

# Commissioner Shulman's Senate Finance Testimony on Ponzi Schemes and Offshore Tax Evasion Legislation

## Prepared Testimony of Doug Shulman, Commissioner Internal Revenue Service, Before the Senate Finance Committee on Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion Legislation

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### INTRODUCTION

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

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

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

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

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

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

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

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

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

## PONZI SCHEME PUBLISHED GUIDANCE

### Summary

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

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

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

### Revenue Ruling

The [revenue ruling](#) sets forth the formal legal position of the IRS and Treasury Department:

- **The investor is entitled to a theft loss, which is not a capital loss.** In other words, a theft loss from a Ponzi-type investment scheme is not subject to the normal limits on losses from investments, which typically limit the loss deduction to \$3,000 per year when it exceeds capital gains from investments.
- **The revenue ruling clarifies that “investment” theft losses are not subject to limitations that are applicable to “personal” casualty and theft losses.** The loss is deductible as an itemized deduction, but is not subject to the 10 percent of AGI reduction or the \$100 reduction that applies to many casualty and theft loss deductions.
- **The theft loss is deductible in the year the fraud is discovered, except to the extent there is a claim with a reasonable prospect of recovery.** Determining the year of discovery and applying the “reasonable prospect of recovery” test to any particular theft is highly fact-intensive and can be the source of controversy. The revenue procedure accompanying this revenue ruling provides a safe-harbor approach that the IRS will accept for reporting Ponzi-type theft losses.
- **The amount of the theft loss includes the investor's unrecovered investment – including income as reported in past years.** The ruling concludes that the investor generally can claim a theft loss deduction not only for the net amount invested, but also for the so-called “fictitious income” that the promoter of the scheme credited to the investor's account and on which the investor reported as income on his or her tax returns for years prior to discovery of the theft.

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

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

### Revenue Procedure

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

The [revenue procedure](#) provides two simplifying assumptions that taxpayers may use to report their losses:

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

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

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

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

### **IRS Enforcement: Tightening the Net**

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

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

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

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

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

### **An Integrated Approach**

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

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

First, I can also tell you that offshore issues are high priority to the President and his Administration. The

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

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

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

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

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

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

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

### **Draft Legislation**

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

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

### **Conclusion**

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