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Statement of William Josephson

Committee on Finance

United States Senate

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

Mr. Chairman, Senator Grassley,

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

14 Internal Revenue Code § 508(e).

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

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

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

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

16 See supra note 1.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[33] Code § 4944(a)(1).

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

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

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

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

Thank you very much for your invitation and attention.