe—separately set up European operations and consolidated supervision by the European regulators, and then we would have had no consolidated supervision whatsoever of the consolidated entity.

So I think it is vitally important that there be consolidated supervision of the large investment banks, and it is something that, post-Bear Stearns, has gotten your attention in Congress.

BEAR STEARNS COLLAPSE

Mr. REGULA. Are we gaining understanding as a result of Bear Stearns, which was the most visible evidence of this, as to preventing these things from happening in the future?

Mr. COX. No. There is no question that an important lesson was learned in the Bear Stearns debacle. And that is that short-term secured funding can be a significant risk factor.

SOVEREIGN WEALTH FUNDS

Mr. REGULA. A couple of other things. What is the role of sovereign wealth funds as investors in the U.S. financial markets, and they are more and more in our marketplace? Is this a cause for concern? And will it affect governance and corporate governance in the United States?

Mr. COX. Sovereign wealth funds and other large private investors that are generally lacking in transparency challenge our regulatory system in a number of ways. As a matter of national policy, the Treasury just made it very clear that the United States welcomes this type of investment. Our markets are open to all forms of foreign investment.

At the same time, at the Securities and Exchange Commission, our approach is to treat sovereign wealth funds the same way in which we would treat any large nonpublic investor. We have challenges that are somewhat unique in the case of sovereign wealth funds, however, such as the fact that, whereas normally we would ask for enforcement cooperation from the sovereign, if the investor that we might have an enforcement concern with and the sovereign from whom we have asked for enforcement assistance are one and the same, you can see the conflict of interest.

U.S. FINANCIAL MARKETS CHALLENGES

Mr. REGULA. What do you see as the biggest challenges facing U.S. financial markets? And how do you see the SEC adapting to build future investor confidence.

Mr. COX. Well, the SEC comes at that question from the investor standpoint. It probably matters where you get on the circle. They are all related answers. But if one tackles that question from the investor standpoint, then the rest of your question is extremely relevant. It is all about market confidence. People, not just in this country but around the world, put their money where they think it is going to be safe, first, and, second, where it can earn a fair or perhaps an impressive return. They want to make sure that they have the rule of law, predictability, sound and orderly mar-

kets and so on. That is the part that the SEC provides. So it is vitally important, as our markets become increasingly interconnected, that the United States play to its strengths, that we align ourselves with other high-standard countries and that we not join in a race to the bottom because that is not America's comparative advantage, and we would lose that race.

PENSION FUNDS

Mr. REGULA. Well, obviously a great chunk of pension funds are invested in the market, and therefore, the individuals who are depending on the financial security of their pension funds ultimately tracks back to SEC, I think, in ensuring that these funds are invested in what would be a stable market. Is this a concern? And is this something that is part of SEC's mission, to give the John Q. Public a sense of security that his pension fund is going to be there when he needs it?

Mr. COX. Orderly markets are at the center of the SEC's mission.

ORDERLY MARKETS

Mr. REGULA. The SEC was created in the absence of orderly markets, wasn't it, back in the 1930s?

Mr. COX. Yes.

Mr. REGULA. I think Franklin Roosevelt said we have to do something about this.

Mr. COX. In fact, our three missions are investor protection, orderly markets and capital formation. Those three are highly complementary.

MARKET SECURITY AND STABILITY

Mr. REGULA. Well, I have a lot of questions for the record, but is the present environment conducive to capital investment and a sense of security? Because moneys have to flow from many different sources to build our industrial and our business structure.

Mr. COX. Well, I think it is a testament to the strength of the U.S. market and the resiliency of our economy that, despite all of the shocks that we have been through, including record high oil prices and other commodities prices, tax increases on the horizon and subprime crises and so on, equity values, although there is a great deal of volatility in the market, are remaining fairly constant.

Mr. REGULA. Well, I see the Dow Jones keeps kind of fluctuating where they are trying to decide whether the market is stable.

Mr. COX. Well, that is right. There is a good deal of volatility now. And, of course, the market is off significantly this year. So while we are stable, I think, from a standpoint of investors, the best investor protection is a rising market.

Mr. REGULA. A lot of 401(k)s riding on that.

Thank you, Mr. Chairman.

I will have some questions for the record.

Mr. SERRANO. Thank you.

I was going to ask the Chairman if the Yankees were still a better investment than the Red Sox. But I don't want him to break my heart on national television. So I won't ask.

Ms. Kilpatrick.

SEC'S RELATIONSHIP WITH OTHER REGULATORS

Ms. KILPATRICK. Thank you, Mr. Chairman.

Good to see you again, Chairman Cox.

Interesting discussion, and you are very calm in light of what I see as a very unstable financial market. Probably in the world because we do contribute to much of that, everyone looks at the U.S. in terms of the world market and how we are doing, which is why I see much of the instability that we are witnessing today. I have a couple of questions, and I love the ranking member's dialogue as he was taking us through it because one of the things, when he talked about Bear Stearns originally, early March, and JP Morgan buying them out, \$30 billion by the Fed, and then it ended up at the end of March at \$2 a share. I think they settled at \$10 and that JP would take \$1 billion of that loss, and the Fed would take \$29 billion, give or take something, still the \$30 billion.

It is amazing to me, and I am a retired investor in much of that system, so I watch it regularly. Thought I could retire early, and I will have to work 5 or 10 more years, as it goes, as it is spiraling. I am concerned that we have helped Bear Stearns. I believe that—I used to be a high school teacher many years ago—and taught how stable it was and how it kept the rest of the country strong. Today I am not so sure. And with some of the other financial institutions having the problems that they are having and then going to the market and having China and India and Singapore and others buy them or save them—save them would be better—I am concerned about what that means for our children and my grandchildren as well as our economy as a whole. And as the SEC looks at it, and you talked about the regulatory gap, and I honestly believe there is one, I am not sure what it ought to be and how we can bring it together to make it more sound and perfect and healthy for our nation as well as for our investors. And I hope you will come to that.

You also talked about a race to the bottom, which I don't want to put in the universe right now because we are not there; we are not going to be there, and we are going to stay up high. I believe that because we are the strong country that we are.

But with foreign investment buying up much of our, not only real estate and housing, you also mentioned short-term secured funding, which is what a lot of Bear Stearns and other banks rely on, mortgages in this instance. What do we see? Give us a picture. I want to hear from you. You are the professional on this. And as we go back and talk to our institutions as well as our constituents, they really want to know. And I know you don't have a crystal ball. You can't really predict this. But as it goes now and as we have been seeing all of this year and really at the end of last year, what can the SEC do in partnership with the Fed? And what is that relationship between the Fed and the SEC? Separate of course, both in Treasury. How do you work together? How do you save America's financial institutions and investors at the same time? By doing what?

Mr. COX. Well, increasingly, as commercial banking and investment banking, and as securities products and derivatives products all start to become of interest to investors from an economic stand-

point and compete against one another to be substitutable, regulators that decades ago used to have very well-defined, if you will, stovepipe functions are now forced into one another's arms. And I should add that this isn't just true in the United States. It is also true overseas. Almost everyone here today, if you have any kind of a mutual fund or a retirement plan of any kind, probably is invested in foreign equities and foreign securities as well as domestic ones in that way, and you might have chosen to do that even directly on your own.

The fact that there is so much cross-border trading now has forced the United States and regulatory counterparts overseas also into one another's arms. We have to work together and collaborate as never before. What will provide the confidence that every single individual investor needs to put their money in the market is a sense that in this country and abroad—it is increasingly necessary abroad—there is a rule of law and there is a certainty and a predictability to the rules that they can rely upon. We will never erase the risk that is inherent in what we call a security because the prices will go up and down. That is part of the arrangement. But we can take away the risk, or at least we can minimize it, that the system itself is somehow not on the level. And we want people to be very, very highly confident that the system is set up to protect them.

And that also extends, I should add, to disclosure. The SEC administers a rather elaborate system of disclosure to put information out there so people can make up their own minds. That is really important for the market to work. Information is really the oil that greases the wheels in the market.

Increasingly over the last many decades, I think that disclosure has been junked up with a lot of people writing, as it were, an insurance contract for themselves to cover their own assets but not with a view to inform investors and making the information accessible to them. So a lot of our initiatives at the SEC are aimed at making that big investment that public companies make in disclosure more useful for individual investors and for the marketplace.

BUDGETARY AND LEGISLATIVE NEEDS

Ms. KILPATRICK. So does the SEC have what it needs to do what you just described? Or are you recommending or will you recommend that Congress take further action? It is a global market. It has been heading that way for the last couple decades. We seem to be spiraling down; others spiraling up. Do you have what you need in terms of law and policy, administrative rule that will keep us strong?

Mr. COX. The budget that we are proposing this year for the SEC will be the largest in the agency's history, and it will be the second year of rising budgets after 3 years of flat budgets.

Ms. KILPATRICK. Sometimes it is not budgetary, because you get most of your operating money from fees. So if we are just giving you under a million, you will handle the \$44 trillion in securities. Do you have enough wherewithal, legislative power as well as other things, with the world market changing, should we be doing something different than we did in 1930 or 1940? Is the market now—

because it is different and you are the professional here, we need some help.

That click there, one last question, sir, may I?

Mr. COX. Just to be clear, I want to say that our budget is entirely appropriated. We do not get to use the fees that we collect. So the budget that I am submitting to you, the just under \$1 billion budget.

Ms. KILPATRICK. \$913 million.

Mr. COX. That is the real number.

Ms. KILPATRICK. All right. So you didn't understand my question then. Is SEC as strong as it possibly can be in terms of the global economy and the world that we live in?

Mr. COX. The SEC is exceptionally strong. We are doing the job I think better than ever before. There is nearly unlimited opportunity for us to do more. The markets are vast. But, given that we are making choices and we operate in a world of finite resources, by asking for the largest budget that the SEC has ever had, I think we are putting ourselves in a position to do the job well.

Ms. KILPATRICK. Thank you.

Mr. SERRANO. Thank you.

Mr. Bonner.

IMPACT OF SARBANES-OXLEY ON SMALL BUSINESS

Mr. BONNER. Thank you, Mr. Chairman.

Chairman Cox, welcome. I must confess that I was telling my 10-year-old son, who lives in Alabama, that I was coming to this hearing today, this morning when I was wishing him well as he went off to school. And he said, "Well, who is coming before the committee?" And I said, "Well, the Chairman of the SEC." And while this is a baseball, and Yankees predominantly, committee, in Alabama, he was thinking I was talking about the commissioner of the Southeastern Conference. So he will be disappointed that I don't have that opportunity.

Mr. COX. You won't be surprised to know the same thing has happened to me.

Mr. BONNER. We all recognize the need for the reforms that came about as a result of Sarbanes-Oxley. But there are many small- and medium-sized public companies that have been hit with unnecessary and expensive regulatory requirements as a result of that legislation. What steps could the Commission take to address some of these problems? And how quickly do you think that it could be done?

And also, if it were to require legislation, would you be willing to submit that or work with Congress to help enact such legislation?

Mr. COX. When I first came to the Commission 3 years ago, compliance with Sarbanes-Oxley, section 404, was a major irritant across, in particular, the smaller public company regulated community, but really across the markets as a whole. And there was great concern, not only in this country but also abroad.

I have met extensively with Members of Congress to formulate a plan of attack to solve that problem. And, with a great deal of support in the House and in the Senate, we overhauled completely the audit standard that the Public Company Accounting Oversight

Board was using for 404 compliance. We also introduced the first ever management guidance so that the companies in their own assessments would not have to rely on the very elaborate, extensive and complicated guidance that had been given for auditors. That new guidance and the new audit standard are now in place. So this will be the first year that we will see whether or not the 404 process is efficient as we expect it to be.

When Congress wrote that provision of Sarbanes-Oxley, as I well recall because I was a Member of the House-Senate conference committee, no one expected that it would be a poster child for waste and inefficiency. Everyone wanted to get the benefits of strong internal controls for the benefit of investors. So that is the object.

We want to get the benefits that were intended by Congress but not all of the waste. And to make sure that smaller public companies don't have to be a guinea pig as we try out what we would expect to be the vastly different, more efficient approach, we have postponed for another year their compliance with the audit portion of section 404(b). And the SEC has undertaken a very formal study of the costs this year, in the first year of the new procedure. That will then inform our determination of how to proceed at the end of this year.

CURRENT MARKET STATUS

Mr. BONNER. Thank you. To follow up on the line of questioning the vice chairwoman and the ranking member had for you, I noted in your biography that when you served in President Reagan's administration, one of the things that you advised the President on was the 1987 stock market crash. And since there is so much concern about consumer confidence is not strong and there is a lot of concern about the economy, I know you are not the Chairman of the Federal Reserve or the Secretary of the Treasury, but from the position you sit on and with your historical perspective and knowledge, fundamentally is the market strong, weak, sound? How would you describe it?

Mr. COX. Well, long ago, it was appropriately noted that the market will fluctuate. In these days, it is fluctuating. I think that is going to continue. The question of the market's strength ultimately is and should be connected to the Nation's economic strength. I think our market should be and generally is a good reflection of that at any moment because I strongly believe in the overall sustenance of the American economy. I think it is a good bet for the long term to invest.

What the SEC is responsible for, however, is not the prevailing price level in the market but rather the rules of the road so that the price discovery works. And we are doubling, as you might imagine, our efforts on the enforcement side, on the regulatory side. I mentioned credit rating agencies here, and there are other important initiatives relating to these current topics, so that everyone can take away confidence that the rules of the road are sound and security will be enforced.

FTE REDUCTION

Mr. BONNER. And the chairman and the vice chairwoman both focused on whether you have the staff and the tools that you needed to do the work. And I noted that the SEC budget more than doubled since fiscal year 2001. But what considerations led to your decision to request a less than 1 percent increase, eliminating 97 positions? And what positions would be eliminated? And how were those chosen?

Mr. COX. Well, first, you need to understand that we are talking about FTEs, full-time equivalents. In real life, what happens is that we don't have FTEs working for us. We have real people. And so as always there is a difference between the authorized level, the number of slots and actual people that you have working. There is normal turnover. People, some of them sometimes die. Sometimes they leave and go on to other things. New people join and so on.

What we are talking about doing in real life is actually slightly increasing the number of human beings that work at the SEC compared to last year.

Mr. BONNER. Thank you, Mr. Chairman.

Mr. SERRANO. Thank you.

Mr. Cramer.

TREASURY REGULATORY REFORM PLAN

Mr. CRAMER. Thank you, Mr. Chairman.

Welcome back, Chairman Cox. We are glad to see you here. We have enormous respect for your role there at the SEC.

I want to make reference to, Secretary Paulson a few weeks ago announced the biggest overhaul of the financial regulations since the Depression, and there has been reaction and commentary. I am referring right now to an AP story that looked or reacted to that plan, that proposal. And it seemed to be evaluating whether the power and authority of the SEC could diminish as a result of that plan. So I would be curious, I know Kathy Casey is one of your Commissioners for whom I have a lot of respect, and I have known her since she was at the Senate Banking Committee, seemed to be carefully defensive or clear to say that your regulations would not be affected and that investors would be protected under this planned plan and that your regulatory approach is really not different from the principles-based philosophy recommended in Paulson's proposal. So, for the benefit of investors, particularly small investors, I would like for you to give us some insight as to your reaction of that plan, your participation in that plan, and if in fact the SEC's role could be diminished.

Mr. COX. Let me pick up where I left off. We had a brief discussion in my colloquy with the Chairman on this topic. As I mentioned, the Treasury proposal is a Treasury proposal. It is meant I think to stimulate discussion and thought. And it has as its major premise the notion that there is a balkanization of regulation of financial services in the United States today. I agree with that major premise. I think we can do a much better job. And in this respect, I may be wearing my U.S. Government hat or my former Congressman hat as much as my SEC hat.

But if you are looking government-wide, there is a better job that we can do at coordinating the regulation of the financial services and products that today are much more integrated than when we first came up with these legislative schemes. One of the things that we do at the SEC is try to stretch the Investment Company Act of 1940 to cover today's mutual funds and their competition with ETFs. None of this was really imagined when the law was written, and it gets increasingly harder with every passing year.

But with respect to the particulars, it is important to recognize not only that this is a Treasury proposal, not an SEC proposal or Fed proposal or anything collaborative in that sense, but also that it is 100 percent a legislative proposal. So whether you go with the three-pot approach in that blueprint or twin peaks approach that others have adopted or the unified approach that some have recommended, there is an awful lot there for the Congress to chew on. And it would be entirely your choice how to do it.

Then you get into some of the fine print, the detail, such as, do we want to be more principles-based or rules based? And that discussion to me has always reminded me of the old beer commercial, "Tastes great. Less filling." How one comes down on the question of whether you want to be more principles-based or more rules-based is something of a Rorschach test. In a principles-based system, or at least a system that wishes to be called that, such as the U.K.'s system, they actually have a big rule book that sits behind their principles. We, on the other hand, have a lot of detailed rules that everyone is aware of, but we also have some pretty broad principles that we like to put into effect. We start out with very sturdy notions of investor protection and orderly markets and the promotion of capital formation that I hope that ultimately our rules always build towards.

So I don't know that calling yourself one or the other is going to help resolve what ultimately would be very difficult questions of implementation. There are different marginal rules that apply for derivative products on the one hand and options on the other. At some point, whether you call it principles-based or rules-based, somebody in Congress, if you were going to merge those things, will have to say, here's how it is going to be done. Those are tough questions. And apart from the jurisdictional divide that I mentioned earlier, if some day there is a conference committee hammering those things out, you are going to need the future Kathy Caseys of the world to sort this out.

Mr. CRAMER. Thank you. I think that is part of my point. This is a little overwhelming, and it is extremely important that we get this right, especially in the context of the problems of today. So I appreciate that comment and further information.

Thank you, Mr. Chairman.

Mr. SERRANO. Thank you.

Señor Kirk, por favor.

Mr. KIRK. Mi jefe supremo.

Mr. SERRANO. Comandante.

CREDIT RATING AGENCIES

Mr. KIRK. Mr. Chairman, I want to thank you for all you have done on Sarbanes-Oxley 404 for the small companies. I know we

are in a new delay for small companies, and my hope is maybe we just permanently extend that to relieve what was a huge unintended burden on the most dynamic part of our economy.

I want to turn to another topic raised in your testimony. With the Credit Rating Agency Reform Act, we eventually gave you the power to look at these agencies. You started operation in June of 2007. Just 4 months later, the price of non-agency asset-backed securities plunged. Assets declined. Investors lost confidence. We then entered into a decline in the U.S. market and a severe liquidity crisis. And did you do that?

Mr. COX. Well, I want to congratulate, once again, Congress. I don't know that Congress had a crystal ball, but it is always better to legislate authority ahead of time rather than after the fact. The statute got enacted towards the end of 2006. We put our rules out lickety split. You know, under the Administrative Procedure Act, there has to be notice and comment and so on and so forth. So, by June 26, 2007, we had the opportunity then to go out and start our program.

Mr. KIRK. It is a bad timeline that you got there.

Mr. COX. Well, I wish that it had been a year earlier. That would have made a big difference.

Mr. KIRK. Absolutely.

Mr. COX. But the good news is that we are going to be able to put sturdy rules in place this year based on what we learned without having to come to you and ask for legislation.

Mr. KIRK. So here is the appropriations question I have though. The Consolidated Supervised Entities program, which is voluntary, and we don't have a dedicated funding stream by the Congress, let me ask you the direct question, would you support this committee providing that dedicated stream so that we have—

Mr. COX. Yes.

Mr. KIRK. Which is the correct answer I think for us. And secondly, you know the legislation limited the operations of your staff and operations so that we can't rewrite credit and agency reports. We can just expose them. But I am wondering, do we have a long-term problem with market concentration of credit rating agencies? Because if there is too much power in just three firms, then an arrogance and concentration and market ability to have customers with no other place to go means that this committee would have to appropriate an enormous amount of resources.

On the other hand, if there were not three powerhouses but say seven or eight, a credit rating agency that poorly advised its clients would quickly lose—well, officially but really we are talking three. And I am thinking of it like a Justice Department antitrust lawyer would look at it. You just look at the HHI index and see, do we have real market power here? Obviously, that is a similar problem with the big four and a half accounting firms. What do you think of that? With a dedicated stream, do we also need to look at market power of the agencies themselves?

Mr. COX. Yes, and I think that that is one of the two main purposes of the Credit Rating Agency Reform Act. It went after conflicts of interest, and it went after the problem of competition or the lack of it. So what we have been able to do with new standards for NRSRO rules that are in place under the new law is to start

and grant registrations for new competitors. And I think that with the rules that we will put in place later this year, we will have even more grounds for fair competition because you will have some data to be able to compare and contrast the performance of others. And if a firm is routinely putting out bad ratings, then it will be in the interest of the other competitors, just as Coke goes against Pepsi, to point out why they are better and others are not.

Mr. KIRK. Bud raised the point that the Secretary raised, which is the systemic risk which is not your purview; you don't have that portfolio yet. He made some proposals here. But for me, let me nail you down further.

Could you get back to us on what your recommended funding line-item for the CSE would be?

Mr. COX. Yes, and in fact, I would endorse the same thing for CRAs, because when that new authority was given to the SEC regarding credit rating agencies, it was without any specific allocation of resources to it.

[CLERK'S NOTE.—The Securities and Exchange Commission provided the following in response to the question:]

Below is proposed report language for the Subcommittee's consideration:

PROPOSED COMMITTEE REPORT LANGUAGE

RELATED TO SEC'S CONSOLIDATED SUPERVISED ENTITIES (CSE) AND CREDIT RATING AGENCIES PROGRAMS

"The Committee's recommendation assumes that no less than \$5,750,000 will be obligated for the personnel compensation expenses of the Consolidated Supervised Entities (CSE) program and that no less than \$2,200,000 will be obligated for the personnel compensation expenses of the oversight of nationally recognized statistical rating organizations (NRSROs)."

Mr. KIRK. Yeah. I would just say, Mr. Chairman, I mean you are presiding over the implementation of Basel II, FASB 157 and now which are giving you tools to look at these agencies. Obviously, if they had got it right, the market would have corrected itself without this huge jolt. And so I want to make sure that you have the resources to create much greater transparency within at least these three agencies and maybe give some opportunities to the competition, which would also help.

Mr. COX. But I think there is great reward for a very small investment relatively speaking of money and people in these areas.

Mr. KIRK. Yes.

Thank you, Mr. Chairman.

Mr. SERRANO. Thank you. I was getting a little nervous where you were going with that line of questioning, when you asked him what he had to do with something at the beginning there. Because just a day or two I was announced—it was announced that I would be chairing this committee, the market crashed in New York. I hope—

Mr. KIRK. The Havana stock market went up.

Mr. SERRANO. Oh, that went up big. Chavez was very happy. The whole socialist world was very happy.

Mr. Hinchey.

HEDGE FUNDS

Mr. HINCHEY. Thank you very much, Mr. Chairman. I must say, this is the most entertaining subcommittee on the Appropriations Committee.

Mr. SERRANO. In more ways than one.

Mr. HINCHEY. Mr. Cox, great to see you. And thanks very much for the job you are doing. I think you are involved currently in what appears to be a very complex set of circumstances. And I think that that is primarily associated with the hedge funds and the way in which they are behaving. Hedge funds apparently have been around for a long time. I think they go back to 1949. But I don't think they have ever been anywhere near as prominent as they are today. And I think the main reason for that is the deregulation legislation which was passed by this Congress and which opened up the ability for a number of financial operations to engage in practices which are not overseen by the government, and that is particularly true of hedge funds.

I agree with what you said; I think the investor should have some confidence in their investment. But the confidence that they should have in their investment doesn't come about without the regulation, the oversight of these investment operations. So the deregulation of investment I think has had a major impact on the way these hedge funds operate. And right now, they are very, very prominent. They control something in excess of \$2 trillion of investment capital out there in the economy.

So my first question I think is, what do you think we should do? There is a speculation out there now that calls for internal monitoring. All of the people involved in hedge funds should now start behaving in a different way. This is what we are recommending. But there is no guarantee that they are going to do that, even though the most responsible people involved in hedge funds are saying that, yes, this is the way it should happen. I think that we need is to go back to regulation. Senator Grassley has introduced a piece of legislation in the Senate which would begin to move us in that direction.

A lot of people around the country now are blaming the subprime mortgage, subprime market, rather, and the fact that people unable to pay their mortgages for the decline in the economy that we are experiencing. But I don't think that that is exactly accurate. I think that that is more a result of the decline in the economy. And I think a decline in the economy is primarily driven by the manipulative way in which investments have been engaged in, including the incorporation of large amounts of these mortgages into these hedge fund investments. So I would be very interested to hear what you think about that and how quickly you think we should go back to a system of complete regulation of this operation.

Mr. COX. Well, two points. First, the term hedge fund covers a variety of animals, as you know.

Mr. HINCHEY. Yes.

Mr. COX. And I think we would all agree, given the breadth of the definition, that there is a lot of good that goes on in that space and there is a lot that goes on to be concerned about or to be suspicious of. Based on the fact that we are primarily a law enforce-

ment agency, we are bringing scores of enforcement actions against hedge funds, 71 since I have been the Chairman, focused on a number of areas, including fraud and insider trading.

Mr. HINCHEY. Yes. Well, that is a good point, what you are making right now. The kind of fraud that is being engaged in by investment practices is becoming more and more obvious. I mean, things like money laundering, for example, the hedge funds are not exempt from money laundering. They can bring all kinds of money in from any place; nobody knows where it came from, what were the circumstances, how legal it may have been, how corrupt it may have been, how it may have been involved in the importation of narcotics, for example, and things of that nature. None of that is being overseen.

Mr. COX. Well, I am not sure that is the case. I think—

Mr. HINCHEY. No. It is specifically the case. There is no—there is no monitoring of the introduction of money. So money laundering is fully capable within the operation of hedge funds if there are some hedge funds who want to engage in that kind of activity.

Mr. COX. Well, the AML surveillance that is conducted routinely, since it is directed, among other things, at notorious felons and so on, does not require that it be set up in any specific way in order for it to work. And I know that, to the extent that anyone suspects that a particular hedge fund were engaged in that, law enforcement would be interested, and we have tools, and the SEC does civil work of course. But we have the Department of Justice and many other authorities that are interested in that.

Mr. HINCHEY. Yes. Well, I am not suggesting that the SEC is at fault there. Because the SEC can only engage in the kind of oversight examination, insight that they are allowed to under the law.

Mr. COX. That is right. And that is the second point that I want to make. As you know, shortly after I became Chairman, we went effective with a rule requiring a registration of hedge fund advisors which was then thrown out by a court. And there was a good deal of concern at the time that that meant the end of the SEC's program of registering hedge fund advisors. What has happened—in fact, we now have a good experiential base to look at—is that nearly 2,000 hedge fund advisors representing over \$2.5 trillion, the number that you quoted, are registered with the Commission voluntarily. And so, in addition to the anti-fraud authority that we have with respect to any hedge fund, whether it is registered or not, we also then have the opportunity to go in and examine those hedge funds and to subject them to our regulatory regime.

Mr. HINCHEY. How frequently has that been done?

Mr. COX. We do that as a matter of course through our Office of Compliance, Inspections and Examinations.

Mr. HINCHEY. But how frequently has it been done? What is the major head hedge fund that has been examined in great detail recently?

Mr. COX. I would be happy, in response to your question, to submit a detailed answer for the record.

Mr. HINCHEY. Okay.

Any more time? My time is up?

INVESTOR EDUCATION

Mr. SERRANO. Thank you.

It is not the practice of any committee to mention folks that come into a hearing. But it is interesting that my next question relates to the fact that some young folks walked into our audience a few minutes ago. The Fiscal year 2009 budget requests states repeatedly that the SEC Office of Investor Education and Advocacy will continue to focus on educating seniors and retirees about ways to assess investment commonly marketed to them and detect and avoid potential frauds and scams. This is clearly an admirable goal that the subcommittee fully supports.

However, this subcommittee is concerned because no other demographics are mentioned in the request when there are clearly additional groups in need of investor education. For example, for many young investors and recent immigrants, the recent market downturn is the first time that they have seen their investments negatively impacted by market conditions.

Are there any other demographics that the office is trying to actively reach, such as minorities or young investors?

Mr. COX. Indeed, that is the pedigree, Mr. Chairman, of this office. Young people are the first demographic that everyone thinks of when they think of investor education or any kind of education. The good news is that young people have the most to benefit by having this education because they have the one thing that some of us older people don't, and that is time. As you know, a major premise of investor education is to help people understand the time value of money. If you set aside money and leave it there for 20, 30, 40 years at a reasonably safe prudent investment with compounding and with growth, you get something that you just can't get for yourself when you are 50 years old or 60 years old or 70 years old.

So getting the young people with those kinds of messages is really important. We work in a number of ways, not only through schools, as you would expect, and groups that are set up across the country to help young people with financial literacy, but with our armed services. A lot of men and women in the armed services are getting a steady paycheck for the first time when they first join, and they are remarkably busy people. They don't have a lot of time to spend thinking about what to do with their money. And so, at the highest levels, including the Commissioners themselves, we go out to these bases and put on big educational events. We are doing everything that we can to focus on that demographic.

Second, with respect to different language groups and ethnic groups and so on, we try and have our over, you know, 800 tapes that we have and other means of presentation translated into a number of languages and make them available through channels that are likely to reach the target audience. So the reason you are hearing about seniors from us is that that is a new addition to an old line-up. We have always been interested, of course, in older Americans as well, but having a big push for seniors has been thought appropriate because of the aging of the population and the fact that there are going to be a lot of people living longer without the kind of nest eggs that they thought they needed when they fol-

lowed their parents' example, you know, 30 years before. And that is going to present a lot of new risks that we have never faced before.

Mr. SERRANO. Let me ask you a question, a related question. Do you get any kind of a pushback on the issue of immigrants and helping them invest? You see, as you know, we have two immigrants in this country. We have the one who is here with documents and is on his way to becoming a citizen; or who has become a citizen and we don't call an immigrant any longer. Then you have the person who is not here documented. That person may have money. One of the biggest mistakes we make is that we seem to stop those people from taking their money to a bank or investing because they are not here legally. Do you single out just folks for help that are here legally? Do you ask that question at all? Do you get a pushback when you meet with other folks and say, well we are not supposed to be dealing with those folks? Because I suspect that there is a lot of money under mattresses in this country out of fear of putting it somewhere else because that somewhere else may indicate how you are here in this country. And meanwhile, the economy is hurting because that money should be invested and put up somewhere.

You know my whole theory on this immigration thing is, all right, you have a border issue; deal with that. You have an issue of what to do about folks in the future; deal with that. But while you are here, while you are here, you are paying taxes. You have money, some money, then let's make use of that. Let's not keep you apart because that only hurts the rest of us. Any thoughts on that?

Mr. COX. Well, first, our investor education initiatives are aimed through a lot of channels, including the Web, and at as many people as we can find. For all I know, we are reaching people around the world, and I hope we are.

Second, some of the problems that you have described with people who are, for a number of reasons, are either frozen out or freezing themselves out of the financial system, there are some good initiatives underway that start with trying to get people to open up savings accounts and checking accounts so that they are not completely disintermediated. That, of course, is a commercial banking initiative ultimately, but we are all aware of the paycheck cashing services and the fees that people pay and how much abuse and potential for abuse exists in that space. And we find ourselves partnering, even though commercial banking is not our line of country, we find ourselves partnering with them in our investor education initiatives.

SUBPRIME LENDING

Mr. SERRANO. Right. Right. I have a few questions that I will submit to the record. I just have one more that I want to ask you. And it is, of course, on the subprime lending issue.

Chairman Cox, in the testimony you submitted for today's hearing, you mentioned that a subprime working group was formed within the enforcement division of the SEC and that this group is investigating possible fraud, market manipulation and breaches of fiduciary duty related to the subprime crisis. The group was probably formed too late to help prevent or mitigate this particular cri-

sis, But what steps are being taken by the group, or by the SEC in general, to prevent a crisis like this from happening again? Is the SEC working with other agencies on a lessons-learned strategy, if you will, from the recent housing crisis?

Mr. COX. Yes, to the second question. And I will answer it in more detail. To the first question, what are we doing in the subprime working group? We have, as a matter of public record, as you know, ongoing law enforcement that we have some trouble talking about publicly. But as a matter of open record, we have opened up approximately three dozen investigations through this task force. The kinds of issues that we are tackling with the subprime task force include whether or not the underwriter that was involved in the offerings knew or was reckless in not knowing that the issuer and the lender were not complying with its disclosed lending policy, whether the lender was misrepresenting the loan or the loan's characteristics or whether the lender failed to maintain adequate reserves. We are, in fact, working closely with other agencies that have regulatory oversight over subprime lenders as well as coordinating our investigative efforts with the Federal Reserve, the FDIC and the Department of Justice. There have been a number of international fora that I have been heavily involved with that have also been inferring lessons learned from this, including the Financial Stability Forum, which reports to the G-7, and the International Organization of Securities Commissioners, where I am going to become chairman of the technical committee this summer. I am the co-chairman of the task force that is looking at this from an international level. And you full well know there are many countries, not just the United States, that have been harmed by this problem.

Mr. SERRANO. Thank you.

I will submit, Mr. Regula, the rest of my questions for the record.

Mr. REGULA.

Mr. REGULA. I am curious, do other countries, industrial countries, have an agency comparable to the SEC?

Mr. COX. Yes.

FOREIGN REGULATORS

Mr. REGULA. It seems like financial securities don't know borders anymore.

Mr. COX. The answer to your question is, most definitely, other countries do have agencies that are our counterparts to the Securities and Exchange Commission. And in fact, the SEC, for most of them, has been the model. Since we created the genre in 1934, virtually every country with a market economy has thought it necessary to have a securities regulator. Our International Securities Regulation Institute, which we conduct at the SEC and is currently underway, has attracted 78 countries to come and be trained and learn how we do things at the SEC and to share best practices.

MONOLINE INSURERS

Mr. REGULA. One of the keys to security in the marketplace is monoline insurers, because they guarantee to some extent. Do you regulate them in any way?

Mr. COX. No. We are not the frontline regulators for monoline insurers. They are regulated by the State insurance commissioners chiefly.

Mr. REGULA. Mr. Chairman, I will submit the rest of my questions for the record.

Mr. SERRANO. Thank you.

Mr. Hinchey.

HEDGE FUNDS IMPACT ON ENERGY PRICES

Mr. HINCHEY. Thank you very much, Mr. Chairman.

Chairman Cox, I wanted to ask you another question about the hedge funds and the way in which they seem to be having an impact on the price of energy, particularly on gasoline and home heating oil.

One of the things that we have seen recently is a statement by the Energy Information Administration and a brief quote is, "Weakness in the U.S. economy has led to softening gasoline demand." And we know that is true. The demand has gone down because of the fact that there is a weakness in our economy, and particularly people throughout the middle class are having a very difficult time meeting their daily obligations, whether it is energy, food, whatever it might be. So I am just curious as to what extent the hedge funds in bidding out for large amounts of these commodities, these oil commodities, are driving up the price, particularly in the context of the weaker dollar. It seems to me that, based upon the information I have been able to look at, that that is exactly what is happening. And a large amount of the increase in the price for energy, particularly oil, is going up based upon hedge funds intruding themselves in there and investing in those commodities. I have to laugh a little bit when I say intruding themselves in there because I mean they are free and open to do that. There is no regulation against them. They can just do it in whatever way they want to. But do you think that we ought to have some sort of regulation on these kinds of investments to ensure that people aren't doing this or these funds aren't doing it in ways that are making it more and more difficult for ordinary people to be able to drive their car back and forth to work, feed their family, all of the things that people are having a difficult time doing in this country today?

Mr. COX. Well, the abuse of trying to corner the market or manipulate the price of the commodities is sufficiently old that one of the oldest playing card games in the country, Pit, is based on that. We can go back to the early 20th century and find an example with that pathology. So not only should there be regulation against that kind of manipulation of the market, but there is. And, to the extent that surveillance can detect it, to the extent that we can get a trail of evidence that leads us to it, our law enforcement can be all over it. It is even possible for that kind of behavior to run afoul of the criminal laws as well, so not only the SEC but the Department of Justice could become involved.

Mr. HINCHEY. Is that an internal regulation within the SEC? Is it based upon Federal law? What is the basis for it? How does it operate?

Mr. COX. Yes. The manipulation of a market or other kinds of abuses or manipulative behavior that is designed to influence particular security of any kind is prohibited by section 10(b) of the Securities and Exchange Act of 1934. And we have a special rule that implements that, rule 10G-5 that we have used very aggressively and for a long time.

Mr. HINCHEY. To what effect was the Deregulation Act of 1999 impinging upon that? How does that make it weaker and more difficult—

Mr. COX. I don't think that in any way affects our ability to use rule 10G-5.

Mr. HINCHEY. So can you give us an example, and I don't expect you to do it right now, but can you give us some examples directly how the SEC is engaging in actions to try to ensure that hedge funds manipulative investments are not actively engaged in driving up the price of energy, particularly oil?

Mr. COX. I will do my level best to answer the question. In fact, if I provided the answer for the record, I might be able to provide you more information than I could in this public hearing about ongoing law enforcement and give you a good inventory of the cases that we have had of late on hedge funds. And then, second, to tell you what we have got going on with respect to energy in particular.

Mr. HINCHEY. Okay. I appreciate that very much. Thank you.
Thank you, Mr. Chairman.

[Clerks note: The Securities and Exchange Commission provided the following in response to the question:

During 2007, the SEC conducted inspections of about 190 advisers managing hedge funds, approximately 10% of the advisers to hedge funds registered with the Commission. SEC examination staff also have several on-going examination sweeps that focus on compliance risks in discrete areas that are specifically applicable to hedge fund advisers.

Examinations indicating deficiencies generally result in non-public deficiency letters requesting that the firm take corrective action. Serious deficiencies may be referred to the SEC's enforcement staff. Firms may be selected for examination for any number of reasons, including for a routine examination, because of an investor complaint, or in connection with a review of a particular compliance risk area. The reason that a firm has been selected for examination is typically not shared with the firm under examination.

The following hedge fund cases have been brought recently against both funds and their advisers based on securities laws violations, including violations for insider trading, valuation practices, conflicts of interest, and manipulation, among other violations. See SEC v. Mitchel S. Guttenberg, et al., No. 07-CV-01774 (S.D.N.Y. filed Mar. 1, 2007) (hedge funds, among others, used inside information misappropriated by executive director at UBS's equity research department to trade ahead of UBS analyst recommendations); SEC v. Michael K.C. Tom et al., No. 05-11966 (D. Mass. filed June 15, 2006) (employee of Citizens Bank tipped off portfolio manager about pending acquisition, who then traded on the material nonpublic information); SEC v. Don Warner Reinhard, No. 4:07-CV-00529 (N.D. Fla. filed Dec. 13, 2007) (defendant provided hedge fund clients with false quarterly account statements showing materially inflated account valuations); SEC v. Edward J. Strafaj, No. 03-CV-8524 (S.D.N.Y. filed Oct. 29, 2003) (hedge fund portfolio manager knowingly and recklessly overstated the value of the convertible bonds and preferred stock held by hedge funds); In the Matter of Melhado, Flynn & Associates, Inc., AP File No. 3-12574 (Feb. 26, 2007) (defendant engaged in cherry-picking to favor one of the firm's advisory clients, an affiliated hedge fund, over his other advisory clients); In re Michael R. Donnell, AP File No. 3-12986 (Mar. 11, 2008) (vice president of registered investment adviser failed to disclose conflict of interest arising from a sub-adviser's payment of substantial referral fees); SEC v. Scott R. Sacane, et al., No. 3:05-CV-1575 (D. Conn. filed Oct. 12, 2005) (investment advisers that managed hedge funds, along with others, manipulated the price of certain stocks by making regular and substantial purchases of the stocks through the hedge funds that they managed and concealed these purchases by falsifying and failing to file various forms); and SEC v. Colonial Investment Management LLC, et al., No. 07-CV-8849 (S.D.N.Y. filed Oct. 15, 2007) (hedge fund, adviser and managing director violated Rule 105 of Regulation M by using shares purchased in at least eighteen registered public offerings to cover short sales that they made during a restricted period).

In addition, the Commodity Futures Trading Commission (CFTC) has exclusive jurisdiction over futures contracts in energy commodities, including crude oil, the CFTC is responsible for ensuring that energy futures prices are determined in an open and competitive environment and investigating alleged manipulation of energy futures prices. The CFTC also has non-exclusive jurisdiction to prosecute manipulation of physical energy transactions in interstate commerce. In recent years, Congress also has provided anti-manipulation authority to the Federal Energy Regulatory Commission with respect to physical energy transactions in natural gas and electricity, and to the Federal Trade Commission with respect to physical energy transactions in petroleum products.]

Mr. SERRANO. Thank you. Well, we thank you for your testimony today. We thank you for your service to our country, and we thank you for your agreement to give us some further information.

Mr. REGULA.

REFORMS RESULTING FROM SUBPRIME MELTDOWN

Mr. REGULA. One more question. Are we putting in place regulatory mechanisms to preclude another meltdown prospectively as a result of the subprime situation? Are we doing something to avoid this down the road?

Mr. COX. Yes, indeed, I would say that not only in the United States but around the world we are very rapidly putting in place reforms that are designed to address each of the kinds of problems that have been identified. We talked about one of them in this hearing, credit rating agencies. There is a great deal of international focus on that and a good deal of focus on the new rules that we will be writing this year. There are accounting issues that are very central to these questions. There were a lot of off-balance-sheet activities that ended up affecting sponsors when either directly or indirectly it was taken back on. There are obviously problems with underwriting standards for lending that gave rise to all of this in the first place. And there are important lessons to be inferred from the Bear Stearns incident. And we are already adjusting both the Federal Reserve and the SEC, the way we look at liquidity measures.

Mr. REGULA. Well, the Fed is getting into the investment banking field, which they had not traditionally regulated. Is that correct?

Mr. COX. Yes. By opening up the discount window, they have done that in a very significant way.

Mr. REGULA. Thank you, Mr. Chairman.

Mr. SERRANO. Thank you.

Once again, we thank you for your testimony, and we thank you for your service.

Mr. COX. Thank you, Mr. Chairman.

Mr. SERRANO. Meeting is adjourned.

FY 2009 Securities and Exchange Commission Budget Request**Questions for the Record****Chairman Serrano**

1. Oversight of rating firms. In 2006 Congress gave the SEC direct oversight of credit rating firms. These firms have faced significant criticism recently, as many of them gave securities backed by subprime loans very high ratings. In response, the SEC has stated its intention to promulgate additional rules for rating firms in the coming months.

What amount of funding above the President's budget request will allow the SEC to fully carry out the needed surveillance and enforcement of this area? How many FTEs will be dedicated to this area? Would these FTEs come from existing personnel or would new hires be needed?

ANSWER:

The SEC's proposed budget for FY 2009 would increase the number of staff responsible for implementing the Credit Rating Agency Act from 7 to 20 positions for oversight and inspections of credit rating agencies. This would more than double the number of staff dedicated to the program. The full-year personnel compensation cost of the program would be at least approximately \$2.2 million in 2009. Whether these additional FTEs come from existing personnel or new hires would depend upon the overall appropriation for the agency in 2009.

2. SEC resource levels. The SEC's fiscal year 2009 budget states that the percentage of all registered investment advisers and companies examined in fiscal year 2009 will be lower than in previous years due to an increasing registrant population and the increasing complexity of registrant operations.

Would the SEC be able to increase the number of examinations with an increase over the President's budget?

What are the risks that we face from examining a lower proportion of registrants?

ANSWER:

Yes. If the number of staff devoted to conducting inspections of registered advisers and investment companies were increased, more inspections would be completed and a higher percentage of the registrant population could be inspected.

The percentage of all firms inspected may not be the most revealing metric, however. Conducting more in-depth inspections of higher-risk advisers is an even more important objective. For this reason, the SEC uses a risk-based approach in selecting advisers for inspection. About 1,400 firms are categorized as high risk by SEC inspection staff. Outside of

this population, SEC-registered advisers are inspected for cause (based on a complaint or tip), as part of an examination sweep focused on a particular risk area, or randomly.

Inspections of investment advisers are conducted for the purpose of achieving three broad goals: (1) to detect violations of the securities laws and rules, (2) to foster strong compliance and risk management practices, and (3) to provide the Commission and its staff with information about the industry's compliance and the implementation of rules and laws. Examining the higher-risk portion of the registrant population in-depth, after all firms are surveyed to determine their risk profile, increases the probability that violations will be detected. If additional funding were available to inspect all advisers in-depth, regardless of risk, the likelihood that violations would be detected would be higher still, although due to diminishing returns, at some point such additional funding might find higher priority uses in the enforcement, supervisory, and regulatory functions of the Commission.

3. Benefits of regulatory proposals. The SEC budget request mentions that the SEC considers regulatory proposals that yield significant benefits for the securities markets.

How are these benefits calculated? How did the regulation proposals recent financial market innovations rate when being considered for approval? Did any of these innovations play a role in our current financial situation?

ANSWER:

The benefits of regulation are frequently difficult to quantify, so rule proposals discuss them qualitatively and ask for comment. For example, rule proposals that improve disclosure and enhance market liquidity clearly yield significant benefits, but these are difficult to quantify. When benefits take the form of reductions in costs, such as moving from paper filings to electronic filings, they are easier to quantify. The most far-reaching Commission initiative in terms of potential quantifiable benefits is increasing the use of interactive data. Making information filed with the Commission quickly accessible to investors and the markets, and enabling more automated filing of this information could significantly reduce costs and improve the usability of public company filings with the Commission.

4. SEC's ability to keep pace with financial innovations. One of the reasons Treasury has stated to justify regulatory reform is that the speed at which financial innovations are developed greatly exceeds the rate at which regulatory agencies can respond.

Do you agree with Treasury's assertion, or do you feel that the SEC has effectively kept pace with financial innovations?

ANSWER:

The Treasury report correctly identifies a key responsibility of every regulator – to keep pace with changes in the marketplace. Doing so is a process and not a result, so at all times the

Commission and other financial regulators must review their existing rules and determine how well the rules apply to the ever-changing financial marketplace. For example, one important area where the Commission is adjusting and responding to the rapid pace of financial innovation is a staff proposal to reform the internal process by which the Commission considers rule changes from exchanges. For many years, although the Exchange Act by its terms requires the SEC to publish SRO rule filings for comment — and if the rule is to be approved, to do so within 35 days — the staff has routinely requested that the exchange agree to extend these deadlines while the rule was weighed and considered within the agency. The result was that it could take years before exchange rule filings were finally approved. This regulatory model is obviously incompatible with the current exigencies of competitive exchanges, in which a competitor operating under a different regulatory regime might be free to pirate a new proposal while it is under review by the SEC for an extended period.

The Commission's staff is nearing completion of a proposal to redesign the rule approval process to make it more efficient. If adopted by the Commission, this streamlining of the SRO rule approval process would be an important contribution to keeping U.S. exchanges competitive and in helping the regulatory regime keep pace with financial innovation.

5. Standardized cost of real-time stock quotes. Please inform the Committee as to the current status of the SEC's ruling on the NetCoalition's petition for standard rates for instantaneous stock quotes.

ANSWER:

Commission staff continue to examine the complex issues raised by the NetCoalition petition and the Commission intends to take further action on the matter in the near future. During the last year, the Division of Trading and Markets and each of the Commissioners have been focused on the novel and important questions of the pricing of market data. Market data permits the essential price discovery upon which a well ordered market depends. Internet and media companies petitioned the Commission to consider their point of view on these issues, and in that connection as well as others, the Commission and its staff have carefully weighed the available evidence. The result of that analysis, which was deliberately thorough because the Commission's first decisions in this area will be precedent-setting, will be reflected in the planned Commission action on this matter.

6. Risk assessment. The SEC's Office of Risk Assessment has the responsibility of helping the Commission anticipate, identify, and manage risks, focusing on early identification of new or resurgent forms of fraud and illegal or questionable activities. The subcommittee notes that the Commission has announced its intent to more than double the size of this office, but the investment in this office remains low relative to the resources available to questionable financial companies and individuals to evade the rules.

Given the lessons learned from the current economic situation, will SEC shift even further resources to this area so that it may become more thorough and diligent in its analyses?

ANSWER:

Yes. As noted above, the current staffing plan increases the size of the Office of Risk Assessment from the five slots to nine full time staff members with experience and expertise in analytical methods and firsthand industry knowledge. In addition, the Office of Risk Assessment will facilitate the extension of risk management and risk assessment to all the divisions and offices of the Commission. Additional staff and resources will be dedicated for this purpose in the Office of the Chief Economist and the Division of Trading and Markets, while new staff in other Divisions and Offices will augment their ability to include within every aspect of their responsibilities the need to anticipate, identify, and manage risks. In this connection, ORA will be working with staff around the Commission to identify and manage risks that threaten the SEC's mission of investor protection, fair and transparent markets and capital formation.

As the Office of Risk Assessment grows, and as this function grows across the Commission, we will continue to review whether the Office has sufficient resources to meet its mission.

What are some examples of projects currently being underway in this office?

ANSWER:

The Office is engaged in a variety of projects, including:

- Developing new, and improving existing, risk assessment models;
- Identifying and analyzing issues involving subprime based securities;
- Developing contingency plans to address potential major breakdowns of markets and financial products; and
- Evaluating market surveillance and market data to assist in the prioritization of potential enforcement actions and examinations.

7. Salary increases. The SEC has stated that it intends to provide its employees merit raises and COLAs at a 4.5 percent average level in fiscal year 2009. However, the SEC's request level for full-time permanent employees is only two percent over fiscal year 2008 enacted levels.

Please provide a breakdown that demonstrates how the SEC's 4.5 percent figure was calculated.

ANSWER:

The budget request for FY 2009 includes funds for eligible staff to receive pay raises of 4.4%. This figure has two components:

- The federal cost-of-living adjustment, which is projected to be 2.9%, according to the Office of Management and Budget's economic assumptions; and
- Merit pay raises equal to about 1.5%.

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The SEC's request level for full-time permanent employees (under budget object class 11.9) increases by 2% between the 2008 enacted level and the 2009 request. This increase covers the 4.4% total pay raise for eligible staff among the 3,473 full-time equivalents funded under the FY 2009 request.

Ranking Member Regula**GAO Report**

In November, GAO concluded that the SEC had a material weakness in internal controls over its financial reporting process and therefore did not maintain effective internal controls over financial reporting. GAO has made several recommendations to improve this weakness. As a financial regulator conducting audits, examinations and investigations into the financial reporting of thousands of companies, it is critical you address this weakness and practice what you preach.

- **Can you tell us what is being done to improve your financial reporting?**

ANSWER:

Yes. First, the agency has recruited highly qualified financial managers and expanded the financial management team. When I became Chairman, the SEC didn't have a CPA in the Office of the Executive Director or as CFO, nor did it have on staff one of more experts in preparing audited financial statements. Since last year, these deficiencies have been corrected. Second, the staff has prepared and is well along in executing a comprehensive Corrective Action Plan to completely eliminate the identified material weakness, as well as other less significant deficiencies. The plan specifically addresses each of the recommendations made by GAO.

Developing a fully integrated financial management system, as recommended by GAO, is the keystone of this plan. We expect that improvements underway this year will eliminate the material weakness.

The strategies for addressing the material weakness include developing or improving process documentation and overlaying manual processes with additional compensating controls as needed. In July, we will deploy system enhancements that will lay the foundation for full integration, support implementation of U.S. Standard General Ledger (SGL) compliant posting models, and enhance the efficiency and effectiveness of our internal controls. These enhancements build on the major improvements already recognized by the GAO in its FY 2007 audit report, in which it noted that the SEC had improved controls over the accuracy, timeliness, and completeness of disgorgement and penalty data, and now uses a much improved database for the initial recording and tracking of these data.

The SEC methodology for preparation of financial statements and disclosures, as well as for data reliability checks, and recording of transaction fees, have also been fully documented and institutionalized over the first half of FY 2008. In addition, during the first quarter of FY 2008, the SEC automated the generation of financial statements and the associated consistency and quality checks. This has reduced manual processes and provides more time for analytical review and quality assurance.

I am firmly committed to ensuring the SEC's financial integrity and operational efficiency, so that the agency can lead by example when it comes to establishing and maintaining effective internal control over financial reporting.

Monoline Insurance

Monoline insurance guarantees the timely repayment of bond principal and interest when an issuer defaults. The industry began by insuring municipal bonds but in recent years monolines began insuring complex securities created by Wall Street by packaging mortgages including subprime mortgages. While most people have never heard of monoline insurers and probably don't know if their investments are insured, I understand that monolines are now responsible for tens of billions of dollars of losses which they may not be able to repay. Our financial markets are incredibly complex and the failure of one segment of the market can have a ripple effect on the entire market.

How have the losses experienced by the monoline insurance industry impacted the market and the economy in general?

ANSWER:

The short answer to your question, from the perspective of securities regulation, is yes – though not nearly to the extent that other aspects of the subprime crisis have affected the capital markets and the broader economy. Rather, the issues that today we confront with monoline insurers concern potential problems that could arise because of their relatively thin capitalization as compared to the risks that they insure.

As a threshold matter, however, I should point out that the Commission does not regulate the financial guarantors known colloquially as monoline insurers; rather, this is the domain of state insurance regulators. The Commission does, however, have specific regulatory authority over the credit rating agencies that have registered with the Commission as nationally recognized statistical rating organizations, and these agencies issue credit ratings to monoline insurers. In addition, market participants which the Commission does regulate, including investment banks, municipal securities issuers and dealers, and municipal bond and money market funds, all have to varying degrees been affected by the troubles being experienced by monoline insurers.

The monoline insurers began by insuring against defaults on bonds issued by municipalities – a market that has not historically experienced many or sizable defaults. During the 1990s, some bond insurers migrated to insuring complex securities backed by home mortgages, including subprime instruments. In insuring such structured products, many of these bond insurers assumed that losses on mortgage-backed securities would stay within historical ranges. As the housing boom continued for many years, defaults were low and housing-related assets were generally considered relatively safe by market participants. However, during 2006 there was increasing deterioration in home prices and a related rise in mortgage default rates. As the deterioration has continued, market participants are questioning whether these bond insurers will in fact be able to pay on their bond guarantees and credit protection that they underwrote if called upon to do so.

Potential monoline insurer downgrades could affect investment banks with substantial exposure to monolines. SEC staff have discussed frequently the various exposures to monolines with firm risk managers, treasurers, and business unit personnel. While the monolines are important

market participants, we understand that investment banks are aware of and are managing their exposures to the monoline sector. The Commission staff is also in regular communication with other financial regulators, and in particular the Federal Reserve Board, which directly oversees the holding companies of most of the systemically important commercial banks; the OCC, which oversees nationally chartered commercial banks; and the UK's Financial Services Authority. Through a variety of formal and informal channels, the staff has worked with these other regulators to understand the possible impact of downgrade or financial distress on individual institutions.

Given the role the monolines have played in the municipal securities market, the problems the monolines have experienced potentially affect investors in municipal securities. As much as 30% of the municipal securities currently held by tax-exempt money market funds are supported by bond insurance issued by monoline insurance companies. Some of the securities may be eligible for investment by money market funds because of the insurance that monoline insurers provide. A significant downgrade in a monoline insurer's rating could result in the securities becoming ineligible under the Commission's rule for investment by money market funds. Also, in the long term, the inability of bond insurers to maintain high credit ratings may restrict the supply of high-quality securities for tax-exempt money market funds. The Commission staff has been in regular contact with fund management companies, which are aware of these risks and have taken steps intended to protect funds and thus fund investors from the potential implications of a credit rating downgrade.

In addition to money market funds, there are other funds that invest in municipal securities. Most of these funds seek to derive most or all of their income from municipal bonds that pay interest that is exempt from federal income tax. Although it is difficult to predict the effect on municipal bond funds of additional rating downgrades of bond insurers, some projections can be made:

- Any overall decline in the value of municipal bonds or insured municipal bonds would be reflected in comparable declines in the value of municipal bond fund shares.
- A more severe downgrade (e.g., from AAA to A) is likely to have a greater effect on the value of municipal bonds and funds than a less severe downgrade (e.g., from AAA to AA).
- A downgrade could present more price risk to an owner of a single municipal bond than to an owner of shares of a diversified municipal bond fund.
- A downgrade could require many insured funds to change their investment policy with respect to the ratings quality of portfolio holdings if those holdings are no longer guaranteed by an AAA-rated insurance company.

How can the SEC help investors to better understand the complexities of our financial markets and make informed investment decisions?

ANSWER:

We can do this by magnifying the impact of the Commission's Office of Investor Education and Advocacy, which provides investors with the foundational information they need to make informed investment decisions.

Since the subprime crisis began, the SEC has found several ways to extend the reach of our investor education efforts. We have crafted special messages and customized information geared towards particular audiences, including seniors, the military, and online investors. We have developed new web pages that reach millions of people with answers to Frequently Asked Questions (FAQs) on popular investor inquiries, including how to check on the credentials of investment professionals and how to file a complaint with the SEC. There's also a mutual fund cost calculator; links to interactive data viewers that make it easier for investors to analyze public companies' and mutual funds' financial results; and links to other financial education websites.

Through these outreach efforts, the SEC now has contact with nearly 100,000 investors and other constituents each year. Our investor advocates research, resolve, or redirect common complaints including allegations of fraud, unsuitable sales practices, and substandard securities products. To expand the communication into more preventative and educational messages, we are implementing technology to enable more direct communication with investors, including interactive messages of interest to investors, interactive web pages, and opt-in email and phone alerts. We are also developing an audio library targeted to investors without Internet access that will offer a wide range of recorded messages on investing topics via telephone.

Investor education and outreach is also closely integrated with the Commission's ongoing regulatory policy and disclosure agenda. For example, we are conducting focus groups on a proposed mutual fund summary prospectus to test investor reaction to highlighting key information in a concise, user-friendly format. We are also conducting a survey of 1,000 investors to gain insights into how understandable and how useful they find other SEC-mandated disclosures, such as proxy materials and annual reports. We will continue to expand our initiatives to test "usability" to ensure that what companies and financial services firms deliver to investors is as effective as possible.

With respect to the insuring of municipal bonds, there is concern that the impaired financial condition of the monoline insurers resulting from losses experienced from insuring subprime financial products will impact municipalities that want new bonds with high ratings and low interest rates. Do you share this concern? If so, is there anything the SEC can do?

ANSWER:

Yes, I share this concern about the effects the impaired financial condition of some monoline insurers may have on municipalities. The problems of some municipal bond insurers have

increased investor concerns about municipal securities generally, including some securities that are not directly affected by those problems. In recent months, municipal securities have traded at very high yields relative to U.S. Treasury securities, reflecting heightened investor concerns about the municipal markets. The “spillover” effect into municipal auction-rate securities has been highly publicized, and we are monitoring the effects on mutual funds.

Recently, market forces have appeared to be resolving some of the earlier dislocations in the municipal credit markets. The problems of some of the existing municipal bond insurers have attracted new entrants into that market, including Warren Buffett’s Berkshire Hathaway Assurance Corp. and Wilbur Ross’s WL Ross & Co. At the same time, a number of municipal issuers have questioned the need to obtain bond insurance, asserting that their underlying credit is strong even without the insurance, and that the demand for municipal bond insurance has been shrinking. Despite the increased issuance of municipal bonds due to the restructuring of auction-rate debt, the yields of municipal bonds relative to U.S. Treasury securities have dropped from their historic highs over the past few weeks.

Currently municipal borrowers are not legally required to reflect their financial condition on the public statements in a uniform fashion before securities are sold. Would it be helpful for municipal borrowers to have a required uniform accounting and disclosure process comparable with the corporate sector? If so, what role could the SEC play in developing those standards?

ANSWER:

Yes. The lack of uniformly applied disclosure and accounting standards in the municipal market raises significant issues for investors and the market. These issues are discussed at greater length in an SEC staff “white paper” delivered to Congress last July and appended to these answers. Fundamentally, investors in municipal securities deserve the same level of timely, high-quality disclosure and protection enjoyed by investors in other areas of the U.S. capital markets.

The model of full registration, Commission review, and other regulation applicable to non-municipal issuers is not necessary or appropriate for state and local governments. Instead, Congress should authorize a limited regulatory regime designed expressly for the needs of the municipal securities market. Possible steps include:

- Requiring that offering documents and periodic reports provided to investors contain information similar to what is required for all other securities offerings;
- Making information on municipal securities available on a more timely basis, for example, by tapping the power of the Internet to provide an easily accessible, free source for the display of that information, similar to the SEC’s interactive data systems for corporations and mutual funds;
- Mandating municipal issuer use of generally accepted governmental accounting standards;

- Providing for an independent funding mechanism and SEC oversight of the independent accounting standards board in this area, the Governmental Accounting Standards Board, just as the Sarbanes-Oxley Act provided for the Financial Accounting Standards Board;
- Ensuring that private companies who access the municipal market indirectly by using municipal issuers as conduits meet the same requirements that corporate issuers must meet;
- Requiring large, complex, and frequent issuers of municipal securities to have policies and procedures for disclosure; and
- Clarifying the legal responsibilities of issuer officials, underwriters, bond counsels and other participants.

Once authorizing legislation were enacted, the SEC could establish the regulatory framework for municipal securities disclosure and provide independent oversight of the accounting standard setter in this area.

Mr. Hinchey

Last August, a group of law professors asked the SEC to convene a series of roundtables on the topic of securities litigation reform.

A number of business organizations and securities industry groups have been calling on the SEC to place limits on the ability of shareholders to enter into securities class action lawsuits.

In light of what appears to be at the very least serious negligence, that led to massive write-downs involving the biggest banks on Wall Street, it seems to me that it would be an odd time to be exploring ways to decrease shareholder access to the courts' remedies.

In addition, you recently testified that the SEC faces enormous challenges in trying to address the turmoil in the securities markets that stems from the subprime crisis.

I fear that the recent crisis of confidence in Bear Stearns, for example, may be just the tip of that iceberg.

- **Given all the challenges facing the SEC today, I am wondering if you are still planning on holding the securities litigation roundtables?**

If so, please answer the following questions or supply them for the record:

- What are the scheduled dates of the roundtable?
 - Who will attend and participate in the roundtables?
 - What is the format of the roundtables?
 - Who are the panelists?
 - What topics will the different panels discuss and what is the purpose of the roundtables?
 - Is the Commission considering any rulemakings in conjunction with the roundtables?
 - Can you provide me with the staff person's name and contact information who is in charge of organizing the roundtable?
- **Do you believe that now is the right time for the SEC to consider weakening accountability in the securities markets by making it more difficult for investors to recover losses from securities fraud?**

ANSWER:

I agree with you that weakening accountability in the securities markets is a bad idea – not just now, in the wake of the subprime crisis and the demise of Bear Stearns, but at any time. On August 2, 2007, a group of prominent securities law professors led by Donald C. Langevoort of the Georgetown University Law Center urged the SEC to convene a roundtable on the topic of shareholder litigation, with special attention to the following: who bears the costs of attorneys fees in securities lawsuits; the role insurance plays in indemnifying companies or individuals; the percentage of investors who file claims and collection portions of settlements; and how the economics of a settlement change when the defendant is a third party. The explicitly stated objective of such a roundtable, according to the professors' letter, was their belief that "the U.S. must do the best it can at investor protection."

In response, to this 2007 request, the Commission announced that it would convene such a roundtable in the next year. Thus far, the Commission has not determined a date, participants in possible panels, the format, or the topics, in order to ensure that a full complement of Commissioners representing both parties would be available to assist in the planning and to attend. Because the Commission's agenda must move forward, the roundtable will likely be scheduled in the coming months even with new Commissioners. When the roundtable occurs, it will be open to the public.

The purpose of the roundtable will be to explore the important topics associated with private securities litigation, its relationship to Commission enforcement efforts, and its effects on investor protection, the maintenance of orderly markets, and capital formation. The roundtable will give the Commissioners and our professional staff the opportunity to invite and hear the views of a wide range of leading experts in the field. The objective would be to strengthen investor protection and accountability in the securities markets.

Along with the public, the Commission and the staff would listen and learn during a roundtable and would use the information from the roundtable when considering whether to begin any further agency response, such as a rulemaking. Andrew Vollmer in the Office of the General Counsel has been the main person involved in the planning so far. Mr. Vollmer can be reached through the Commission's Office of Legislative and Intergovernmental Affairs at (202) 551-2010.

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