

NOMINATION OF HENRY M. PAULSON, JR.

HEARING

BEFORE THE

**COMMITTEE ON FINANCE
UNITED STATES SENATE**

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON THE

NOMINATION OF

HENRY M. PAULSON, JR., TO BE SECRETARY OF THE TREASURY,
U.S. DEPARTMENT OF THE TREASURY

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JUNE 27, 2006
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**NOMINATION OF HENRY M. PAULSON, JR., TO
BE SECRETARY OF THE TREASURY, U.S. DE-
PARTMENT OF TREASURY**

TUESDAY, JUNE 27, 2006

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

The hearing was convened, pursuant to notice, at 10 a.m., in room SD-106, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Present: Senators Hatch, Lott, Snowe, Kyl, Santorum, Bunning, Crapo, Baucus, Conrad, Wyden, and Schumer.

**OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S.
SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. Today our committee meets to consider the nomination of Henry, better known as “Hank,” Paulson, to be the next Secretary of the Treasury.

Obviously, as we move from one Secretary to another, we ought to remember the hard work of Secretary Snow and wish him well as he goes on to other endeavors or retirement, or both, for the job that he did as Secretary of Treasury.

The Treasury Secretary is an original Cabinet Department position. Institutionally, there has been a very close relationship between the jurisdiction of the Finance Committee, the oldest committee of the U.S. Senate—maybe more accurately, spoken as the oldest standing committee of the U.S. Senate—and the Treasury, which happens to be the administration’s second-oldest department.

Since the Treasury Secretary is the top economic policy officer in the administration and the Treasury Department implements so much of the policy made by this committee, we have a tradition of moving with all deliberate speed when a vacancy occurs.

That tradition has held, no matter which party controlled Congress or the White House, and I thank Ranking Member Baucus and all the members of the committee for helping us to aggressively move this nomination.

I would move so, but the time line is very consistent with past Secretary nominations, and I will just use one example, that of Secretary Rubin’s time line. The Senate received that nomination January 4, 1995, and that happened to be the first day that the Senate was in session that year.

The official ethics-related paperwork was received on January 5 of 1995. The Finance Committee staff expedited review of the complicated financial details of Secretary Rubin, who also happened to be a senior official at Goldman Sachs.

The Finance Committee held a hearing 5 days later, on January 10. On that same day, the committee reported Secretary Rubin's nomination. On that same day, the full Senate confirmed Mr. Rubin, and he was then immediately sworn in as Treasury Secretary.

Now, we are moving as aggressively, in a similar manner and on a similar schedule, with this nomination. I appreciate the cooperation that members have on what I will acknowledge is a relatively short notice.

I also want to thank committee Tax staff, and that is on both sides of the aisle, because they put in hard work and long hours to get here.

My staff examined Mr. Paulson's complicated financial record, his tax returns, and the activities of his firm, Goldman Sachs, in the area of tax planning. I am pleased to say that Mr. Paulson, like Mr. Rubin over a decade ago, has been transparent with our committee staff and taken all necessary steps to cut his ties with Goldman Sachs.

Mr. Paulson left a lucrative, exciting, interesting, and successful position as head of one of the most prestigious financial service firms on this planet. He brings to the table an enviable set of assets.

Mr. Paulson spent a good amount of his youth in the cornfields of Illinois. As a bright young man with excellent academic credentials, he served in the Pentagon and served in the White House. After government service, Mr. Paulson rose through the ranks at Goldman Sachs.

When you look at Mr. Paulson's story, you come away with an impression that this is a person—or in the Midwest, as we say, a guy—that gets the best results at whatever he tackles.

That impression is obviously reinforced for those of us who meet Mr. Paulson for the first time. I met him for the first time in a very satisfactory meeting we had on another issue about 3 years ago when I had an opportunity to host him in the members' dining room.

So Mr. Paulson is here at just the right time, when we have a lot of issues that must be dealt with, in what is a very good economy in the United States, though there are still things that need to be done.

He will have an opportunity to work with us, by himself, and with other administration officials on things like tax reform, China currency, and with a whole host of major economic issues facing this country, and for that matter, our influence on the world economy and other world issues.

I am pleased that Mr. Paulson has answered the call to return to public service. I look forward to his testimony and dialogue this morning and over the next years, as we work between the business of this committee and the business that he has as Secretary of Treasury.

Senator Baucus? Thanks, again, for your cooperation.

**OPENING STATEMENT OF HON. MAX BAUCUS,
A U.S. SENATOR FROM MONTANA**

Senator BAUCUS. Thank you very much, Mr. Chairman.

Today we meet to consider the nomination of Hank Paulson to become the Secretary of the Treasury. Since Alexander Hamilton took the job 217 years ago, this has been one of the most important jobs in America. The Secretary has the potential to lead the American economy.

The great Secretaries that we can think of have done just that, they have dominated their times. One thinks of Bob Rubin, one thinks of Jim Baker, and remembers our departed colleague, Lloyd Bentsen, sadly taken from us this past season.

Mr. Paulson, you have the potential to join these ranks. As chairman and CEO of Goldman Sachs, you have led one of the Nation's premier financial institutions. You, more than almost anyone, have seen the effects that the U.S. Government can have on markets, and you have seen how quickly those markets can judge what we do.

You have much work to do. The government has run \$300 billion budget deficits for 4 years in a row. The balance of trade has been on a roller coaster ride to extremes. America faces new economic competition from China, India, and most places on the globe, and the Treasury Department has suffered depressed morale and a diminished policy role. I wish you luck.

On the deficit, the government is plainly on an unsustainable path. The administration's budget looks through rose-colored glasses. It ignores the cost of war, the cost of fixing the Alternative Minimum Tax, and the cost of realistic growth for the rest of government.

And like clockwork, people born in 1945 will reach age 62 next year. Baby boomers will begin becoming eligible for Social Security next year. Through a lifetime of work, they have earned their benefits under Social Security and Medicare.

With the zeal of Captain Ahab, this administration has focused solely on entitlement programs to bear the burden of balancing our books. But those numbers do not add up.

Let me suggest another option. The government should collect the taxes that people owe, but do not pay. The government should shut down abusive tax shelters, and the government should close overly generous tax loopholes.

The Treasury loses \$300 billion a year in taxes owed, but not collected. Three hundred billion dollars a year. The cumulative tax gap over the last 6 years is \$2 trillion. Yet, the administration's budget has a plan that it says would raise just \$3.5 billion of that over 10 years. That is one-tenth of 1 percent of the solution.

Mr. Paulson, you will be able to do something about this. Today, I ask you to pledge to send this committee, in October, a credible plan to reduce the tax gap. On the same schedule, I also ask you for a plan to stem the proliferation of abusive tax shelters and off-shore schemes.

Chairman Grassley and I have asked the IRS Commissioner, in consultation with Treasury, to submit such a plan by October 1 of this year. I expect that we will also have a hearing shortly thereafter.

I hope and expect that the Treasury will be ready to tell the American people how it is going to collect taxes that are owed.

Despite its flaws, our voluntary tax system is a remarkable tribute to the 85 percent of Americans who pay what they owe and contribute the more than \$2 trillion that helps to fund our society's commitments, and we owe it to the honest taxpayers to simplify the tax laws. We owe it to them to lessen its burdens and remove opportunities for those who want to cheat. That is our obligation; that is our goal.

The administration promised tax reform, then the administration stacked its advisory panel. That panel reported to the Treasury, but we have yet to see the administration's plan. With your tenure comes a new opportunity to work together to modernize our tax system, and I reach out my hand to work with you on this.

On the current account, America is also on an unsustainable path. As night follows day, our current account deficits are bringing on a weaker dollar. Our growing trading imbalances risk precipitating a dollar crisis. You are an acknowledged expert on international finance, and I will be interested in your plan for how we can avoid this risk.

You and I share a belief that America must work to maintain its preeminent standard of living in an environment of increasing competition from China, India, and elsewhere.

As we have discussed, I have introduced legislation addressing American competitiveness in trade, energy, savings, research; education, tax, and health legislation will follow. I look forward to working with you to advance this agenda.

You are an acknowledged China hand, having flown there more than 70 times. I will be particularly interested in your take on how we should engage China. What is the proper way?

In the wake of China's much-ballyhooed announcement of its managed float, China's currency has not appreciated as much as many of us had hoped. China's relatively closed financial services sector, state-owned industries, and weak local brokerages all add concerns.

This administration has spoken with many voices on China. With one voice it talks about China as a military threat. With another voice, it talks about China as a responsible stakeholder in the international economic system.

You know China, and I hope that you will be able to play a greater role in the administration's China policy formation than prior Treasury Secretaries. Again, I look forward to working with you on this.

Mr. Paulson, with great opportunities come great responsibilities. It is my hope and prayer that your tenure as Secretary will be one that ranks with the likes of Hamilton and Rubin.

Frankly, the economy that you have been given requires it, and for the good of the country, we all hope that you are a very, very lucky man. Thank you.

The CHAIRMAN. Thank you, Senator Baucus.

It is the tradition of most committees to have either Senators from the States, or other States, who want to introduce and/or sponsor nominees, for us to turn to that now. Senator Schumer is

a member of this committee, so he will not be sitting down there beside you, as is traditionally done.

So I would call on Senator Schumer to introduce and to say whatever he wants to about the nominee.

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

Senator SCHUMER. Well, thank you, Mr. Chairman. I want to thank you and Ranking Member Baucus and members of the committee for moving this nomination with alacrity.

I am delighted and proud to introduce to this committee a great New Yorker, Hank Paulson, former Chairman of Goldman Sachs, and now nominee to be the 74th Treasury Secretary.

I have known Hank for 15 years. I recommend his nomination wholeheartedly and without reservation. He is an extraordinary leader, financial thinker, businessman, and father. Though he is not a native New Yorker, we consider him to be an adoptive son, like so many others who have come to our city from all over the country.

Hank has excelled in every area of life, from the classroom, to the football field, to the board room, and everywhere in between. He is a straight shooter and gives direct answers to direct questions. We certainly need somebody like that now.

Hank graduated from Dartmouth College in 1968 and received his MBA from Harvard. After working at the Department of Defense and then the Nixon White House, he found his true calling when he joined Goldman Sachs as an associate 32 years ago.

Hank became Chairman and Chief Executive Officer of Goldman in 1999, and, should he be confirmed, which I hope he will be, he will continue the long history of Goldman Sachs heads, including former Treasury Secretary Bob Rubin, New Jersey's John Corzine, Deputy Secretary of State John Whitehead, serving their country with great distinction and success.

But the thing that Hank really goes off the charts about is the environment. I go into a meeting with Hank, thinking we were going to talk about finance or a banking issue, and he would end up talking about some bird he had recently seen.

He is an avid environmentalist and a lover of all things natural, but I hope no one on the committee holds that against him. Actually, he would make a great Secretary of Interior.

However, I am glad the President nominated him for Secretary of Treasury because financial issues and the health of the global economy are his passions.

In the world of finance and international markets, there is simply no equal to Hank, and, at this critical point in our economy's history, we need Hank's expertise and experience to lead the way.

I believe that the rise of China and economies in East Asia pose both the greatest threat and the greatest opportunity for the American economy. Expanding markets abroad can open up enormous new avenues for trade and business growth domestically, but only if our international partners play by the rules.

As this committee and Hank know, I have been very concerned about two issues relating to China, currency and financial services liberalization. On currency, Senator Lindsey Graham and I have

worked closely with your predecessor, Secretary Snow, and I want to give him praise, tribute and thanks for the wonderful job he did in this area, working with us closely.

We did not always agree, but we were able to work very well, I think, towards a good result to push and prod China to allow their currency to float, based on international market forces. We have made some progress, as I mentioned, but China has not moved enough since last July.

Hank's extensive experience in China, personal relationships with its government and business leaders, and unique knowledge of international markets make him the right man, at the right place, at just the right time to tackle the critical issues involving the American and Chinese economies and their interrelationship.

I believe that Hank will be able to show the Chinese that it is not only in our interests, but in theirs as well, to allow the yuan to float freely. I know that Hank will work to explain to the Chinese that reforming their practices and markets more quickly, rather than dragging their feet, can lead to a win-win situation for both countries.

On financial services liberalization, I know Hank will work closely with Ambassador Susan Schwab, who was just confirmed to be the new U.S. Trade Representative, to make sure that China lives up to its WTO commitments.

On December 11 of this year, many of the current restrictions faced by American financial firms that want to do business in China and purchase Chinese companies will be lifted. Hank is the perfect person, my colleagues, to monitor China's progress, and also to prod the Chinese to go further than it has already promised.

In sum, Mr. Chairman, Hank is a thoughtful, dedicated, and renowned financial leader. All Americans of every political philosophy are lucky that he has decided to spend the next few years in public service.

I look forward to working with him to tackle significant issues and perils facing our economy. I fully support his nomination and urge, Mr. Chairman, that we move this nomination as quickly as we can so that the Senate can confirm this nomination before we break on July 4, so Hank can roll up his sleeves as Secretary of the Treasury and get down to the important tasks that we need done to move this country forward economically.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. I heard you ask us to move very quickly.

Senator SCHUMER. I hope so, yes.

The CHAIRMAN. I always confer with the Ranking Member on that, but since you are also in the leadership of your party, could you speak to your leadership?

Senator SCHUMER. I have, and we are on board.

The CHAIRMAN. Thank you very much.

Senator SCHUMER. Thank you.

The CHAIRMAN. That is good news, Mr. Paulson. Now I will be embarrassed if some Republican wants to slow this up. [Laughter.] But I do not think so.

Now is your opportunity. Three things, usually. One, we do not swear in nominees, so you do not have the opportunity to hold your

hand up and get on the front page of the *Washington Post* with that sort of posture, but obviously nobody is going to know that you are guilty of any crime, either, coming before Congress.

The second thing is for you to introduce any family or friends who are here to support you. The reason I asked you if you want to introduce them is we have a redacted copy of a statement of information that we received from you.

I do not know who redacted date and place of birth, whether or not you have a marital status, whether or not you have children. We get a lot of redacted stuff from the executive branch. I do not know why they would not want us to know that information. But if you do not want us to know it, you do not have to introduce anybody. [Laughter.]

Senator BAUCUS. I think we would like to know how old you are, though. [Laughter.]

The CHAIRMAN. So, would you like to introduce family and friends? That is a tradition here.

Mr. PAULSON. Thank you very much, Mr. Chairman. I am sorry. You can see that I am not terrific with technology.

Senator BAUCUS. But that wonderful lady behind you, who I presume is your wife, was trying to indicate to you to turn that on.

Mr. PAULSON. Absolutely. And that is what I wanted to do, is to introduce that wonderful lady, my wife Wendy. I have made a number of good decisions in my life, but by far the best was the decision to marry her almost 37 years ago. So, she is a great partner and a great friend, and I am delighted she is here today.

The CHAIRMAN. Wendy, we would like to have you stand, if you would, please. Thank you. Thank you.

Anybody else you want to introduce, family or friends?

Mr. PAULSON. Well, in terms of my family, I have a 33-year-old son who works at the National Basketball Association, and a 31-year-old daughter who is the Bureau Chief for the *Christian Science Monitor* in Chicago. They are both working, so they are not here today, but they are with me in spirit.

Then I have a number of friends. I have, sitting next to Wendy, John Rogers, who has worked with me very closely over the years, and is a friend and works with me at Goldman Sachs. Then I have three other very good Goldman Sachs friends: Esta Stecher, Lori Laudien, and Greg Palm.

The CHAIRMAN. Thank you.

Now you have an opportunity for an opening statement to say whatever you want to say, then we will have a series of questions.

**STATEMENT OF HENRY M. PAULSON, JR., NOMINATED TO BE
SECRETARY OF THE TREASURY, U.S. DEPARTMENT OF THE
TREASURY, WASHINGTON, DC**

Mr. PAULSON. Thank you very much. Chairman Grassley, Ranking Member Baucus, and members of the Finance Committee, thank you very much for inviting me to testify here today.

I am honored that President Bush has nominated me to serve as the 74th Secretary of the Treasury, following the distinguished leadership of Secretary John Snow. I very much appreciate the time members of this committee have taken to meet with me and consider my nomination.

Frequent communication between the Treasury Department and this committee is of vital importance, and, if confirmed, I look forward to building on the dialogue that we have already begun. I am also grateful to my family for supporting my decision to pursue this opportunity.

The Treasury Department has a critical role to play in helping to set the direction of the United States' and the global economy, a role that reaches back to America's founding. If confirmed, I will strive to carry forward the Treasury Department's rich legacy.

I have admired the work of the Treasury Department throughout my 32-year career in finance, and particularly during the last 8 years when I led a global financial institution.

As the steward of the U.S. economy and financial systems, the Treasury has helped lay the groundwork for the American economy to become a model of strength, flexibility, dynamism, and resiliency.

This is a system that generates growth, creates jobs and wealth, rewards initiative, and fosters innovation. It is also a system that offers considerable social and economic mobility. We must never, never take this for granted, and we cannot allow Americans to lose faith in the benefits our system offers.

America is the land of opportunity. We need to be vigilant in ensuring that each and every American has the opportunity to acquire the skills to compete and to see those skills rewarded in the marketplace.

One way we can do this is to maintain a macroeconomic climate that enables workers, families, and businesses, both small and large, to thrive. That calls for spending discipline and predictable taxation, combined with prudent regulation. If confirmed, I will focus intensely on how the United States can maintain and strengthen our competitive position.

As the product of a mid-sized town in Illinois, I will, of course, always remember Chairman Grassley's succinct description of the Treasury Secretary's role: "to understand how tax policy, capital markets, international trade, and currency policy affect Main Street, USA."

As we work to promote greater economic opportunity for the American people, we must always remember that the American economy is deeply integrated with the global economy. That brings challenges, but even greater opportunities.

While maintaining confidence in our ability to compete throughout the world, we must be prepared to embrace the change that will contribute to our long-term prosperity. Open markets help to boost productivity and drive America's economic growth, which in turn creates new and better jobs for American families.

It is also true that the global integration of economies and markets holds the promise of a more prosperous and a more secure world. In my extensive travels throughout the world, I have seen countless examples of the benefits of economic reform.

If confirmed, I will be active in affirming America's leadership role in the global economy, where we continue to be a constructive and a stabilizing force. I also look forward to working alongside other colleagues in the Cabinet to advocate policies and actions

which would provide open and level markets for U.S. investments and for U.S. products.

To close, I will briefly outline some of the steps that might be taken to achieve a stronger and a more competitive U.S. economy.

First, addressing the long-term unfunded obligations of Social Security and Medicare that threaten to unfairly burden future generations.

Second, keeping taxes low and collecting them in a simpler and fairer manner that does not distort economic decision-making.

Third, expanding opportunities for American workers, farmers and businesses, big and small, to compete on a level playing field with the rest of the world.

Fourth, maintaining and enhancing the flexibility of our capital and labor markets, and preventing creeping regulatory expansion from driving jobs and capital overseas.

Finally, the U.S. economy will be stronger if we can continue to foster an entrepreneurial spirit and culture which generates innovation, risk-taking, and productivity growth that raises living standards to keep America the economic envy of the world.

If confirmed, I look forward to frequent consultation with members of this committee to advance these, and other, ideas. If confirmed, I also look forward to working with the Treasury Department's select corps of professionals, who play a critical role in the stability and the vitality of the U.S. economy.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Paulson.

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

The CHAIRMAN. There are three questions that we ask every nominee. I want to ask those questions, and only those questions at this point, then call on Senator Baucus. Then I will go back to myself for my 5-minute round of questioning.

Then after Senator Baucus and myself, we will have: Conrad, Wyden, Schumer, and I will go down the list later on, in the order of arrival.

These are questions that we ask every nominee, not just you.

The first is, whether or not there is anything that you are aware of in your background that might present a conflict of interest with the duties of the office to which you have been nominated.

Mr. PAULSON. No, Mr. Chairman.

The CHAIRMAN. Do you know of any reason, personal or otherwise, that would in any way prevent you from fully and honorably discharging the responsibilities of the office to which you have been nominated?

Mr. PAULSON. No.

The CHAIRMAN. All right.

Third, do you agree, without reservation, to respond to any reasonable summons to appear and testify before any duly constituted committee of Congress, if confirmed?

Mr. PAULSON. I do.

The CHAIRMAN. All right.

Then I want to add to that, without your having to respond to it, an additional request that I have of every nominee, not just you.

Anything I have to say about this subject at this point obviously would not apply to you, because you have not been in office.

In fact, I referred to a meeting you and I previously had, and I have been very satisfied with the transparency that you evoked as a result of that meeting, and how cooperative you were several years ago.

This is an admonition that I give to every nominee, and it involves transparency to some extent. That is, the extent to which we not only ask you, as I did in that last question, to appear before our committee as you might be called, but it would be a request that, when you get letters from us as individuals, that they be fully responded to, and hopefully fully responded to in the first instance, not after we have to write two or three times back to get additional responses, or to make phone calls as to why we have not received an answer.

Now, I can only speak as one member of a group of 100, but I think to some extent every member takes somewhat seriously the responsibility of what I call Congressional oversight, the responsibility of a Senator, once laws are passed, to make sure that the laws are faithfully executed. We call that Congressional oversight. Sometimes it is done by an individual member, more often it is probably done by a committee.

But I want to give you an example of how people previously before this committee, or people who have not been before this committee but might be under my oversight in a manner other than as Chairman of this committee. This is a series of letters since January 1 that I have sent to various Cabinet people, some of them in the jurisdiction of this committee and some not, that I have not either received an answer to, or have not received a full response to.

So I do not want to say that these have not been responded to to some extent, but in some instances—maybe not all, but more often—not fully. It just makes our job very difficult when we have communication with people like this.

I recently had a communication with a Secretary who said we could not talk to some line agent. Well, just 2 months before, in that same department, we talked to line agents.

So I do not get what the game is, except I think that maybe there is a desire lately to not be fully cooperative with Congress and its oversight work. We are not doing our constitutional job, and the administration is not being as transparent.

Now, maybe that comes as a shock that a Republican would say that, but I think I have had a consistent standard, under five different Presidents, both Republican and Democrat, of doing a job of oversight. And just because we have a Republican President does not mean I am going to stop my job of oversight.

The only thing I notice a little bit different is, I get a little more cooperation from Democrats when we have Republican Presidents than when I am doing my oversight with a Democrat President. But regardless, my standard is the same.

So if you would let me admonish, without any criticism whatsoever, because you have not done anything I can be critical of, that you would help me, if I write you a letter—and hopefully I do not

have to write you letters—that you would fully respond, and fully respond the first time.

Just as one example of what you might not be aware of. Some official in OMB, at a meeting of some staff people of some committee, said, is this oversight not going just a little bit too far, and is it not just a little bit too public, and things of that nature, I think in an effort to dampen Congressional oversight on the part of Congress.

It happens that my staff was invited to that meeting. We did not go, because I felt what it was is what it turned out to be. What we want to do is do what American government is all about.

This is public business. The public's business ought to be public, except maybe in two or three areas, national security, personal privacy, and those things that are protected by the President by what you call executive privilege. I am not a lawyer, so I am not going to define that.

But outside of those areas, there is nothing you do or nothing I do that should not be made public. Our efforts to make it public make everybody in government responsible.

It is perfectly legitimate for you to say, Grassley, I do not agree with you on this, or something. But that ought to be public information when we make these requests. So, I hope that you will help us do our job of constitutional oversight. I would appreciate it very much.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Paulson, I would like to follow up a little bit on what the Chairman just said. I did not know he was going to make that point, but it is a good one.

As we all know in life, first impressions count. You have the opportunity to create the right first impression. The right first impression includes full cooperation with the Congress, that is, working with the Congress—open, accessible, candid, just talking to us—because we are all on the same team. We are all seeking these positions to serve our constituents, serve our country as public servants.

There is a danger in this era that we are becoming a parliamentary form of government, not a constitutional government, that is, when the government has majority in both bodies, the House and the Senate, so there is a tendency for there to be insufficient oversight, as is the case in the parliamentary form of government. There is no oversight to speak of.

I just strongly urge you to create that first impression the right way, talk to us, and it will go a long, long way, I think, in not only developing a good sense of cooperation with this committee, but also, more importantly, serving the public in the right way, and I know you will do so.

My question, Mr. Paulson, really revolves around your views on how we get a handle on the fiscal problem that we are facing. That is, the deficits. You mentioned as one of your five steps the unfunded liabilities and baby boomers about to retire.

How do we get a handle on all that? I would like your sense of how we approach it, because to get a solution here we have to work

together, both ends of Pennsylvania Avenue. This really should not be a partisan issue.

Regrettably, it has, in my judgment, to this point, been a bit partisan in the sense that the administration has proposed various entitlement commissions to clamp down on entitlements. There is the Medicare Commission, there is the Social Security Commission.

They are both dead on arrival because they were stacked. It was a stacked deck. They were not perceived to be honest. They were not perceived to be a good-faith effort for how to handle the problem.

Now we see, Mr. Chairman, the Budget Committee with another proposal, including the line item veto as another commission proposal that addresses really only entitlements, and addresses, basically, only some entitlements, Social Security, Medicaid, and Medicare.

In my judgment, there is no way in the world we are going to wrap our arms around, get a handle on the fiscal problems that we are facing now, and face in the future, unless everything is on the table. That is, all spending. Not just entitlements, but also other spending.

Revenue is going to have to be on the table, somewhat similar to what this country did in the early 1980s when Social Security was in tough shape. President Reagan appointed a commission. It was bipartisan. Alan Greenspan was the chairman. Members of this committee, Bob Dole and Pat Moynihan, were on the commission.

It was truly bipartisan, if push came to shove, near the end. I think it was Secretary Baker, or somebody called up Tip O'Neill that morning and said, hey, we have to work this out. The Democrats agree to reduce benefits a little bit if we Republicans agree to raise taxes a little bit. So they did. They joined hands. Nobody took pot-shots at each other. It was not a partisan, political statement.

In my view, that is about the only way we can honestly, realistically get a handle on the fiscal problem. I would just like your views on how you think we should set up a process, a way to realistically solve it.

Mr. Paulson. Senator, I do agree that, as we look at the fiscal issues, that the biggest issues this country faces are out a number of years. They are related to the entitlement programs, largely health care, Medicare and Social Security. They are driven by demographics, the aging of our society, and by the fact that health care costs are going up much faster than the GDP.

As we look out, it is a formidable challenge. As I have traveled around the world, I have witnessed on a first-hand basis what happens to countries if they do not begin dealing with these problems in advance, because it is much less costly if you can deal with them in advance. I believe that is what the President had in mind with the Social Security initiative.

But in any event, stepping back a minute, I do believe that there is no way we can solve these problems without approaching them on a bipartisan basis. One of the things that I look forward to doing, if confirmed, is spending time with my colleagues in the ad-

ministration, Treasury, spending time with all of you, and talking with the President about this topic.

Now, as I look at 2½ years, there are certain things that may be easier to accomplish in a 2½-year period. In some ways, it may sound naive to think that these problems could be addressed in a 2½-year period, but I really do believe that we do need to begin, very seriously, the process of addressing them, because the earlier we step up to these issues, the less costly will be the ultimate solution.

Senator BAUCUS. I appreciate that. But let me just remind you, when the Social Security Commission was presented to the country, it was perceived, I think, to be a way to privatize Social Security, and therefore it was, as I said earlier, dead on arrival.

That got nowhere because it was perceived to be not an honest, good-faith effort to address Social Security, in a way where different people keep their minds open and figure out reasonably how to solve it. Rather, it was more one way: privatize Social Security.

That just does not work in this town, in this country, for an issue of that magnitude and of that importance. I am concerned that we are running up against the same kind of approach with the line item veto. The commission approach is now being heralded in the Congress.

The bill passed the Budget Committee, by the chairman of that committee, which is perceived to be a back-door attempt to privatize Social Security. It is not going to work. If we are going to solve these problems—and we all want to—they have to be in good faith.

I was approached by the administration 4 or 5 months ago to see if there was some interest in working out some kind of a process, whether it is a commission, committee, or something, to try to get a handle on it and try to cut down on future excessive spending.

I said to the administration, well, gee, I am very interested, but it cannot just be entitlements only on the table. You also have to have revenue to make it work. I fully want to make it work. This is totally nonpartisan. I am an American citizen, first. But you have to also put revenue on the table.

The response I got back was, yes, that is interesting, now let us see what we could do about that. I kept talking to them, but they never came back again. It was my sense that they did not really want to do it the right way. Again, now we come up with this new idea in the Budget Commission.

So, I do not want to take too much time here, but I would just urge you, if you agree that everything has to be on the table—if you agree, and it is hard to say whether you agree now or not. I understand that, because the administration has a different point of view thus far—to make that point known forcefully in the administration so that we can finally solve it.

Your thoughts on that, please.

Mr. PAULSON. Senator, let me say again that I really do believe that the fiscal challenges that you have identified are significant ones. They are addressable ones. I am really looking forward, if confirmed—

Senator BAUCUS. And I urge you to vigorously go after this tax gap. Some say it is more than \$350 billion a year.

Mr. PAULSON. Yes, I hear you. As I went around with my various courtesy calls, beginning with Chairman Grassley, with you, and with many others, they all emphasized the importance of closing that tax gap. I will be working very hard to do just that.

Senator BAUCUS. And I might tell you that you have a huge challenge there, too, because unfortunately the IRS has been asleep at the switch. There are computer programs that have not been developed. Millions of dollars, tens of millions, perhaps, have been spent allegedly on developing software for computer programs. It is just down the drain. It is more than tragic, it is more than outrage. Frankly, they do not want the public to know about those shortcomings, those failures.

So, you have a huge, huge battle ahead of you to work with the IRS to develop the capability, the resources, and the software to finally address the problem. We are in the Dark Ages. IRS is in the Dark Ages: insufficient computers, personnel not up to snuff. You have a huge problem ahead of you. We want to work with you, but I am just warning you, it is huge.

Mr. PAULSON. Thank you.

The CHAIRMAN. Thank you, Senator Baucus.

We have notified staff that we will have 10-minute rounds instead of the 5-minute rounds, just so everybody is aware that Senator Baucus and I are not going over our time limit.

Mr. Paulson, I want to get my questions, here, in order. I want to bring up the issue of the proliferation of tax shelters. I am going to end my statement with three questions that are long, but I think my staff gave them to you so you would have them and you will not have to write notes about what I am saying.

First of all, this committee has been very involved in that activity of proliferation of tax shelters, particularly in the late 1990s and the early part of this decade. That activity underscored the need for full disclosure of tax shelters so that the IRS can better police abuses; I believe sunshine is the best disinfectant.

Unfortunately, the Finance Committee's proposals in this area became law in 2004, so it was a long time after this industry developed before we actually legislated in that area.

We had Treasury staff at that time very much helping us with that effort. Finance Committee staff have reviewed your tax returns and found that you did not participate in tax shelter activities as an officer at Goldman Sachs.

They have also concluded that in your role as senior executive, you were not active in aggressive tax planning or shelter activities. I am very pleased with that outcome. I hope that it would be true of your colleagues on Wall Street.

So, three questions. Do you find tax shelter activity a serious tax policy problem? If the answer is yes, do you pledge to continue Treasury's efforts to combat tax shelter activities?

My second question. Many commentators focus on what they describe as one of the breeding grounds of corporate tax shelters, meaning management's desire to maximize book income and minimize tax liability.

A particular role is played by the favorable tax treatment of debt-over-equity financing. I wonder whether or not you agree with that view.

Then the third question. If there is a link between tax shelter activities and the tax treatment of debt versus equity, are there other reasons that we ought to examine this policy in the context of business tax reform? We just, within the last week, had such a hearing before this committee.

Mr. PAULSON. Let me be as brief as I can here. First of all, clearly, with regard to cracking down on tax shelters and abusive tax shelters, I feel very strongly about that issue. Everything I will do will be to encourage the IRS to continue with its efforts there. I do believe, from what I understand, the IRS is making significant efforts.

Second, as I look at corporate activity in the tax area, I think the very best corporations look to obey the law, the letter and the spirit of the law, and they look to minimize all of their costs within those guidelines.

One of those costs is taxes. So, clearly, no corporation is trying to say, how can I pay more taxes? They are trying to say, how can we do it right, how can we comply with the law, but how do we minimize our taxes?

Now, there is a bit of a bias favoring debt over equity. That is why I was really very positive about the tax reform effort to bring down the taxation on dividends, equalizing it with capital gains, because I think that removed part of that bias.

We may have a chance to deal with serious tax reform. Let me say, as I talked with a number of members of the committee, I know a number of members on the committee would very much like the opportunity to deal with fundamental reform. My own view is, if we are able to do so, that corporate taxes and individual taxes should all be on the table.

I do believe, again, looking at corporate taxes, simplicity is a good objective, as is the case in individual taxes. I think an overriding objective with corporate taxation has to be ensuring that our businesses stay competitive. That is just key to the long-term success of this country. So, those are my comments, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Now I would turn to an issue that, in reading about you, you find very close to your heart, and that is the issue of charities, particularly the environment. I want to commend you publicly for your leadership, as chairman of the Nature Conservancy. I think that organization had lost its way, and I think you have brought it back on track.

In addition, your family has its own private foundation that is well-managed, and you are active in supporting many, many charities.

As we talked privately in my office, you bring good understanding to the importance of the tax-exempt sector to encourage charitable giving. As Secretary of the Treasury who oversees the IRS, you are in a unique position to strengthen efforts to ensure that charities are operated in the best interests of the public good.

As you have seen first-hand with the Nature Conservancy, with the best of intentions, things can run afoul. Unfortunately, there are far too many who take advantage of tax benefits of charities for personal benefit. The IRS has been active in the area of over-

sight of charities, thanks to the leadership of Commissioner Everson.

But I want to understand your views in this area and your priorities as Secretary of Treasury to ensure that charities are acting in the best interests of the community, in other words, protecting the tax exemption, because the tax exemption is the one that encourages charitable giving, and in turn then protecting all the taxpayers who have to pay the bills when tax exemption brings in less money.

I believe your background allows you to be a tremendous leader on the best practices in the nonprofit area. So, your response?

Mr. PAULSON. Yes, Chairman Grassley. Like you, I believe that charitable organizations play a unique and very, very positive role in this country. That role, plus, really, the generous tendencies of U.S. donors, is in many ways a differentiating characteristic of our society.

I believe that not-for-profits need to be well-run and have good governance, because ultimately the boards of nonprofits have a fiduciary responsibility to the donors. I think some of the things you have done to bring attention to this are precisely the right things.

Now, getting to my role, if confirmed, as Treasury Secretary. As I looked at this issue, it seemed to me that one area of abuse involves situations where donors make gifts in-kind to charities. This could be automobiles, it could be art, it could be land, where the donors might take and inflate an appraisal, really under-stating their taxes.

To me, this is an area for the IRS to focus on because, I think, at the end of the day, all that will do is make the charitable sector stronger. People, and many, many good people, give money to charities for the right reasons. I just think, like everything else, it is important to get the abusers who are inappropriately using the charities.

Incidentally, the charities often are just unwitting accomplices, and the donors are using the charities as unwitting accomplices to rip off the taxpayers. So, it is that area where I think we really need to focus. I would be hopeful that most of the vast majority of the donations are done properly.

The CHAIRMAN. Yes. I would like to bring up the specific matter regarding Nature Conservancy. Despite repeated requests by our committee, we still have not received a copy of Nature Conservancy's closing agreement with the IRS based on the IRS audit of the Nature Conservancy.

It is important for the public to understand, what was the resolution of matters raised by the press and the Finance Committee in the review of the Nature Conservancy? I would ask for your commitment that the Finance Committee receive from the Nature Conservancy today that closing agreement.

Mr. PAULSON. Mr. Chairman, we received the request. I am one member of the board of the Nature Conservancy. I am the chairman of the board, one member of the board. I am not the CEO. What the Nature Conservancy would prefer to do would be to have the IRS give you that closing agreement so it would be kept in confidence.

The CHAIRMAN. Yes. Well, it is going to work better for our purposes to get it from the organization.

I have more questions of you, but my time is up in the first round.

Now it is time to call on Senator Conrad, then Senator Wyden.

Senator CONRAD. I thank the Chairman.

Mr. Paulson, thank you for your willingness to serve. As I indicated to you, you come to this town with an outstanding reputation. The trick is, when you come to this town with a good reputation, to keep it. It is not always easy to do, but I have confidence that you will be able to do that because you are, by all accounts, a first-rate person.

Let me just pick up on something Senator Baucus said which I think is very important, and that is the tax gap, now estimated at \$350 billion a year. That is more than the deficit will be this year.

So, if we were collecting the amount of money that this current tax estimate is supposed to yield, we could eliminate the deficit. Not the increase in the debt, which, as you know, is much bigger, but at least we could make meaningful progress. So, Senator Baucus is exactly right to highlight that issue.

The second thing that I also wanted to share is something Senator Baucus mentioned with respect to tackling these massive fiscal shortfalls, really record budget deficits, record increases in debt that are completely unsustainable.

I want to share the same view that Senator Baucus shared with you, that is, this is going to have to be done on a bipartisan basis. Proposals that are before Congress now to have partisan commissions whose results are fast-tracked up here, with limited ability to debate or amend, are dead on arrival. That is not going to happen.

This is going to have to be done in a partnership. Anybody who thinks they are going to come up here and run this thing through with limited debate and limited right to amend, that is not the American way. That is not the way the Greenspan commission functioned, and nobody should have an expectation that that is the way it is going to be done, because that is just unacceptable.

Let me turn to a question that is being asked a lot in this town, and that is the question of, do tax cuts pay for themselves? I want to ask you that question. The former Federal Reserve Chairman, Alan Greenspan, rejected claims that tax cuts pay for themselves. He said, "It is very rare, and very few economists believe that you can cut taxes and you will get the same amount of revenues." That is Chairman Greenspan.

The current Chairman of the Federal Reserve, Chairman Bernanke, also believes tax cuts do not pay for themselves. He said, in testimony this year, "I do not think that as a general rule that tax cuts pay for themselves."

The current OMB Director, Rob Portman, also believes tax cuts do not pay for themselves. He said, in a hearing, again, this year, "As a general matter, most tax cuts do not pay for themselves."

Finally, the former Chairman of the Bush Council of Economic Advisors said he believes tax cuts do not pay for themselves. In fact, he said in an economics textbook, "There is no credible evidence that tax revenues rise in the face of lower tax rates. An econ-

omist claiming tax cuts pay for themselves,” he said, “is like a snake oil salesman who is trying to sell a miracle cure.”

Let me just, before I ask you directly what your view is, show you the historical record here, what we have seen since 2000 in terms of the real revenues of the country.

The real revenues in 2000 were over \$2 trillion. Then we had the massive tax cuts in 2001. We were told that would generate more revenue. At least, some made that claim. We can see what happened in the real world: we did not get more revenue.

We had more large tax cuts in 2003. Again, we were told we would get more revenue. Again, what we saw in the real world, is it did not happen.

I would ask you, what is your view? Do you believe that tax cuts pay for themselves?

Mr. PAULSON. Senator, no. As a general rule, I do not believe that tax cuts pay for themselves. But I have clearly seen, and I think some of those people you quoted would say the same thing, that tax cuts change behavior, there is no doubt.

I can remember very clearly what it was like, running a Wall Street firm in 2001: the bubble had burst, we were in recession, we had had the terrorist attack September 11th. I watched the tax cuts add to consumer confidence, investor confidence, market confidence, CEO confidence, and I watched it change behavior. So, there is no doubt about that.

Senator CONRAD. Thank you for that. I, for one, agree with your assessment. I do not think tax cuts pay for themselves. By and large, they do not. There may be some anomalous situations where, for a short term, they do. But it is also true that tax cuts affect behavior. The problem with all of this is sustainability.

Let me go to my next question, which really goes to that question. We have a circumstance in which the debt of the country—foreign-held debt, our own debt—is skyrocketing. This chart makes the point with respect to foreign holdings of our debt. I have shown this several times.

It shows that it took 42 Presidents 224 years to run up \$1 trillion of external debt, U.S. debt held abroad. This President has more than doubled that amount in 5 years. More than doubled. Most would say that is a completely unsustainable course.

Let us go to the next. In the midst of all this, we are also running up the debt of the country in a stunning way. This chart shows what has happened to the gross debt of the United States since this President took over, and what will happen if the budget plan that is before Congress is actually enacted and implemented: the debt will skyrocket to almost \$12 trillion, and at the worst possible time, before the baby boomers retire.

Let us put up the final chart that is also, I think, striking. This chart shows the percentage of world borrowing by country. What it shows is, the United States is now by far the biggest borrowing nation. In fact, we have gone from being the biggest creditor nation in the world to being the biggest debtor nation in the world.

We were the biggest creditors as recently as the 1980s, now we are by far the biggest debtor nation. Of the borrowing that is going on in the world, we account for 65 percent of it. We are borrowing 65 percent of what is available to borrow.

Let me ask you, do you think this is a sustainable circumstance? Mr. PAULSON. Senator Conrad, as I look at the deficit, let me begin by saying that charts are put together in different ways, on a different basis, with different numbers. I do not understand all of the numbers you have up there, but let me just comment on the overall fiscal situation as I see it.

Like all of us, I wish our deficit was lower. But as I look at it, I am actually encouraged by the fact that, despite the bursting of the bubble and the recession in 2001, despite the war on terrorism in Afghanistan and Iraq and the corporate scandals, we are in a situation right now where our economy has been growing, and it has been growing for some time.

As I look at the fiscal deficit, roughly 2 percent of GDP, that is within a realm of historical norm. I think we are better prepared to do something about it when we have a growing economy. So, I look at that fact and say, is it an issue? Yes. Would I like spending to be less? Yes. Would I like the deficit to be less? Yes. But it is manageable. It is within the realm of historical norm, and we can attack it from the standpoint of a strong and growing economy.

The issue that I am most concerned about—not that I am not concerned about the deficit today, but the thing I am even more concerned about—is what Senator Baucus talked about in terms of what we have coming, with entitlements, Medicare, Social Security.

Senator CONRAD. Let me just stop you there if I could, because my time is running out, and just say to you, if you are not concerned about this massive growth of debt before the baby boomers retire, I will tell you, we have a much more sobering circumstance once they do.

I would just say to you, this notion that the deficit is manageable because it is 2 percent of GDP, what that leaves out, of course, is that the deficit is growing much less rapidly than the debt.

If you look at how fast the debt is growing, the debt is not going to grow by \$320 billion this year. The debt is going to grow by \$600 billion. We have completely left out of the calculation that you just mentioned the amount of money that is being taken from every trust fund in sight to float this boat.

So, I would just say to you, we have to be focused like a laser on what is clearly an unsustainable course of borrowing from abroad, borrowing from ourselves in amounts that are unprecedented, and before the baby boomers retire.

I thank the Chair.

The CHAIRMAN. Right now, Senator Wyden. Then after Senator Wyden, of those who are present now, it will be Snowe and Bunning, unless Schumer and Crapo come back before.

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Paulson, welcome. I very much enjoyed our discussion in my office, and I look forward to your service.

I want to begin by getting your thoughts on what can be done to improve the economic well-being of middle-class Americans in, I think, exceptionally difficult times.

The reason I say these are exceptionally difficult times is that this is the first time in decades, for example, when we have seen corporate profits up—we are glad to see that—productivity is up—we are glad to see that—but the middle class just cannot get

ahead. Their wages barely keep up with inflation. The Federal Reserve says that their net worth is hardly moving. In effect, those people are just living paycheck to paycheck, millions of middle-class folks who, say, make \$60,000 a year.

Now, I think what is needed are fresh policies that give everybody in the United States the chance to accumulate wealth. That is going to be pretty hard to do when Warren Buffett says that he, as the second-wealthiest fellow in America, paid a lower tax rate than his secretary. So to try to turn that around, I introduced the Fair Flat Tax Act. We talked about that.

And I think what I would like to do is set aside my legislation, or any other bill, but give me your thoughts on what you might be able to do in your position to improve the economic security, the economic lot of those millions of middle-class folks who are so hard pressed now to be able to get ahead.

Mr. PAULSON. Senator Wyden, I, like you, care deeply about the economic well-being of the middle class in America. As I have looked at this situation, I see an economy that is, as you said, strong, with good GDP growth, good growth in employment, good productivity growth.

I believe that it would not be at all unusual—as a matter of fact, I think it might be expected—to see employment growth and productivity growth lead, but then find wage growth follow that.

So, to begin with, I would be optimistic that if we keep this economy growing, we have good GDP growth, good employment growth, that we will see wage growth for the middle-class Americans that you are talking about.

Now, I do recognize that there are other factors. I do recognize that our economy is more and more connected to the international economy, and there is no turning back there. I do recognize how important education and training are to give our workers the skill sets they need to be successful in today's world. So, I think that is part of it, and that is something I know the President has emphasized. It is important.

To get to the issue of taxes and tax reform, I remember very well our conversation and some of your creative ideas. A number of members on the Senate Finance Committee expressed their views that they were hopeful that there would be an opportunity to look at fundamental tax reform.

That is something that I, if confirmed, really look forward to thinking about in a lot more detail, spending time with you, with others on the committee, and colleagues in the administration. But as I have learned, having good ideas is one thing. Having good ideas that are doable is another. So, I do not underestimate the challenge of fundamental tax reform.

Senator WYDEN. I thank you for that. As I indicated to you, my jump shot is not as good as Bill Bradley's, but I want to try to play that same kind of role that we saw several decades ago, about trying to drive down rates for everybody, but also create more fairness and opportunities for people to accumulate wealth. I think that is going to be essential for middle-class folks to get ahead.

Let me turn to the second area I want to discuss with you. I also serve on the Intelligence Committee, and I want to get your assess-

ment about financial privacy law, particularly as it applies to national security.

Now, as you know, the U.S. statutes, particularly the International Emergency Economic Powers Act, gives the President the power to investigate, regulate, or prohibit several categories of financial transactions if the President declares a national emergency.

Now, the administration has said that the President declared such an emergency in September of 2001 and delegated this power to the Secretary of Treasury. Now, I have looked at the statute. The statute calls, for example, that you make periodic reports on this.

But let me begin the discussion by your assessment of what really constitutes an emergency here. Does this mean that the administration can use these powers forever? How do we strike a balance here between fighting terrorism ferociously and still dealing with the expectation of privacy? How would you approach it, given the fact that this statute—and there are others—give you a role in trying to make sure that we strike this responsible balance?

Mr. PAULSON. Senator, I guessed I might get this question today, after reading all the newspapers. Clearly, I understand, just as you commented, how very, very important this war on terror is. I do understand the vital role that the Treasury plays in seeking to cut off funds from terrorists. I understand that; I realize how important it is.

I have obviously not been briefed on these confidential programs, so, if confirmed, this will be something that I am going to need to get my arms around very quickly, learn as much as quickly as I can.

You have laid out the issues. Financial privacy is an important objective. Protecting the safety of the American people is essential. When you really think about it, it is essential to preserving our fundamental freedoms. So what is the right balance? I am going to need to learn a lot, and I look forward to learning about this issue quite quickly.

Senator WYDEN. Does an emergency, though, strike you as something that just goes on indefinitely? Because that is what the President's authority is, to deal with emergencies. Again, I want to emphasize the need to fight terrorism as aggressively as possible. But how do you look at the concept of what constitutes an emergency in this effort to strike a balance?

Mr. PAULSON. Senator, I really would like the opportunity to reflect on that, consult with others, and learn the law. Clearly, an emergency does not go on forever. But I will tell you, this war on terror is a very serious matter today, there is just no doubt about it.

Senator WYDEN. It is, indeed. Your answer is a thoughtful one. I look forward to working with you on both this committee and on the Intelligence Committee.

Let me get into one other issue that we touched on in the office, and that is health care. As you tackle this question of entitlements, the fastest-growing piece of the entitlement equation, of course, is health care. There are no costs going up like health care costs in our country today.

What are some of your initial thoughts, again, as you just get into this, about health care cost containment?

Mr. PAULSON. Senator, there are many areas I am not an expert in, and you would probably need to put health care at the top of that list. I see the problem. Of course, as I have often said to people in my current job, do not come to me with just the problems. What are the solutions, and what are the workable solutions?

Clearly, some of the steps that have been taken, the HSA accounts, which can give the individual consumer a bigger stake in the outcome, are steps in the right direction. But I have not yet seen a credible, long-term, comprehensive plan for dealing with this, and I really look forward to learning more.

Senator WYDEN. My time is up. I would only say, in this health care area, for those middle-class folks that I was talking about, it is almost like two sides of the coin. The tax issue and the health issue go right to the heart of their economic security. I think we are going to have to have some fresh strategies on the table.

I happen to think that health savings accounts should play a role, but if we are going to do more in terms of wellness and prevention, one of the problems is, health savings accounts go just the opposite direction of prevention and wellness.

I look forward to working with you, and I thank you for your thoughtful answers this morning.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Wyden.

Now, Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

Welcome, Mr. Paulson, to this committee. We appreciate your willingness to serve our country at this time in the capacity of Secretary of Treasury. Certainly, you will have a leading role to play, both as principal advisor to the President, as well as key spokesman, on financial and economic matters that are truly at a pivotal point in our country.

You would be assuming the position of Secretary at a critical economic juncture, at a time of a confluence of events that you have already cited here today that have contributed to the historic deficits that we are now confronting in this country.

I am well-reminded of back in 2001, when we were projecting \$5.6 trillion in surpluses, and today we are at a point not only of historic deficits, we have had, the last 3 consecutive years, the highest deficit recorded in history. So, obviously we are at a troubling point in our Nation's economy.

I wanted to sort of explore your views with respect to, when do deficits matter, and particularly, which issues and which policies, whether it is spending or tax cuts, that contribute to increasing our deficits.

We have a dichotomy of views here in the Congress; it has been debated endlessly across America as well. But there are those who believe that deficits matter in terms of which policies generate the deficits, whether it is tax cuts versus spending.

Do you ascribe to this policy that deficits only matter when it comes to spending restraint, but not when it comes to tax cuts?

For example, just a few years ago, in 2003 and 2004, the deficit was at a historic high as a percentage of the GDP. Today it is a little bit less so; it is within historic norms, as you indicated.

For a few years, the administration was not concerned about addressing the deficit question when it came to tax cuts. Now it is interested in addressing the deficit question when it comes to spending restraint. Do you think that both should be considered in the context of reducing our deficits?

Mr. PAULSON. Senator Snowe, my view is, clearly, that deficits do matter. They are one of a number of things that matter, but they clearly matter, number one. Number two, I would say, going back to what the world was like after the technology bubble burst when this economy headed into a recession, I really do believe the right thing to do there was to say what really matters is growth, getting this economy growing, restoring confidence, getting things going. So now that the economy is growing and revenues are coming in, we are in a stronger position to focus on deficit reduction and focus on spending cuts.

Senator SNOWE. Well, do you think that we ought to be considering whether or not we should extend the tax cuts permanently in the context of that issue? That is one of the debates that is looming on the horizon.

That is what is affecting the estate tax debate when, originally, frankly, it was not logical to have made that temporary at the time, but we did. We have had an endless merry-go-round of tax cuts with sunsets that are scheduled to expire each and every year, so we have to consider the extension of these tax cuts. So we are in this perpetual cycle, unfortunately. Frankly, it is not responsible policy.

So we have had tax cuts in each of the last 5 years. Granted, we need to do it to stimulate the economy at certain points, but going beyond that, we are going to be facing, on the horizon, a \$2 trillion extension, essentially, to make these tax cuts permanent.

Do you think that we ought to be considering selectively which should be made part of our permanent tax code and those that should not, rather than just extending permanently all of these tax cuts that are going to have a tremendous impact on the deficit?

Mr. PAULSON. Senator, I appreciate your view there. I would just say that I think it would be a big mistake to increase taxes. This economy is growing, and jobs are being created. I think we are going to be in a stronger position to deal with the deficits when we have a growing economy.

Senator SNOWE. Well, would you agree with former Chairman Greenspan who said, last fall, in this whole context of discussing whether or not to extend tax cuts, that "we should not be cutting taxes by borrowing. We do not have the capability of having both productive tax cuts and large expenditure increases and presume that deficits do not matter?"

Mr. PAULSON. Alan Greenspan is a very wise man. I just would simply say, you are never going to get me to say deficits do not matter, because I know they do matter. I feel very strongly that we should not be increasing taxes now.

Senator SNOWE. Well, I guess it gets back to the question of permanency, because that does have an impact ultimately and weighs heavily, and particularly in terms of who these tax cuts benefit.

I mean, if you look at the tax cuts this year, 48 percent of the deficit is attributable to tax cuts. The top percentile, 73 percent, are benefitting from the tax cuts that had been passed extending the capital gains and the dividends.

So, the weight and the burden is going to fall on the low- and middle-income taxpayer, without question. So you have all of those issues. But in addition, just simply extending permanent tax cuts of more than \$2 trillion, irrespective of what the impact is on the deficit, I think, raises serious concerns.

The second issue is the question of sunsets. Should we be engaged in this masquerading the true size of the tax cuts by just simply sunseting these tax cuts every 2 or 3 years, and going back to the drawing board and extending them while we expand the overall size of the tax cut package?

Mr. PAULSON. Senator, I appreciate your point. You know how strongly the President feels about permanence and making the tax cuts permanent as opposed to sunseting them. I would just tell you, speaking from my experience on permanence, I am well aware of how important it is for families to be able, as they make their projections, to budget.

I have watched the private sector for a long time. I have looked at investment decisions, and they are forward-looking, whether they are made by individuals, small businesses, or companies. The private sector wants permanence.

Again, I just come back to what I said. I watched the role that the tax cuts played in getting this economy to where it now is, and I think we should all feel very fortunate the economy is growing. I believe tax increases would be counterproductive.

Senator SNOWE. Well, I think that some tax cuts certainly do, and I have certainly supported them for that purpose, and they do play a role. The question is, to what extent and how much, and who consistently benefits?

That is the concern, because ultimately the economy may be growing, but the average income of wage earners in America is not growing. It is not keeping pace with inflation. If economic growth is as it was this year, 5.3 percent the first quarter of 2006, 3.5 percent for all of 2005, wages are not keeping up with inflation. That is a fact. So the average wage earner in America is losing their purchasing power, and they are feeling it mightily.

That is a problem, because the economy has been growing for several years and there is a lag time between economic growth and wage growth. So, if we are in sort of a downturn here, then exactly when do their wages ever grow? It is further distorted by the picture of those tax cuts, and who they benefit.

When you have the top percentile assuming the greatest benefits from these tax cuts, that certainly weighs heavily on the average and middle-income taxpayer in America, not to mention all the wage earners who are in those categories as well.

Mr. PAULSON. Senator, did you want me to respond to that?

Senator SNOWE. Yes.

Mr. PAULSON. I think you raised two questions. The first one was the question that Senator Wyden had asked about middle-income taxpayers. I do believe, and I think you made the point, that the economic growth, job growth, productivity growth hopefully will be followed by increases in wage income.

You also made the point that rising health care costs and inflation eat into workers' income. You are right, those are considerations. So, again, I believe if we keep this economy growing and create jobs and opportunities, have the proper education, training, and so on, we are going to end up where you want to go.

Now, your second question was on progressivity, whom the tax cuts affect and how. I have discussed this with a number of you in the courtesy calls. I know there are different definitions of progressivity. But the U.S. tax code is progressive.

I believe, in looking at it, that the tax cuts have resulted in the wealthiest taxpayers, the highest-income taxpayers, paying a bigger percentage of taxes than ever before. At the same time, the lowest-income taxpayers are paying less, largely because we have the new 10-percent bracket.

So, again, I would not be increasing taxes. I do not think that is the answer to the issues we are facing. I think what we need to do is keep this economy growing and keep creating opportunities for the middle-income taxpayers.

Senator SNOWE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Schumer is here. After Senator Schumer, then Senator Bunning. Senator Crapo was here a little bit before, but we will go according to that, then.

Go ahead.

Senator SCHUMER. Thank you, Mr. Chairman.

Again, Mr. Paulson, I am glad you are here. I believe you will be a great asset to the administration, and I think they need you right now.

My questions are going to focus, first, on China. This cartoon that my able aide is holding up, if you cannot see it, it appeared in the *Denver Post* first, then the *Washington Post*. There is a gentleman there saying, "I am the new Treasury Secretary. Where is our treasure?" The answer is: "Beijing." That just points out the importance of the Chinese-American relationship in a whole lot of ways. It is funny, it is not so funny; you can use your judgment.

But here is what I wanted to talk to you about. First, is about currency and the currency issues. As I mentioned before, we had a pretty good relationship, Senator Graham and I, with Secretary Snow. He did not agree with our legislation, but he made it clear that something had to be done, and our legislation was helping move the Chinese.

One other thing. On the trip that Senator Graham and I made to China, we came to the conclusion that the Chinese know it is in their interest to let their currency gradually revalue.

They do not like change, they do not like instability. But with their current problems, currency revaluation, as well as other things, it would help them because they realize that they cannot just be an economy that sucks in foreign capital, changes it into ex-

ports, and then accumulates wealth. It is creating discombobulation within China itself.

So could you just give me your general views on the China currency situation and if it will differ in any way from that of your predecessor?

Mr. PAULSON. Senator Schumer, I have spent a lot of time in China. I agree with your assessment that the Chinese have made significant change, and they recognize that it is not only in our interests, that it is in their interests over time to have a more flexible currency. There is no doubt about it.

Now, as I think about the currency issue with China, there is the intermediate term, where China has a currency that is freely tradeable, set in the marketplace. This is where they really need and want to go, and where we and the rest of the world need them to go.

That is not possible until they have a modern, open, well-functioning capital market system and banking system. They have been moving in that direction, and they want to go in that direction.

We need to encourage them to move quicker because, in my judgment, they are not going to be as successful as they would like to be until they open that up to competition, in particular foreign competition.

If they try to just reform that with the internal players, the domestic players, it is going to take them a long, long time. So, I think we need to encourage them to do what they want to do anyway, encourage them to move quicker there.

Senator SCHUMER. Glad to hear you say that.

Mr. PAULSON. So, now, dealing with the immediate, I would give the administration and Secretary Snow a lot more credit than they are given by some people, because China has moved to accept the principle of the open capital account and a flexible currency, and that was a very big step in China. They see the need to show flexibility. So, again, I think we need to encourage them to move quicker there and show more flexibility.

Senator SCHUMER. No, I agree with you, they have made some changes. Even more heartening to me was, when we visited, they realize they have to go further. There almost seems—and I am not going to ask you to comment on this—to be a division.

The people who know economics and are involved in economics want them to move more quickly, and the people who are more political, mainly in the Communist Party, slow it down, not so much from a Communist doctrine, but they do not like change. They want it very gradually. A lot of these people cut their political eye teeth during the Cultural Revolution, and they are very much afraid to change.

On the other hand, they do not like instability. There is a lot of discontent in the inland of China because of almost the “two Chinas,” and this is something that will importune them to move.

But you brought up this second question I want to relate to, where we have less experience. On December 11, 2006, China will have to comply with WTO on financial institutions.

You are exactly right: the best way they can get there, on currency, but on a whole lot of other things—allocation of capital—in the most rational, efficient way, is to let foreign companies—as you

know better than anyone, we lead the world, and I say that proudly as an American and as a New Yorker—into their country.

I have had some experience with this with Japan, a different economy, but similarly reluctant until about 15 years ago. They are very slow. They are very slow. I mean, they agree with it in principle, but will say, well, the Governor of Hubei Province does not want to let Citigroup open up a branch in whatever the biggest city in Hubei Province is, or we are not sure that we should let Goldman Sachs come in and be able to freely underwrite or let Chinese companies bid on that freely.

Tell me your approach in that regard. I think it goes hand in hand with the currency issue, as you point out. It is brand new for us. Give me your prognosis, given your knowledge of China, as well as how willing they are going to be to open up at the beginning and what we can, as a country, do to increase the speed with which they do it.

Mr. PAULSON. Senator, one thing I see around the world, which is sort of an interesting phenomenon, is that every country globally that has opened itself up to economic reform, market-driven economic approaches, relatively free trade, open markets, has benefited, and the rest have been left behind.

Yet, in almost every country, there is strong protectionist sentiment, and there is strong protectionist sentiment in China. There are some people, people you were talking with, who understand what good economic policy is and believe it makes sense to open up, yet there is strong protectionist sentiment there.

To me, you are going to find everywhere that the incumbents resist competition. However, competition is a great thing for any society. What we are going to have to do, and have to do it fairly aggressively, is encourage the Chinese to do what not only is in our best interests, but clearly in their best interests.

While they are a sovereign nation and they are going to make their own decisions, it is clearly in their best interests because, until they have a fully functioning financial system, a modern financial system, which they do not have now, they are not going to be able to have a currency that trades in the competitive marketplace. So that is why this has to be a big part of the focus, the intermediate focus, in addition to the immediate focus of getting more flexibility with the renminbi.

Senator SCHUMER. A final question on a different issue. This is a little more parochial. It is on terrorism insurance, something we have talked about, wearing your other hat, your previous hat as head of Goldman Sachs.

There are 18 months left in the Terrorism Risk Insurance Extension Act. Many of my constituents, who tend to be in real estate, financial services, and other issues in New York are concerned that we will not be able to secure adequate coverage after 2007 unless Terrorism Risk Insurance is extended. They can get coverage at some ludicrous price, but it really puts a premium against us.

So one of the first things you are going to have to do, wearing your hat as chairman of the President's Working Group on Financial Markets, is to review the future availability of terrorism insurance. I think your working group is going to have to report back on September 30 of this year.

What will be your approach to tackling this vital issue? How do you see the debate moving forward? Are you of the view that terrorism insurance is not needed any more, which I hope you are not?

Mr. PAULSON. Senator Schumer, just as a general proposition, like you—and I think probably everyone on the committee—I believe that wherever possible, the best way to do something is in the private market. That is the most efficient means, and that is the best way to do it.

Now, clearly, right after September 11th, it was difficult or impossible to get terrorist insurance, so we clearly needed that. I was very supportive, as you know, in 2005 when the administration made the decision to extend it.

Right now, I really look forward, if confirmed, to spending time with this working group, getting more of the facts, and understanding where things are, because it is not obvious to me that we need it today, as it was before. But that does not mean we should not.

So again, I just look forward to learning more and to having an opportunity to talk more with you before coming up with a view on this.

Senator SCHUMER. Thank you. Again, as I said, I think you are going to be an outstanding Treasury Secretary, and I hope we can move and confirm you this week so you can get right to work next week on all the issues we care about.

Mr. PAULSON. Thank you.

The CHAIRMAN. Thank you, Senator Schumer.

Now, Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

First of all, I would like to put my opening statement into the record, please.

The CHAIRMAN. Without objection. Let me announce that anybody who had a statement that they wanted included in the record, it will be.

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

Senator BUNNING. Thank you for being here, Mr. Paulson. I really appreciate the fact that you are here. I have some questions, in follow-up to Senator Schumer's, on China.

Under the current law, in order to identify a country as a currency manipulator, the Treasury must find that a country is not only influencing its currency, but also that it is doing so with the intent to gain an advantage over its trading partners.

Secretary Snow has repeatedly told me, and also this committee and the Senate Banking Committee which he has testified before, that the Treasury Department is unable to determine this intent requirement. Because the Treasury has not found evidence of intent, they have failed to cite China as a currency manipulator.

Can you comment on this intent requirement as it stands in current law?

Mr. PAULSON. Senator Bunning, first of all, I appreciated the opportunity to talk with you about China earlier. I know how strongly you feel about it.

I am not an expert on the law. That is one of the things that I look forward to being briefed on in some detail and, if confirmed, talking about with my colleagues in Treasury and with you.

But again, to me, the issue here is to encourage the Chinese to show more flexibility with their currency. You and I share a common objective, and a big part of my job in working with China will be to help realize the objective that you and I have for there to be more flexibility with regard to their currency.

Senator BUNNING. All right. In the early 1990s, the Treasury cited China twice as a currency manipulator. As far as finding intent on the part of China, what was the difference in the 1990s as compared to today?

Mr. PAULSON. Senator, I cannot answer that question. I know that in the 1990s there was a far different economy in China than there is today. There have been tremendous changes in the world, tremendous changes in China.

Today, China is far along in its economic reform, and China has recognized the principle of an open capital account, of a flexible currency. But as I said earlier, I am not an expert on that law or on what was the basis of the Treasury decision in the 1990s, or even the more recent one.

Senator BUNNING. Well, let us talk about, since the beginning of 2006, reports on China have been published by the Treasury Department, the Defense Department, and the U.S. Trade Representative. China's enforced over-valuation of their currency has far-reaching impact for the United States, not only in economic terms, but also for national security.

Yet, these reports leave the impression that these agencies have not worked closely together to fashion a consistent response to China's concerted action to under-value its yuan and the activities that rely on this misalignment.

For example, without the enormous currency reserves China has amassed, due in large part to its yuan under-valuation, China's ability to purchase sophisticated military technology would be more limited.

Do you believe that our Federal agencies have been working together in a manner appropriate to address the broad and interconnected challenges posed by China?

Mr. PAULSON. Senator, I have not had a first-hand view, so I do not want to comment on how our agencies have been working together.

Senator BUNNING. All right. Under your leadership, will you, as the head of the Treasury Department, take further measures to achieve greater coordination in this regard?

Mr. PAULSON. Senator, I do not know whether measures need to be taken to achieve greater coordination, but I am a team player, I am someone who believes in coordination. So, I look forward to collaborating with my fellow Cabinet members, if confirmed, to think through the right approach to China.

Senator BUNNING. Well, but see, that is the judgment we have to make in making the confirmation judgment, whether you will or whether you will not.

Mr. PAULSON. Senator, I tried to answer that question and said I believe my role, if confirmed, will be to be part of a team, where I work closely and collaborate with other Cabinet members.

Senator BUNNING. Mr. Paulson, as you know, the Fed is scheduled to meet again this week, and it is anticipated that we will be facing yet another increase in the Fed fund rates.

If this does happen, it will be the seventeenth straight increase, over 400 basis points in the last 2 years. Some feel that the effect of these increases is already starting to become evident in the deflating of the housing market, shaky consumer spending, and weakening economic growth.

As someone who has been closely involved with markets for years, can you comment on the effect that interest rates, pushed too high, too fast, can have on investors and the economy in general?

Mr. PAULSON. Senator Bunning, I have a very high regard for Chairman Bernanke, so I have strong confidence that he is going to do what is right to maintain price stability consistent with long-term growth.

Senator BUNNING. Well, see, some of us do not have the same high regard for his decisions—not him personally, but for the decisions that the Fed has made over the last 2 years.

I am looking at a prime rate very close to 9 percent, if in fact they do raise the Fed fund rates. We are looking at 8.75 percent prime. There are not too many Americans that are listening to this broadcast today that can borrow at prime. It is usually prime plus 1 or prime plus 1.5.

I get worried every time we get near 10 percent, because the economy does not react well to a 10 percent prime rate. I am sincerely worried that they are going to overstep, like they did in the early 1990s, like they did right after the bubble burst, or right as the bubble burst.

Mr. Paulson, as you know, the Treasury Department influences our export policy with Cuba through the Office of Foreign Asset Control. I have been very supportive of the positions taken by this administration in these matters.

Under your leadership of the Treasury Department, do you anticipate major changes in the United States' policy towards Cuba and the embargo?

Mr. PAULSON. Senator Bunning, President Bush's policy and position here is very well known. As Secretary of Treasury, I know that my job would be to enforce the law.

Senator BUNNING. All right.

In 2001, the Congress enacted several important cuts, including a package of incentives to encourage retirement savings. The package includes such items as increasing IRA and 401(k) contribution limits, and allowing catch-up contributions by older workers.

With more than 70 million baby boomers headed into the golden years, these incentives are an important way of helping them pave the way for a more comfortable retirement. However, these incentives expire at the end of 2010.

The House-passed Pension Reform bill includes a permanent extension of these provisions. I hope that the conference report we see on the Pension bill will include these extensions.

Mr. Paulson, how important is it to the country's future that we find ways to encourage Americans to save and invest for retirement? Is the confusion about the rules from year to year limiting the effectiveness of these incentives, or is it not important?

Mr. PAULSON. Senator Bunning, as you and I discussed, I think there are few things that are more important in the economic sphere than getting our savings rate up and encouraging Americans to save. So, we have no disagreement about that. That is very, very important.

Senator BUNNING. Thank you, Mr. Chairman. My time has expired.

The CHAIRMAN. Senator Lott? Then if nobody else comes, we will have a second round of 5 minutes each.

Senator LOTT. Thank you, Mr. Chairman. I will not take the full 10 minutes, hopefully, because I know you have had a full morning. But I want to thank you, Mr. Chairman and Ranking Member, for moving forward with this hearing.

This is a very, very important position for our government and the President's Cabinet, and I think we should, barring any problems, which I do not see, get this confirmation done as soon as possible, and hopefully before we go out this week. So, thank you for scheduling the hearing this morning.

Thank you, Mr. Paulson, for being willing to take on this assignment. I know that perhaps there were some reservations, perhaps from your family, about this position for a while. But thank goodness, you are doing it. You are doing the right thing. We need you. I think you are absolutely the right choice for this very critical position at this time.

We will overlook the fact that you obviously were a cradle robber, having been married 37 years, to such a young lady. That is very impressive, showing good judgment, once again, on your part.

But I am excited that you have agreed to take this assignment. It is a very critical one. You know what the issues and the problems are that we face, but your background, your experience in administrations over the years, your experience at Goldman Sachs, your education: you have everything we need in this very important position, so I congratulate you on your nomination and certainly will vote for your confirmation.

Now, just a couple of issues that I do want to address. Number one, I am sorry I missed this, but you have identified, I am sure, some of the priorities you intend to focus on when you are confirmed.

Would you kind of just quickly enumerate that once again, and maybe expand on it, if you would like to take a couple of minutes to do so?

Mr. PAULSON. Senator Lott, as I think about this job, I probably have the same objective you do. I would like my grandchildren—who, to the best of my knowledge, are not yet conceived, so you can see I am an optimist here—to grow up in a United States where they have the same opportunities that I have had.

As I think about that, I would be hopeful that there will be some things we can find, all of us together, in the next 2½ years that will be practical and actionable to help maintain and enhance the competitiveness of the U.S. economy.

Then there is a second topic that Senator Baucus brought up, which is looking to some of the really formidable long-term economic challenges this country faces. Here we are talking about entitlement spending potentially leading to very big deficits, given the aging of this country's population, and with health care costs rising as quickly as they are, when you look at Medicare or Social Security. So, one lesson you can learn in looking around the world is, if you do not deal with these issues early on, they are more expensive—much more expensive—to deal with later.

There are also other big, formidable issues that we need to address, such as the need for energy security, energy independence. Again, this is a difficult, long-term, very important issue. The fundamental tax reform, which again is not an easy issue, is another critical issue that a number of you have talked about.

So when I think about these issues, it would be quite naive to say that they could be addressed and solved in a 2½-year period. Nevertheless, I look forward to learning more about them, talking with my colleagues in the Cabinet, with the President, talking with all of you, and hopefully making some recommendations to the President. Then the question is, what is doable? At least beginning to seriously address some of these issues hopefully will be helpful.

Third, if confirmed, I would plan to be active internationally. I am looking to work with some of my counterparts around the world in managing some of the global imbalances. In addition, I see a need to keep my finger on the pulse of the global economy, and again advocate reforms, policies, and actions that will create economic opportunity, particularly for U.S. products, U.S. investments.

Senator LOTT. Well, thank you. That was very, very interesting. I think you touched on all the right subjects. I have four grandchildren, and it does change the way you view things.

I feel very strongly that we are going to have to, at some point, find the leadership and the courage to address some of these long-term issues like Social Security and genuine tax reform. The odds are, minutiae are going to gobble you up, just because there are going to be so many things coming at you.

But I hope that you will make sure that you take the time to also provide us some visionary leadership and that you communicate that directly to the President of the United States, because we have some big issues we do need to try to address. It is so easy in this city just to get involved in trying to keep paddling instead of taking the big leap. So, I hope that you will consider that.

You have been a supporter of extending the 15-percent tax rate on capital gains and dividends. In fact, I think I met with you a year or so ago and we talked about that. Basically, you said it is unthinkable that you would not do it, because the markets have already factored that into their thinking, that it was going to happen.

You do still feel that those are very important provisions and support the importance of getting that done, do you not?

Mr. PAULSON. Yes, Senator. I view those as being very fundamental, because I have just seen biases in the corporate tax system. I think those changes in the tax law eliminated or minimized some of those biases.

Senator LOTT. Right.

One point of personal privilege. I am from Pascagula, Mississippi, the Mississippi Gulf Coast, the area that was devastated by Hurricane Katrina. You and I had a chance to speak briefly about that. I think you are looking for some ways to have some public/private efforts to help in the recovery, and I thank you for that.

I want to bring to your attention the need to extend the bonus depreciation provisions of the Gulf Opportunity Zone, the GO Zone. I think this is going to be very critical as we look to recovery, retention of jobs, and the creation of new jobs.

We need to have the deadlines extended beyond 2007, the end of 2007, and synchronized with the other provisions on the GO Zone and extended to December 31, 2009. I hope you will take a look at that and be supportive of our effort.

I look forward to working with you on trying to come up with some other innovative ideas of how we can have public/private partnerships to help the New Orleans and the Mississippi Gulf Coast areas to recover.

Mr. PAULSON. Thank you very much, Senator Lott. I look forward to working with you on those issues, I really do.

Senator LOTT. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

We will have a second round of 5 minutes each.

To the point that Senator Lott just brought up, that issue is still in conference between the House and Senate, and it will be something that will be discussed just as soon as we get the conference on pensions done.

Senator LOTT. When will that be, Mr. Chairman? [Laughter.]

The CHAIRMAN. Mr. Paulson, you have talked a lot about China. I do not want to go back to specific issues on China, but Senator Baucus and I have introduced a bill that would change the 1988 law that has been our policy, because we feel that the President does not have sufficient authority to deal with problems like China.

But I do not want to concentrate on China, because I think if our legislation had been in place 20 years ago we would have been talking about Japan, and who knows, 20 years from now, what country we might be talking about other than China.

But there was a 2006 economic report of the President attributing the trade deficit, in part, to China's foreign exchange regime. The report said that the President plans to push for greater exchange rate flexibility in Asia, including China, along with financial sector reforms.

Do you have any sense of whether our current legal framework for oversight of currency exchange rates, which dates back to 1988, is sufficiently strong enough to help the President to achieve his stated goal, and do you have any opinion on whether our bill, meaning to strengthen and improve laws in this area, would be helpful?

Mr. PAULSON. Senator, I need to learn more, and I look forward to learning more, about the legal framework, if confirmed.

The CHAIRMAN. All right.

Mr. PAULSON. I look forward to talking with you about that.

The CHAIRMAN. All right.

You may not have an opinion on our legislation. Does your answer apply also to our present policy, based on the 1988 law, whether or not that is adequate?

Mr. PAULSON. Yes.

The CHAIRMAN. I would like to ask a question about the back-dating of stock options. That has recently been in the news, executives of major corporations doing that.

I would like your general views on this and your commitment that Treasury and IRS would make it a priority to go after tax due and owing, as well as applicable penalties, from both individuals and companies that engage in the transaction.

Besides your opinion, I would like to have kind of an expansion in the form of some sort of a report 30 days after you are sworn in on what Treasury and IRS has been, or will be, doing in that area.

Mr. PAULSON. Senator, if confirmed, we will definitely get back to you on that topic.

Now, my general view is, as you know, executive compensation is a very, very sensitive issue. When there are abuses, it undermines confidence in our whole system and undermines confidence in the corporate sector. So, I have been very disappointed, to say the least, to read some of these stories.

Now, again, I do not know the facts. I have not investigated these stories. I have just read the same press stories that everyone else has been reading in this area, but I have been disturbed to read them, number one.

Number two, I know—again, from what I have read, not from first-hand conversations—that the SEC is very involved here, and I know a number of other enforcement groups are very involved.

So one of the things I will do, if confirmed, is talk with Chairman Cox at the SEC, talk with others in the administration, obviously talk with the people at IRS and make sure that I am up to speed on this topic, that we are dealing with it in an appropriate way, and that we are discussing it with you and reporting back to you.

The CHAIRMAN. Thank you very much.

On another area, I have been involved with legislation protecting whistle-blowers over a couple of decades and was the author of the False Claims Act of 20 years ago. One of the loopholes in the False Claims Act is that it does not apply to tax matters.

Now, there may be some good reasons why we should be cautious about having the False Claims Act apply to whistle-blowers in tax matters. It is clear to me that the government and the people can benefit significantly by making good use of whistle-blowers in tax cases.

The IRS already has clear legislative authority to have a broad-based program to reward tax whistle-blowers. What the IRS has not had, is a clear, cited management that has taken full advantage of the possibility of tax whistle-blowers.

A recent report by TIGTA said that the matter has only made it all the more clear that there are great benefits to rewarding tax whistle-blowers, and that the IRS and Treasury have fallen down on the job of using that.

Based on this report, cases based on whistle-blowers are far more productive for the IRS than other cases. The return to the Treasury

for dollars per hour worked in cases from whistle-blowers is \$946, compared to \$548 for IRS regular cases.

In addition, the no-change rate is about a third lower for whistle-blower cases, meaning that whistle-blower cases are more likely to target tax cheats and not bother honest taxpayers as compared to regular IRS audits.

So, since you are a smart business person, and I mean that from the heart, does common business sense not suggest that we should be encouraging a program that is highly productive, more productive than normal IRS exams, and has a lower no-change rate that is less likely to hit innocent taxpayers? Unfortunately, the exact opposite has happened at Treasury.

Now, this report recommends that there be a centralization of whistle-blower work at the IRS and other points. But I would say to you, Mr. Paulson, that this is the tip of an iceberg, that we need to have leadership committed to moving this along.

So I would like a commitment from you that you will ensure that there is leadership to make this program a success, and that the necessary reforms will happen now, right now, to make this a success. This is another one of those things where I am kind of tired of waiting on the bureaucracy.

So, I would appreciate very much a time line, along the spirit of Senator Baucus asking for things to get done on time, that this important work be done, and that we have a written response to the committee in regard to this, and your nomination in regard to this.

Mr. PAULSON. Mr. Chairman, I know how strongly you feel about this issue and how important closing the tax gap is, and cracking down on tax cheats. I share all those objectives.

I will just ensure you that, if confirmed, this is an area I will look into very, very quickly. I will make sure I understand all the issues. I will follow up with you on it. I just know how much you care about it. You know more about it right now than I do, and I look forward to learning.

The CHAIRMAN. All right.

What I would like to have, and you have answered it well, and I believe in your intent, but if we could just have along the lines of a previous request that Senator Baucus made, not exactly on the same thing, but a time line in which certain things might be done in this area, not that you have to have a complete response to me on how it be done.

But it is the law, there is factual basis for it, and I think it is just a point of giving us a plan and how you work it out. This is not going to close the entire tax gap that Senator Baucus is talking about, but it is going to help.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Paulson, this means a lot to this committee, the tax gap. When Commissioner Everson was before the committee not long ago, the Chairman and I asked the Commissioner to give a plan to this committee by the end of this fiscal year, on which we will have hearings shortly thereafter, the plan which outlined the dates by which we can achieve certain results in getting this tax gap closed.

I know as the chief executive of a major company, that is the way executives think. They want a plan; as you mentioned earlier, do not bring me the problems, but if you do, bring me the solutions. We are asking for the solutions, and how do we get from here to there.

You are going to find us very reasonable, but also very firm. My general view on most subjects is, be fair, but firm. We have set a firm date, the end of this fiscal year, September 30, by which we want this plan for the IRS and how they are going to close the gap, and that plan will include dates by which certain actions have to be taken to achieve certain numerical results to get this tax gap down.

So I am asking you, will you commit to this committee to assure that that plan is put together, and work with us when we have our hearing?

Mr. PAULSON. Senator, I will sure commit to be on top of this and to understand the issues and what is doable. I think it is difficult, and maybe imprudent, for me, before I am confirmed and before I have had an opportunity to talk with the people at the IRS to understand where they are and what the issues are, to commit to some plan I do not know all the details of.

Senator BAUCUS. I am asking you, you are going to be confirmed quickly.

Mr. PAULSON. Yes.

Senator BAUCUS. You are going to have a couple of months to work on a plan.

Mr. PAULSON. Yes.

Senator BAUCUS. I am asking you just to help make sure that plan is, in fact, submitted on time. You will use your best judgment as to what is in the plan, working with the Commissioner, but we need to get moving.

Mr. PAULSON. Senator, I hear you. I will tell you, I understand the important oversight role you have, and I believe in working very closely with you. I am surely going to do everything I can to be responsive to that.

Senator BAUCUS. But can you commit to have a plan here by September 30?

Mr. PAULSON. To have the plan here?

Senator BAUCUS. Whatever. You have a big role in what that plan is going to include.

Mr. PAULSON. The only reason there is any daylight at all here, is one of the things I have tried to do all my life is, rather than over-promising and under-delivering, to under-promise and over-deliver.

Senator BAUCUS. Well, we are expecting you to over-deliver on September 30.

Mr. PAULSON. So I hear you, and I want to be as responsive as possible.

Senator BAUCUS. Thank you.

Mr. PAULSON. I just would like to have an opportunity to talk to Commissioner Everson.

Senator BAUCUS. Yes.

The CHAIRMAN. You and Commissioner Everson think that we are expecting you to close the tax gap by October the first. We are

not doing that. What we are trying to do is, tell us a plan and time lines on how you are going to do that. We only want the plan and the time lines by October 1.

Mr. PAULSON. I got it. I understand that. It is an interesting thing on the tax gap. I will just say this.

Senator BAUCUS. Briefly, because I have another question.

Mr. PAULSON. All right. Sorry.

Senator BAUCUS. The other question is equally, I think, sensitive and important, and that is the role of the Treasury in the SWIFT issue.

It is my belief that there is a pattern and a practice in this administration of challenging the Constitution's Fourth Amendment protection against illegal search and seizure; first we had the NSA tracking phone calls, now Treasury looking at financial records.

Frankly, the first thing I did after reading about the SWIFT program, was write a letter to the President asking whether the same methods are being applied to the tax records of American citizens.

We have, as you know, procedures in place that make it tough for the government to troll through our tax returns, to make sure that their privacy is protected.

This is delicate, but it is extremely important. It gets to the constitutional question of the role between the Congress and its oversight roles and the executive, but also the Constitution, the Fourth Amendment. What is a prohibition against illegal search and seizure in the Fourth Amendment mean in this case?

I think you will agree that we could fight terrorism properly and adequately without having a police state in America; frankly, we are strong because we are not a police state. Other countries have failed because they were police states. We have to work ever harder, mightily, to find how we strike that balance.

My sense is that it is lopsided now. The executive has just, willy-nilly, done things it wants to do without sufficient sensitivity to the Constitution, and I am speaking here about the Fourth Amendment.

So I would like you to do a few things, please, a few simple requests. One, is that you personally review this program if you become Secretary of Treasury. That is, the commitment that you will personally review it.

Do I have that assurance?

Mr. PAULSON. You do.

Senator BAUCUS. Second, that you ensure every law related to these inspections is followed, that the law is followed.

Mr. PAULSON. We clearly need to follow the law.

Senator BAUCUS. And I have the assurance that you will ensure, to the best you can, that that is the case?

Mr. PAULSON. To the best I can, absolutely.

Senator BAUCUS. Do you commit also to regularly brief the Finance Committee about this program? I am not asking about the full committee, but to brief this committee. Because after all, you are here because we have oversight over the Treasury.

Mr. PAULSON. Right.

Senator BAUCUS. So will you commit to that?

Mr. PAULSON. And you are talking about which program?

Senator BAUCUS. I am sorry?

Mr. PAULSON. You are talking about which program?

Senator BAUCUS. I am talking about SWIFT, and also my request to look at whether the administration is using the same basic methods to examine tax returns.

Mr. PAULSON. All right. Let me just make a couple of comments on that.

As I said earlier, I really understand how important this war on terror is, and I understand the Treasury Department has a very major role. If confirmed, I will also have a very major role to understand that and to help drive that. So I think that is very important.

I believe very strongly that you have your oversight role; we need to communicate, I need to communicate, and the communication has to be done through the proper channels. I do not know enough now about the security issues, and others, to say exactly how that communication should take place. But I will tell you, I understand it needs to take place through the proper channels.

What I have been told, and I clearly believe this to be the case with regard to the IRS—and you would know a lot about that law, because this committee writes the law—there is a strong legal right to privacy, and my job is to enforce the law there.

Senator BAUCUS. This committee was not informed about the SWIFT operation, even though we have jurisdiction over the Treasury. The Treasury did not inform this committee about that massive operation, where billions of dollars change hands worldwide daily. I am asking you to change that and inform this committee.

Now, I am not saying exactly what you tell this committee, but you can certainly inform us of certain operations, and we can take the next steps to see what the proper information should be.

The same would apply to IRS material, that is, the degree to which the administration is also trolling, looking at, surveilling, IRS records without American taxpayers knowing, and without this committee knowing.

We have to know because we represent Americans. We run for office and we seek these positions because we want to do our best for our people. You do not face the voters, we do. I say that because it is the voters who are in charge. We are the servants, we work for them.

I, frankly, sought this position I have, ran for public office, in many respects because of a deep reverence for the Constitution and civil liberties, and the Bill of Rights, including the Fourth Amendment.

I believe that the strength of this country very much depends on adherence to the basic principles in the Constitution. It takes work. It is difficult.

It is easy for administrations to kind of push some of the protections in the Constitution aside, or to fudge, because it is expedient to. It is messy, it is difficult, it is hard work to deal with some of the Constitutional protections, but it is necessary for a strong government.

So I am asking you to just go the extra mile to make sure that happens and to inform this committee of any operations along the lines of SWIFT, IRS, or whatnot from the jurisdiction of the Treasury.

As I said, we could then get to the point we discussed, and I am urging you to go the extra mile. We will protect and respect what you say, because we are all working together for the same purposes.

If that includes any changes in the law that you think are necessary, then we are asking you to tell us that, if times have changed, new surveillance techniques are necessary, or whatnot. Whatever you suggest, if you think there need to be changes, let us know.

I am quite disturbed, frankly, that the administration did not suggest any changes to this Congress with respect to telephone surveillance, not any changes with respect to the FISA court.

As you know, we have a system—this is not in this jurisdiction—called the FISA courts, where the executive branch has gone to the secret court—it is not secret, but its proceedings are secret—and that court has, 99 percent of the time, agreed to any request that administrations have made with respect to electronic surveillance.

This administration did not use FISA. It did not go to it at all with respect to the recent telephone surveillance, I think, basically because it found it inconvenient. I understand there is a war on terrorism. It is pretty hard to speak up about protection of American privacy, because people will say, well, you are for terrorism.

Of course we are not for terrorism. Of course we are not. Of course we are trying to fight terrorism as much as we possibly can. But this is democracy. It is hard. It is not a police state. We have to work even harder to make sure it is done properly.

The CHAIRMAN. Did you want to respond?

Senator BAUCUS. Maybe one minute or two, but no more, Mr. Paulson, if you have any thoughts on what I just said.

Mr. PAULSON. First of all, I understand clearly what you have said. Second, I will not repeat what I have said before about how important the responsibilities are, with respect to the war on terrorism, and about the SWIFT case, the details of which I have read in the newspapers, because it clearly would be inappropriate for anyone to brief me on that before confirmation. So, I understand the points you have made.

If confirmed, I am going to get up to speed on this issue quickly and make sure I learn everything there is to learn, make sure I understand the law thoroughly. Let me say to you, I appreciate what you said about our rights and freedoms. I really believe that there is a very important right to safety, and I really do believe protecting that right is going to be fundamental to protecting other rights and freedoms.

So, I am not debating it with you. I am looking forward to learning about it, if confirmed, and I am looking forward to talking to you about it more in the future.

Senator BAUCUS. I appreciate that. And, as you are learning, you are agreeing, are you not, that you will regularly inform this committee of actions that Treasury has taken in these areas?

Mr. PAULSON. Yes. I totally agree that we need to communicate, and we are going to figure out the proper channels to do that.

Senator BAUCUS. I appreciate that. Thank you.

The CHAIRMAN. Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Paulson, I had asked you earlier about the issue of financial privacy and national security. Let me pick up on what Senator Baucus has been talking about as well.

First, I do think it was constructive, in answer to my earlier question about this question of emergency powers, emergency powers that are granted under the International Emergency Economic Powers Act, that you had stated that emergency powers do not last forever.

I think that that is a constructive step and is a key element of what I and other Senators want to see, and that is striking a balance between fighting terrorism ferociously and protecting privacy.

But there is another issue that has not been addressed, and I have seen it again and again in my work both here and as a member of the Intelligence Committee, and I want to get your thoughts on it.

The key statute in this area, the National Security Act of 1947, states that the executive branch keep Congress “fully and currently informed” about intelligence activities.

So what that means is, I, as a member of the Intelligence Committee, should be “fully and currently informed.” But what happens is, usually the Intelligence Committee, and even some of the leadership in the Congress, basically does not hear in a current fashion. We hear at the last minute, when a program is about to be described in the paper.

So, I think we need to get at this issue, and I would like to hear your thoughts about what constitutes keeping the Congress—and in this case it is the Intelligence Committee, on which I serve—currently informed?

Mr. PAULSON. Senator Wyden, let me make a couple of points. But let me go back, because I do not want you to misread anything in my statement, which was, I think, a truism. It is intuitively obvious that, by definition, an emergency power cannot last forever, or then it would not be an emergency power.

But I certainly did not mean to imply that we were not in an emergency situation right now because, as a matter of fact, I do believe that this war on terror is very serious, very real, and there is nothing more important. As I said, I think the rights to privacy are quite important. I think the right to safety here is essential.

But putting that aside, because I just did not want that to be taken out of context, since a number of people, Chairman Grassley, Senator Schumer, were gracious in saying that I was an expert on financial matters. You serve on the Intelligence Committee. I really have a lot to learn about intelligence.

In other words, I have had no experience there. I have not been briefed on the law. I am not a lawyer. So I really do think it would not be a very productive exercise for me to be speculating about these issues and what the right channels are for communication under the law, and so on, in this area.

I think, really, the right way for me to leave this, is that this is the area that I have the most to learn about. I realize how important it is. I look forward to learning about it, and I really look forward to talking with you about it.

Senator WYDEN. Well, I consider you to be very sincere in your approach to these issues. I would only say, and that was why I

asked the question earlier, and come back to it today, this means a real effort, in a bipartisan way, to look at what is being done anew to strike the right kind of balance, because this committee, certainly the Intelligence Committee, wants to ensure that the government has the tools to fight and win the war on terror.

But we also have to comply with the laws of the United States, and that was why I read the 1947 law that says “currently keep the key committee,” the Intelligence Committee, “informed.” That has not been done.

I often joke, the way people find out on the Intelligence Committee about what is going on, is you buy a subscription to the newspaper. That is unacceptable. You have said you will look into this, and I appreciate it.

Let us talk about one other issue that I know you are interested in and have a lot of history in, and that is the environment. I want to talk about how you could play a real role as Treasury Secretary, particularly using marketplace forces, using the private sector, to help green up government and to create good-paying jobs.

The area that I am especially interested in your thoughts on is the global trading market in carbon credits. This is the market that allows for the opportunity to reduce pollution and create good-paying jobs, and it is a very fast-growing market, and it is growing quickly, in spite of the fact that the United States has largely been on the sidelines.

At this point, it looks like the market will be a \$40 billion per year business worldwide. Because you have consistently, under your credit, said that good environmental policy is also good business, I would like to hear your thoughts on what you could do as Secretary of Treasury to help the United States get into this very large, growing global market for carbon.

Mr. PAULSON. Senator Wyden, when I went around and made courtesy calls, my interest in the environment came up. It came up with people on both sides of this issue, those who agreed with some of my personal views and some that did not.

One of the first things I said, no matter which side someone was on, is the President of the United States has nominated me to be Secretary of Treasury. He has not nominated me to be Secretary of the Interior, and he has not nominated me to be head of the Environmental Protection Agency.

The really big focus I am going to have, if confirmed, will be in dealing with so many of the issues we have been talking about today, the economic issues that are on all of our agenda.

Now, as you have said in your comments, I have personally looked at climate changes as being an issue. This is a very significant issue for this planet. I have said that good economic policies go hand in hand with good environmental policies. I do not think they are in conflict; I think they are the opposite side of the same coin.

As you said, I am a believer in market-driven approaches. I believe that one of the big answers, as the President has said, is going to be investing in technology, and I believe we are going to have to invest in technology big time. We are going to have to invest in renewable fuels, alternative energy sources, all of those things.

Now, in terms of trading carbon credits and emission credits, that was a market-driven approach, and Goldman Sachs had some experience there, largely in Europe, but to a small extent in the United States. That is a market that may develop.

I had not actually thought much about what the Treasury Secretary should be doing in that capacity, because that is not going to be a major focus for me relative to some of these other issues that are going to require a lot of time and attention.

Senator WYDEN. I understand that. That is why I wanted to save it for last. But I think that we all understand that, in the international trade arena where you are going to have discussions, this is a chance to look at businesses that are clean energy business opportunities for American citizens to get high-skilled, high-wage jobs.

That is something we all understand has bipartisan support around here. Probably the best way to ensure that you have influence in this area is for characters like me to give you a little breathing room to have a chance to get at it.

I just hope that you can help green up government using private marketplace forces as you go about your activities in the international trade arena, because I do think, at the end of the day, this is about something that is indisputably good for our country. It is about creating good-paying jobs in an area that all Americans are looking with great interest at, and at the same time improving our quality of life.

But I thank you. I have probably given you as many questions this afternoon as anybody, other than the Chairman and Senator Baucus, and it is because I very much look forward to working with you on a variety of fronts. I thank you for the discussion today, and I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Wyden.

We are done now. I was going to have one more question, but Senator Wyden really asked it. To repeat your answer, I think it would have been an answer that would have satisfied my question, that you are nominated to be Secretary of the Treasury, not to be head of the EPA, not to be head of the Interior Department. Right?

Mr. PAULSON. Absolutely.

The CHAIRMAN. I think you have such a good environmental interest, record, and reputation that precedes you, that probably the superintendent of that building you will be in down there is probably right now figuring out how he can gain your favor by having a bird-watching station built for you by the time you get sworn in, I would guess. [Laughter.]

Anyway, let me close with just some administrative things in regard to this nomination, some for the committee members, some for the entire Senate, and some for Mr. Paulson.

Our goal is to report Mr. Paulson out of this committee as soon as possible, and I think we have already had some indication from Minority members that we would be able to do that.

I do want to make sure that members have a chance for follow-up questions, so you may get some follow-up questions in writing. Those questions should be in by 5 p.m. today, so any members or anybody that has questions that need to be asked, get those in right away.

Then I am hopeful that you would respond to these questions as quickly as possible, because that is almost necessary to get to your nomination, unless, I would surmise, that somebody is writing you 500 questions just to slow down the nomination for some unreasonable reason.

I think we ought to have a seamless transition from Secretary Snow to Mr. Paulson. A vacancy in the Secretary's office is something that we should all be concerned about. Since Secretary Snow has announced that he intends to leave on July 3, we have 6 days to not have a vacancy in that office, and we should be mindful then of that calendar.

I appreciate my colleagues' cooperation to this point, and I ask that they continue to cooperate so we can help move this important position along. I would ask all of them for assistance in doing that.

Thank you, Mr. Paulson. You have been very forthcoming, and we appreciate it very much.

Mr. PAULSON. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Meeting adjourned.

[Whereupon, at 12:40 p.m., the hearing was concluded.]

A P P E N D I X

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

STATEMENT FOR SENATOR BUNNING SENATE COMMITTEE ON FINANCE Nomination of Henry Paulson 26 June 2006

Thank you, Mr. Chairman.

I look forward to the hearing today on the nomination of Henry Paulson to be our Nation's 74th Secretary of the Treasury.

Mr. Paulson, you have been nominated to one of the most influential jobs in the world. You will be responsible for many of the activities that are central to the primary functions of our government.

Not only is Treasury Secretary of the United States a very important job, it is also a very difficult job.

In addition to tax policy, the Treasury Department is responsible for essential functions related to Federal debt finance, financial and capital markets regulation, and areas of U.S. international economic policy.

Mr. Paulson, this is a big job and one that will impact the daily lives of my constituents.

I hope—and expect—that you will stay receptive to suggestions and concerns of members of Congress.

I have some questions, and I am looking forward to your responses.

Thank you.

**OPENING STATEMENT OF HENRY M. PAULSON, JR.
BEFORE THE SENATE FINANCE COMMITTEE**

Chairman Grassley, Ranking Member Baucus, and members of the Finance Committee, thank you for inviting me to testify here today. I am honored that President Bush has nominated me to serve as the 74th Secretary of the Treasury, following the distinguished leadership of Secretary John Snow. And I appreciate the time members of this Committee have taken to meet with me and consider my nomination. Frequent communication between the Treasury Department and this committee is of vital importance, and if confirmed I look forward to building on the important dialogue that we have already begun.

I am also grateful to my family for supporting my decision to pursue this opportunity.

The Treasury Department has a critical role to play in helping to set the direction of the U.S. and global economy – a role that reaches back to America’s founding. If confirmed, I will strive to carry forward the Treasury Department’s rich legacy.

I have admired the work of the Treasury Department throughout my 32-year career in finance – and particularly during the last eight years, when I have led a global financial institution. As the steward of the U.S. economic and financial systems, the Treasury has helped lay the groundwork for the American economy to become a model of strength, flexibility, dynamism and resiliency.

This is a system that generates growth, creates jobs and wealth, rewards initiative, and fosters innovation. It is also a system that offers considerable social and economic mobility. We must never take this for granted, and we cannot allow Americans to lose faith in the benefits our system offers. America is the land of opportunity. We need to be vigilant in ensuring that each and every American has the opportunity to acquire the skills to compete, and to see those skills rewarded in the marketplace.

One way we can do this is to maintain a macroeconomic climate that enables workers, families, businesses – both small and large – to thrive. That calls for spending discipline and predictable taxation, combined with prudent regulation.

If confirmed, I will focus intensely on how the United States can maintain and strengthen our competitive position. As a product of a mid-sized town in Illinois, I will of course always remember Chairman Grassley’s succinct description of the Treasury secretary’s role: “to understand how tax policy, capital markets, international trade, and currency policy affect Main Street USA.”¹

As we work to promote greater economic opportunity for the American people, we must always remember that the American economy is deeply integrated with the global economy. That brings challenges, but even greater opportunities. While maintaining confidence in our ability to compete throughout the world, we must be prepared to embrace the change that will contribute to our long-term prosperity. Open markets help to boost productivity and drive America’s economic growth, which in turn creates new and better jobs for American families. It’s also true that the global integration of economies and markets holds the promise of a more prosperous and secure world. In my extensive travels throughout the world, I’ve seen countless examples of the benefits of economic reform.

If confirmed, I will be active in affirming America’s leadership role in the global economy, where we must continue to be a constructive and stabilizing force. I also look forward to working alongside other

¹ <http://finance.senate.gov/press/Gpress/2005/arg053006.pdf>

colleagues in the Cabinet to advocate policies and actions which provide open and level markets for U.S. investment and for U.S. products.

To close, I will briefly outline some of the steps that could be taken to achieve a stronger and more competitive U.S. economy:

- Addressing the long-term unfunded obligations of Social Security and Medicare that threaten to unfairly burden future generations.
- Keeping taxes low and collecting them in a simpler and fairer manner that does not distort economic decision-making.
- Expanding opportunities for American workers, farmers, and businesses – big and small – to compete on a level playing field with the rest of the world.
- Maintaining and enhancing the flexibility of our capital and labor markets, and preventing creeping regulatory expansion from driving jobs and capital overseas.
- Finally, the U.S. economy will be stronger if we can continue to foster an entrepreneurial spirit and culture which generates innovation, risk-taking, and productivity growth that raises living standards to keep America the economic envy of the world.

If confirmed, I look forward to frequent consultation with members of this Committee to advance these important ideas. And if confirmed, I also look forward to working with the Treasury Department's select corps of professionals, who play a critical role in the stability and vitality of the U.S. economy.

Thank you Mr. Chairman.

SENATE FINANCE COMMITTEE
STATEMENT OF INFORMATION REQUESTED OF NOMINEE

A. BIOGRAPHICAL INFORMATION

1. Name: (Include any former names used.)
Henry Merritt Paulson, Jr.
(Hank)
2. Position to which nominated:
Secretary of Treasury
3. Date of nomination:
June 19, 2006.
4. Address: (List current residence, office, and mailing addresses.)
Home (also mailing): 154 West Dundee Road
Barrington, IL 60010

101 West 67th Street, #50A
New York, NY 10023

Office (also mailing): The Goldman Sachs Group, Inc.
85 Broad Street
New York, NY 10004
5. Date and place of birth:
March 28, 1946
West Palm Beach, FL
6. Marital status: (Include maiden name of wife or husband's name.)

Married to Wendy Paulson née Judge.

7. Names and ages of children:

Henry M. Paulson, III 33
Amanda C. Paulson 31

8. Education: (List secondary and higher education institutions, dates attended, degree received, and date degree granted.)

Barrington High School
1960 - 1964 High School Diploma June 1964

Dartmouth College
1964 - 1968 B.A. June 1968

Harvard Business School
1968-1970 M.B.A. June 1970

9. Employment record: (List all jobs held since college, including the title or description of job, name of employer, location of work, and dates of employment.)

1970 - 1972	Comptroller, Analysis Group	U.S. Department of Defense	Washington, DC
1972 - 1974	Staff Assistant	White House	Washington, DC
1974 - 1977	Associate	Goldman Sachs	Chicago, IL
1977 - 1982	Vice President		Chicago, IL
1982 - 1999	Partner		Chicago, IL/New York, NY
1983 - 1988	Head of Investment Banking Services for Midwest Region		Chicago, IL
1988 - 1990	Managing Partner for Chicago Office		Chicago, IL
1990 - 1994	Co-Head of Investment Banking		Chicago, IL/New York, NY

1994 - 1997	Vice Chairman & Chief Operating Officer		New York, NY
1997 - 1998	President & Chief Operating Officer		New York, NY
1998 - 1999	Co-Senior Partner		New York, NY
1999 - present	Chairman & Chief Executive Officer		New York, NY

10. Government experience: (List any advisory, consultative, honorary, or other part-time service or positions with Federal, State or local governments, other than those listed above.)

President's Export Council.

11. Business relationships: (List all positions held as an officer, director, trustee, partner, proprietor, agent, representative, or consultant of any corporation, company, firm, partnership, other business enterprise, or educational or other institution.)

The Goldman Sachs Group, Inc.: Chairman & Chief Executive Officer

Harvard Business School: Dean's Advisory Board Member

Indian School of Business: Governing Board Member

Tsinghua University School of Economics and Management: Advisory Board Member

The Bobolink Foundation: Co-Trustee

Henry M. Paulson, Jr. Family Trust: Trustee

Catalyst, Inc.: Director

Financial Services Forum: Chairman

The Nature Conservancy: Chairman

Asia Pacific Council of the Nature Conservancy: Co-Chairman

12. Memberships: (List all memberships and offices held in professional, fraternal, scholarly, civic, business, charitable, and other organizations.)

Member Only:

Alfalfa Club, Membership

Business Council: Corporate Member

Business Roundtable: Corporate Member

Catalyst: Corporate Board Member

Chicago Club: Non-resident Member

Commercial Club of Chicago: Non-resident Member
 Committee to Encourage Corporate Philanthropy: Corporate Member
 Economic Club of Chicago: Non-resident Member
 First Church of Christ, Scientist: Member

13. Political affiliations and activities:

- a. List all public offices for which you have been a candidate.

N/A

- b. List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

Chair of a New York reception honoring President Bush (2003).

Chair of a New York fundraiser for the NRCC (2003).

Served as State Finance Committee member for Bush/Cheney '04 (2003).

Served on a fundraising committee for Senatorial candidate Jack Ryan (2004).

Vice Chairman, New York City Host Committee, Republican National Convention (2004).

- c. Itemize all political contributions to any individual, campaign organization, political party, political action committee, or similar entity of \$50 or more for the past 10 years.

Date	Recipient	Amount
4/26/06	Goldman Sachs Group, Inc. PAC	\$5,000.00
1/31/06	VOLPAC	\$5,000.00
12/30/05	Enzi for US Senate	\$2,100.00
12/16/05	Friends of Roy Blunt	\$2,100.00
12/14/05	Sue Kelly for Congress	\$2,100.00
12/13/05	Stevens for Senate	\$2,100.00
12/13/05	Crapo for U.S. Senate	\$2,100.00
8/29/05	Baker for Congress (campaign did not realize limits had been increased)	-\$100.00
8/19/05	Baker for Congress (campaign did not realize limits had been increased)	-\$100.00
7/21/05	Team Sununu	\$2,100.00
7/21/05	Friends of John Boehner	\$2,100.00

7/21/05	Baker for Congress	\$2,100.00
7/21/05	Baker for Congress	\$2,100.00
7/21/05	NRCC	\$15,000.00
7/21/05	Cantor for Congress	\$2,100.00
7/21/05	McCrery for Congress Committee	\$2,100.00
7/21/05	TOMPAC	\$5,000.00
7/21/05	Chambliss for Congress	\$2,100.00
5/19/05	Goldman Sachs Group, Inc. PAC	\$5,000.00
5/3/05	NRSC	\$25,000.00
10/15/04	Citizens for Arlen Specter	\$2,000.00
10/6/04	Martinez for Senate	\$2,000.00
10/6/04	Reynolds for Congress	\$2,000.00
9/15/04	DeMint for Senate Committee, Inc.	\$2,000.00
9/15/04	Richard Burr Committee	\$2,000.00
9/15/04	Baker for Congress	\$2,000.00
9/15/04	Defend America PAC	\$5,000.00
9/15/04	Grassley Committee Incorporates	\$2,000.00
5/20/04	Citizens for Gillmor	\$2,000.00
5/17/04	Shelley Moore Capito for Congress	\$2,000.00
5/17/04	TOMPAC	\$500.00
5/17/04	Shelby for US Senate	\$2,000.00
5/17/04	Richard Burr Committee	\$2,000.00
2/4/04	Goldman Sachs Group, Inc. PAC	\$5,000.00
12/8/03	VOLPAC	\$5,000.00
12/5/03	Portman for Congress Committee	\$2,000.00
12/5/03	Cantor for Congress	\$2,000.00
12/5/03	Missourians for Kit Bond	\$1,000.00
12/5/03	Crapo for U.S. Senate	\$1,000.00
12/5/03	Citizens for Arlen Specter	\$1,000.00
12/1/03	NRSC	\$10,000.00
9/18/03	Jack Ryan for US Senate	\$2,000.00
6/25/03	Bush-Cheney '04	\$2,000.00
6/25/03	NRCC	\$15,000.00
6/19/03	League of Conservation Voters PAC	\$5,000.00
3/10/03	TOMPAC	\$2,500.00
2/12/03	Goldman Sachs Group, Inc. PAC	\$5,000.00
1/9/03	Shelby for US Senate	\$2,000.00
9/23/02	NRSC, Non-Federal	\$50,000.00
6/20/02	NRCC	\$5,000.00
6/14/02	Team Sununu	\$1,000.00
5/16/02	NRSC	\$10,000.00
4/1/02	League of Conservation Voters PAC	\$5,000.00
3/26/02	Goldman Sachs Group, Inc. PAC	\$2,000.00
4/18/01	Goldman Sachs Group, Inc. PAC	\$2,000.00
7/28/00	RNC, Republican Nat'l State Elections	\$40,000.00

	Committee	
5/30/00	RNC, Presidential Trust, Non-Federal	\$10,000.00
3/14/00	Goldman Sachs Group, Inc. PAC	\$5,000.00
2/18/00	McCain 2000, Inc.	\$1,000.00
2/11/00	Friends of Phil Gramm	\$1,000.00
9/27/99	League of Conservation Voters PAC	\$5,000.00
6/21/99	Committee to Re-Elect Marge Roukema	\$1,000.00
3/26/99	Bill Bradley for President Committee	\$1,000.00
1/18/99	Goldman Sachs Group, Inc. PAC	\$1,250.00
11/2/98	Mark Udall for Congress	\$500.00
10/26/98	Mike Ferguson for Congress	\$1,000.00
9/14/98	Freedom Project	\$2,500.00
9/14/98	NRCC	\$2,500.00
8/19/98	League of Conservation Voters PAC	\$5,000.00
7/20/98	Hagel for Senate	\$1,000.00
4/23/98	Lazio for Congress	\$1,000.00
4/2/98	McCain for Senate '98	\$1,000.00
1/30/98	Goldman Group, Inc. PAC	\$2,000.00
11/04/97	NRSC	\$10,000.00
9/2/97	NRCC	\$10,000.00
8/13/97	Emily's List	\$500.00
5/20/97	Evan Bayh Committee	\$1,000.00
3/14/97	Citizens for Arlen Specter	\$1,000.00
1/30/97	Goldman Sachs Group, Inc. PAC	\$3,000.00
10/28/96	NRSC, Non-Federal	\$25,000.00
4/25/96	NRSC	\$10,000.00
3/15/96	Friends of Schumer	\$1,000.00
2/23/96	Goldman Sachs Group, Inc. PAC	\$2,500.00
2/2/96	Zimmer for Senate	\$1,000.00
2/2/96	Zimmer for Senate	\$1,000.00
1/3/96	Idaho 2000 (Idaho Democratic Party in connection with Minick Senate race)	\$5,000.00

14. Honors and Awards: (List all scholarships, fellowships, honorary degrees, honorary society memberships, military medals, and any other special recognitions for outstanding service or achievement.)

N/A

15. Published writings: (List the titles, publishers, and dates of all books, articles, reports, or other published materials you have written.)

- *Cafta is the American Way*, Wall Street Journal, July 14, 2005;
- *Under the Same Sky*, Finance Manager Magazine, February, 2005;

- *Trustworthy Observer*, Financial Times, May 2, 2003;
- *Good for All Americans*, Wall Street Journal, March 19, 2003;
- *China's Entry into WTO*, China Securities News, January, 2002;
- *Restoring Investor Confidence: An Agenda for Change*, Financial Services Advisor, November-December 2002;
- Book Review: *Comments & Analysis – A Washington Power Broker Regrets*, Financial Times, September 30, 2002;
- *Congress Should Put Trade on the Fast Track*, Wall Street Journal, November 20, 2001;
- *Global Free Market is Good for All*, Irish Times, November 16, 2001;
- *The Gospel of Globalisation: Business Leaders Must Promote the Social and Economic Benefits of Liberalisation*, Financial Times, November 13, 2001;
- *Cut Taxes Broadly, Boldly, Now* (also listed as *Bush Tax Plan: Just What the Economic Needs*), Wall Street Journal, February 15, 2001;
- *Integrating Technology into Every Business Process*, Investment Dealers' Digest, May 22, 2000;
- *More Than the Boom of One I.P.O.*, New York Times, April 15, 2000

16. Speeches: (List all **formal** speeches you have delivered during the past five years which are on **topics relevant to the position** for which you have been nominated. Provide the Committee with two copies of each formal speech.)

- Introductory Remarks, GS 2006 Chief Investment Officer Conference, May 11, 2006;
- Introductory Remarks, GS Alternative Energy Conference, May 2, 2006;
- Remarks, HBS Leadership & Ethics Forum, March 28, 2006;
- Remarks, WCS Annual Meeting, March 1, 2006;
- Introductory Remarks, The Executives' Club of Chicago, February 23, 2006;
- Remarks, Dinner by Mathias Dopfner, February 7, 2006;
- Remarks, Site 26 Groundbreaking, November 29, 2005;
- Remarks, Financial Services Forum, October 18, 2005;
- Welcoming Remarks, GS IMF Reception, September 25, 2005;
- Handelsblatt Conference, Frankfurt, Germany, September 7, 2005;
- Remarks, China Institute in America Gala, June 15, 2005;
- Speech, Swiss-American Chamber of Commerce Speech, Zurich, April 22, 2005;
- Remarks, GS 2005 Chief Investment Officer Conference, Paris, April 21, 2005;
- Opening Remarks, Howard University, March 30, 2005;
- Remarks, London School of Economics, March 17, 2005;
- Remarks, Arthur Burns Dinner, February 16, 2005;
- Remarks, Wharton School, January 12, 2005;

- Remarks, TiE Tri-State Organization, Remarks, November 20, 2004;
- Remarks, Wildlife Conservation Society Gala, October 13, 2004;
- Remarks, Stanford Law Directors College, June 21, 2004;
- Remarks, U.S. - China Executive Summit, June 17, 2004;
- Remarks, Carlyle Group, May 4, 2004;
- Remarks, Association of German Business Correspondents, April 27, 2004;
- Remarks, The GS Group, Inc. Annual Shareholders Meeting, March 30, 2004;
- Remarks, Yale School of Management Dinner, March 18, 2004;
- Remarks, Parlour Club, London, March 10, 2004;
- Remarks, The Goldman Sachs Group, Inc., 2004;
- Remarks, The Goldman Sachs Group, Inc., 2004;
- Welcoming Remarks, NRCC Luncheon, June 16, 2003;
- Principia College Commencement Address, June 8, 2003;
- Remarks, Harvard Business School Statesman Award, May 29, 2003;
- Remarks, MOMA Acceptance of David Rockefeller Award, March 11, 2003;
- Remarks, Promoting and Protecting Shareholders Interests, February 14, 2003;
- Remarks, Yale Dinner Honoring Mayor Bloomberg, February 10, 2003;
- Remarks, Ivy Football Association Dinner, January 22, 2003;
- CNBC/WSJ CEO Summit, 2003;
- Remarks, Wharton Global Business Forum, Philadelphia, Pennsylvania November 15, 2002;
- Remarks, Welcome to Communicopia Dinner, 2002;
- Introductory Remarks, GS Board Dinner, Munich, September 2002;
- CNBC Script, Business Center, July 9, 2002;
- Tribute to John Whitehead, Spirit of America Dinner, June 20, 2002;
- Welcoming Remarks, Consumer Products Dinner, May 8, 2002;
- Remarks, Women's Leadership Conference, May 3, 2002;
- Concluding Remarks, American Bankers Association Dinner Honoring Chinese Vice President Hu Jintao, New York, April 29, 2002;
- Introduction of Mayor Bloomberg - Annual Meeting of New York City Partnership/New York City Investment Fund, April 10, 2002;
- Remarks, Fire Engine Truck Dedication, April 5, 2002;
- Remarks, CEO Round Table, Chicago, February 25, 2002;
- Remarks for Citizens' Committee for NYC Dinner, February 11, 2002;
- Remarks, The Goldman Sachs Group, Inc. Annual Shareholders Meeting, 2002;
- Talking Points for Holiday Party with Engine 4, December 2001;
- Translation of Capital Piece, November 23, 2001;

- Financial Times Conference, November 12, 2001;
- Welcome to Communicopia Dinner, October 2, 2001;
- Remarks, Interfaith Service, October 1, 2001;
- Speech, Capital Investor Relations Awards Dinner, Frankfurt, September 4, 2001;
- Remarks, British Museum Dinner, London, June 25, 2001;
- Speech, Microsoft Conference, May 22-23, 2001;
- Talking Points, US Economic Outlook, May 9, 2001;
- Opening Statement, Fortune Conference, May 9, 2001;
- Forum Opening Remarks, April 28, 2001;
- Remarks at Tsinghua University Boa, Effectively Leading a Modern Enterprise, April 28, 2001;
- Remarks, Big Brothers/Big Sisters of New York City 21st Annual "Sidewalks of New York" Awards Dinner, April 23, 2001;
- Remarks, Introduction of Richard Wagoner, Battle Royale, April 4, 2001;
- Remarks, Dinner With Technology Leaders, February 1, 2001;
- Points for Davos, January 29, 2001;
- The Goldman Sachs Group, Inc., Annual Meeting of Shareholders, 2001

17. Qualifications: (State what, in your opinion, qualifies you to serve in the position to which you have been nominated.)

During most of my 32-year professional career at Goldman Sachs, I have worked in management and leadership positions. In this capacity, as well as in positions at the White House and at the Department of Defense, I have dealt with a range of issues faced by the Treasury, both at home and abroad. As a banker and business executive in the private sector, I have acquired extensive knowledge of the market place as well as international finance and economics. I have considerable familiarity and experience with many of the areas for which the Treasury Department has primary responsibility and oversight. In addition, both in government and the private sector, I have had the opportunity to work with Treasury's key external counterparts: the Congress, the interagency process, the financial, business, and non-profit communities, and the international financial community. Lastly, having led a large, truly global, organization, I have had some exposure dealing with the budget and appropriations processes.

B. FUTURE EMPLOYMENT RELATIONSHIPS

1. Will you sever all connections with your present employers, business firms, associations, or organizations if you are confirmed by the Senate? If not, provide details.

Yes.

2. Do you have any plans, commitments, or agreements to pursue outside employment, with or without compensation, during your service with the government? If so, provide details.

No.

3. Has any person or entity made a commitment or agreement to employ your services in any capacity after you leave government service? If so, provide details.

No.

4. If you are confirmed by the Senate, do you expect to serve out your full term or until the next Presidential election, whichever is applicable? If not, explain.

Yes, if confirmed by the Senate, I expect to serve at the pleasure of the President.

C. POTENTIAL CONFLICTS OF INTEREST

1. Indicate any investments, obligations, liabilities, or other relationships which could involve potential conflicts of interest in the position to which you have been nominated.

Any potential conflicts of interest have been identified and resolved in accordance with the terms and conditions of my ethics agreement with the Department of Treasury, which is documented by letter to John Schorn, Deputy Assistant General Counsel (General Law and Ethics) and Designated Agency Ethics Official. Should any potential conflict of interest arise in the future, I will seek guidance from a Treasury ethics official.

2. Describe any business relationship, dealing or financial transaction which you have had during the last 10 years, whether for yourself, on behalf of a client, or acting as an agent, that could in any way constitute or result in a possible conflict of interest in the position to which you have been nominated.

Any potential conflicts of interest have been identified and resolved in accordance with the terms and conditions of my ethics agreement with the Department of Treasury, which is documented by letter to John Schorn, Deputy Assistant

General Counsel (General Law and Ethics) and Designated Agency Ethics Official. Should any potential conflict of interest arise in the future, I will seek guidance from a Treasury ethics official.

3. Describe any activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat, or modification of any legislation or affecting the administration and execution of law or public policy. Activities performed as an employee of the Federal government need not be listed.

From 1996 to 2006, as the Chairman and Chief Executive Officer of The Goldman Sachs Group, Inc., I helped represent or oversee representation of the company's interests before both the Congress and the Administration on a wide range of issues, including:

- Global competitiveness
- Market Structure
- Social security reform options
- General tax and trade
- Mutual fund legislation
- Financial modernization legislation
- China PNTR
- President's Export Council

On February 29, 2000, I testified on behalf of The Goldman Sachs Group, Inc. at a field hearing of the Senate Banking Committee regarding Marketplace of the Future.

4. Explain how you will resolve any potential conflict of interest, including any that may be disclosed by your responses to the above items. (Provide the Committee with two copies of any trust or other agreements.)

Any potential conflicts of interest will be identified and resolved in accordance with the terms and conditions of my ethics agreement with the Department of Treasury, which is documented by letter to John Schorn, Deputy Assistant General Counsel (General Law and Ethics) and Designated Agency Ethics Official. Should any potential conflict of interest arise in the future, I will seek guidance from a Treasury ethics official.

5. Two copies of written opinions should be provided directly to the Committee by the designated agency ethics officer of the agency to which you have been

nominated and by the Office of Government Ethics concerning potential conflicts of interest or any legal impediments to your serving in this position.

6. The following information is to be provided only by nominees to the positions of United States Trade Representative and Deputy United States Trade Representative:

Have you ever represented, advised, or otherwise aided a foreign government or a foreign political organization with respect to any international trade matter? If so, provide the name of the foreign entity, a description of the work performed (including any work you supervised), the time frame of the work (e.g., March to December 1995), and the number of hours spent on the representation.

N/A

D. LEGAL AND OTHER MATTERS

1. Have you ever been the subject of a complaint or been investigated, disciplined, or otherwise cited for a breach of ethics for unprofessional conduct before any court, administrative agency, professional association, disciplinary committee, or other professional group? If so, provide details.

No.

2. Have you ever been investigated, arrested, charged, or held by any Federal, State, or other law enforcement authority for a violation of any Federal, State, county or municipal law, regulation, or ordinance, other than a minor traffic offense? If so, provide details.

In mid-August 1969, I climbed the fence of a public swimming pool in West Lafayette, Indiana and swam in this pool after hours. I was arrested for trespassing and fingerprinted. Subsequently, all charges against me were dropped.

3. Have you ever been involved as a party in interest in any administrative agency proceeding or civil litigation? If so, provide details.

From time to time, I have been named as a defendant or respondent in litigation relating to the business of The Goldman Sachs Group, Inc. and its affiliates, and on several occasions I have given testimony as a witness in response to a deposition subpoena or regulatory request. To the best of my

recollection and information available to me, I have been a defendant or respondent in the following matters:

1. *Jean Mullin v. John Browne, et al.* (USDC/SDNY) (derivative action alleging breaches of fiduciary duty by The Goldman Sachs Group, Inc. Board of Directors in connection with the firm's research and IPO allocation practices);
2. *Lapin v. Goldman Sachs Group, Inc., et al.* (USDC/SDNY, USNV/DLV) (alleges violations of the federal securities laws in connection with Goldman Sachs' research activities);
3. *Christopher Carmona v. Henry M. Paulson, Jr., et al.* (USDC/SDNY) (derivative action alleging breaches of fiduciary duty by The Goldman Sachs Group, Inc. Board of Directors in connection with Goldman Sachs' role as an underwriter of Refco's IPO);
4. *Jeanne Masden v. Henry M. Paulson, Jr., et al.* (USDC/SDNY) (purported class action relating to fee practices of certain Goldman Sachs sponsored mutual funds);
5. *Osher v. Browne, et al.* (USDC/SDNY) (derivative action alleging violations of the federal securities laws, dismissed by stipulation of the parties in 2001);
6. *NYC Dept. of Finance v. Paulson* (NY Judgments and Liens) (no information is available in the public record regarding this lien except for a docket sheet; according to the docket sheet, this lien was vacated in 1997).

To the best of my recollection and information available to me, I have given testimony as a witness in the following matters:

1. *Spitzer v. Grasso* (NY State Supreme Court, NY County) (deposition testimony arising from services as a former director of the New York Stock Exchange) (2005);
2. Investigation by the Massachusetts securities regulator in connection with merger of Procter and Gamble and The Gillette Cos. (June 2005);
3. Field Hearing of Senate Banking Committee on the topic of Financial Marketplace of the Future (February 29, 2000).

4. Have you ever been convicted (including pleas of guilty or nolo contendere) of any criminal violation other than a minor traffic offense? If so, provide details.

No.

5. Please advise the Committee of any additional information, favorable or unfavorable, which you feel should be considered in connection with your nomination.

N/A

E. TESTIFYING BEFORE CONGRESS

1. If you are confirmed by the Senate, are you willing to appear and testify before any duly constituted committee of the Congress on such occasions as you may be reasonably requested to do so?

Yes.

2. If you are confirmed by the Senate, are you willing to provide such information as is requested by such committees?

Yes.

**Questions for the Record
Confirmation Hearing of Henry M. Paulson, Jr.
June 28, 2006**

Grassley Question 1 (Executive Stock Options):

We have heard a lot about backdating of stock options by executives in the news. I would like your general views on this and your commitment that the Treasury and IRS will make a priority to go after the tax due and owing as well as all applicable penalties from both the individuals and companies that engaged in these transactions.

Answer:

Congress has taken important steps to give the Internal Revenue Service (IRS) and other federal agencies the tools they need to address serious problems with corporate governance. Recent reports about the backdating of stock options may raise a number of corporate-governance issues, including whether there were any violations of the federal tax laws. I understand that the Treasury Department and IRS are focusing on this issue. If confirmed, I look forward to working to ensure that all appropriate steps are taken to address this issue.

Grassley Question 2 (TNC):

In reviewing The Nature Conservancy's response to The Finance Committee, which the Committee is releasing today and will include in the hearing record. While I read many things about reform of The Nature Conservancy in response to the Finance Committee's work and the reporting of The Washington Post, there was a matter that particularly troubled me that I would like your comment.

In appendix two of the response involving decisions by the Risk Assessment Committee at The Nature Conservancy, I was troubled by the organization's discussion about accepting a conservation easement that includes a golf course.

This Committee heard extensive testimony last year about the abuses of conservation easement involving golf courses. In fact, that testimony about abusive golf course easements was at the same time the Committee released its report on The Nature Conservancy and heard from the President of The Nature Conservancy. And yet here we see The Nature Conservancy making excuses to accept a conservation easement involving a golf course.

I imagine you know more about both birds and golf than I do, Mr. Paulson, but I find it very difficult to understand how having a conservation easement on a nice long fairway and a big sand trap is proper and appropriate for The Nature Conservancy – and all at taxpayer's expense. I worry that there are still problems at The Nature Conservancy. Particularly troubling is that the discussion by the Risk Assessment Committee seems to be more about the publicity problems of the golf course easement as opposed to deciding if it's the right thing to do.

I appreciate your comments on this particular matter and also your general views on reform at The Nature Conservancy and its relationship with the charitable sector overall.

Answer:

I believe that charities play a significant role and are important to our society. I also recognize that good governance goes hand and hand with good charities. With respect to conservation easements, I believe they are permitted under the law, and they serve an important purpose. While I support conservation easements, I also understand that the Finance Committee has identified areas of abuse. My work at The Nature Conservancy focused on improvements in charitable governance issues as well as in the area of conservation easements, particularly the validity of appraisals. Ultimately, I believe the latter issue comes down to ensuring that the Internal Revenue Service is enforcing the law and making sure that appraisals are correct.

Grassley Question 3 (TNC):

Please provide all closing documents and agreements between the Nature Conservancy and the IRS.

Answer:

I am not in a position to direct The Nature Conservancy to provide any specific documents. That is a matter within the purview of the organization's CEO and board of which I am only one member. I understand, however, that TNC may have concerns about maintaining the confidential nature of its tax records and has respectfully asked that this matter be addressed through the Chairman's authority under the law to obtain specific tax records from the IRS.

Snowe Question 1 (Energy Incentives):

I have worked hard over the past five years for performance-based energy tax incentives for commercial buildings - one third of energy usage is from the building sector, so there are great energy savings to be made with the proper incentives. My tax incentives came to fruition in the Energy Policy Act, or EPAct, of 2005. The provisions were then taken up by Treasury to accomplish regulations to harmonize with the law. On June 2nd, 2006, the Internal Revenue Service issued guidance on how to comply with Section 179D of the Internal Revenue Code establishing a deduction for commercial buildings that achieve a reduction in energy consumption of 50 percent. Unfortunately, I find the regulations inadequate, which may stem from the fact that we are into some uncharted territory and there may be a basic lack of understanding of what it takes to make performance-based performance energy efficiency tax incentives work. It is important to me that the IRS guidance is written correctly so as to incentivize great energy efficiencies while making sure any guidance promotes the best use of taxpayer dollars.

Specific Problems:

Calculating and Verifying Energy and Power Consumption: First, the biggest legal failure is that in Section (d)(2) of EPACT Section 1331 there is a requirement that

the Secretary shall “promulgate regulations which describe in detail methods for calculating and verifying energy and power consumption and cost, based on the provisions of the 2005 California Non-Residential Alternate Calculation Approval Manual.” The problem is that the guidance does not include any detailed regulations at all. Instead, the IRS document substitutes a different and much less detailed requirement that, “the energy performance of the reference building shall be determined by following the methods for baseline building performance in the PRM (Performance Rating Method) in Appendix G of Standard 90.1-2004.”

It continues, “in calculating baseline building performance, the reference building shall use the following additional requirements from the 2004 California Title 24 Non-Residential Alternative Calculation Method (ACM) approval manual...” This section of the guidance document selects minor parts of the California ACM manual. Thus, the method suggested in the Notice is not “based on” the ACM manual as required.

Public Buildings, Including Schools: Secondly, Section (4) in EPACT Section 1331 “Allocation of Deduction for Public Buildings” says that, “the Secretary shall promulgate a regulation to allow the allocation of the deduction to the person primarily responsible for designing the property in lieu of the owner of such property.” The Treasury guidance document fails to do this.

The most serious problem in administering a technically complex requirement based on energy calculation is to provide unambiguous guidance on how to do the calculation automatically. Such unambiguous guidance is provided in the California ACM manual, which is why it is cited explicitly in the Energy act. A tax bill that cites a non-tax related regulation is very unusual, and therefore the reference was placed in the law intentionally and for a good reason. It is not appropriate for Treasury to ignore this special requirement.

All Systems are Not Equal: Technically, there are also problems with the way Treasury assigns a deductions for heating, ventilation and air conditioning (HVAC) within the commercial building envelope by requiring a sixteen and two-thirds percent reduction in energy use by each single system. This is technically erroneous, because the energy use of a commercial system is interactive and three successive savings of sixteen and two-thirds percent will not necessarily add up to a total savings of fifty percent. Section (d)(1)(A) requires that the single systems be installed “as part of a plan to meet such targets (of 50 percent savings for the whole building).” A system of requiring a sixteen and two-thirds percent reduction in energy use solely accomplished by the single system is inconsistent with this requirement.

The wording of this section of the law on establishing system-specific savings targets is somewhat complex. If Congress had wished a simple solution such as dividing fifty percent by three for each of the three systems, it would have specified that. Instead, by delegating the authority for setting system-specific targets to the Secretary, Congress implied that the decision was not straightforward and required some analytical effort. It

is therefore disappointing that the IRS has chosen to take a simple approach that Congress itself could have taken if it had desired this result.

Fuel Neutral: The IRS guidance also fails to implement requirements of the Committee Report that accompanied EPACT. The report specifically requires the calculations be fuel neutral, therefore no winners and losers. But the IRS document fails to even mention this requirement.

Lighting Systems: An additional technical problem is that the Guidance provides two alternate methods for the lighting system to meet its goal, and they are inconsistent. The permanent method establishes a sixteen and two-thirds percent energy use reduction. But the interim method specifies prescriptive methods that save a different amount of energy than this goal. It is likely that in almost all cases, it is significantly larger than the sixteen percent target. This means that the sixteen and two-thirds percent target may be a cutback in stringency compared to what was in the legislation for no apparent reason.

I would like to see the IRS devote the resources to correct the June 2, 2006 guidance as soon as possible. Is this possible?

Answer:

The Energy Bill you enacted last year was an important step in the effort to ensure energy independence in this country. While I am not familiar with the specific details of the guidance you cite, I believe we share similar goals. I agree with the President that we should have a multi-faceted approach to addressing the issue – address supply and demand, conservation, invest in new technologies (R&D), find greater efficiencies and promote alternative energy. If confirmed, I will learn more about the issues you raise and look forward to discussing them with you.

Kyl Question 1 (China):

Your close working relationship with various entities owned or controlled by the government of the People's Republic of China (PRC) presents questions about whether conflicts of interest will arise in the many duties you will have as Treasury Secretary, but it also gives you a unique perspective to address the challenges faced by the United States because China is not a market economy. The Chinese government owns or controls significant assets – ranging from banks to oil companies – that are engaging in the global economy, and the U.S. cannot treat these entities like privately-owned entities. In your capacity as Treasury Secretary you will be representing the economic and security interests of the U.S., which is a very different mission than you have had at Goldman Sachs. One of the responsibilities of the Treasury Secretary is to chair the Committee on Foreign Investment in the United States (CFIUS).

How do you believe the CFIUS process should be reformed to better protect the real and vital security interests of the U.S.? Further, how will you use the insights and understandings you gained in your work in China to better evaluate transactions that involve Chinese state enterprises?

Answer:

CFIUS performs a very important function – helping to ensure that national security is protected in a post-September 11th world. Yet we must continue to welcome the foreign investment into the United States so we can maintain the strength of our economy and create millions of jobs for American workers.

Should I be confirmed, I will serve as Chairman of CFIUS. It is important Congress have confidence that CFIUS is fulfilling this critical responsibility. I look forward to working with Congress to ensure that its concerns are addressed in the process, including providing adequate scrutiny to investments that involve a foreign government.

A reduction in foreign investment would cost American workers good jobs, reduce innovation, and lower the growth of the U.S. economy. Moving away from an open investment policy could lead other countries to impose restrictions on U.S. investors. That too would cost American jobs and cut U.S. exports. Therefore, any reforms to the CFIUS process should send a signal that the United States is serious about national security, but welcomes legitimate foreign investments.

Thomas Question 1 (Energy):

My State of Wyoming is rich in fossil energy reserves like coal. As Secretary of the Treasury, what is your view of using tax policy to limit carbon emissions?

Answer:

I don't have a view on a cap-and-trade system. I would note that such a system has been up and running in Europe, but I believe they have had too limited an experience with it to be able to draw useful conclusions. To the extent I would deal with such issues if confirmed as the Treasury Secretary, I would simply note that we ought to seek solutions to our environmental policies that are built on market-based mechanisms that enhance and not impair our economic growth and competitiveness.

Thomas Question 2 (Chilean Land Deal):

I've been hearing from some of my constituents about the so-called Chilean land deal, specifically citing concern over your level of commitment to private property rights. Could you briefly explain your, The Nature Conservancy's, and/or Goldman-Sachs' involvement in this transaction?

Answer:

The opportunity to donate the land in Chile came out of the Goldman Sach's (GS) fixed-income unit that was involved in purchases of underperforming assets, which in this case, included certain loans secured by the land in Chile. Therefore, GS personnel, not its senior management, discovered this opportunity to donate the land. I did not take part in the GS Board of Directors Corporate Governance Committee's ultimate decision to recommend donating land to the Wildlife Conservation Society. GS's independent directors hired a special advisor to help make the actual decision. Employees at GS also needed help in managing the land, and they hired TNC independent of me.

Thomas Question 3 (Charitable Giving):

Some have suggested that tax-exempt organizations that engage in inappropriate or illegal behavior should be penalized by forfeiting their tax-exempt status. Do you support the revocation of tax-exempt status for bad actors in the charitable community?

Answer:

The charitable sector is a vital part of our society. There are roughly one million charities in the United States. The vast majority of these charities carry out valuable missions in a manner consistent with their exempt purposes and the law.

However, some organizations have abused those privileges. I believe that good governance goes hand and hand with good charities. If confirmed, I look forward to working with Congress in its efforts to ensure charities are complying with their exempt purposes.

Thomas Question 4 (Tax Gap):

We've had a lot of discussions over the last year or so regarding the "tax gap." As Treasury Secretary, what would be your first priority in addressing the tax gap?

Answer:

I share your concern about the tax gap. I believe that every American taxpayer should pay taxes honestly and accurately. While most American taxpayers do meet their tax obligations, I understand that the tax gap is a significant issue. Reducing the tax gap requires a multi-prong strategy. Improving enforcement is critical, but we need to strike a good balance between enforcement and taxpayer rights. Simplifying the tax code would also help reduce the tax gap. If confirmed, I look forward to working with you to develop specific policies that can reduce the tax gap.

Santorum Question 1 (Entitlement Spending):

The Congressional Budget Office reports that federal tax revenue has averaged 18% of GDP since 1962. What are the implications for the economy if the federal government were to spend 18 percent of GDP on Social Security, Medicare, and Medicaid alone, as is projected by 2040? What effect would that likely have on the tax rates?

Answer:

The entitlement situation represents an enormous and urgent challenge for us all. We should not underestimate the consequences of inaction on entitlement reform. In my travels across Europe and Asia, I have seen first-hand the tremendous fiscal and economic burdens created by large entitlement programs in the wake of aging populations. The sooner we act, the more we can limit the cost of reform.

However, it is important that we do not compromise the economic engine that has made the United States so competitive and successful. We must work together in a bipartisan fashion to find feasible solutions to these important issues. If confirmed, I look forward to working with Congress to make needed changes to address the entitlement situation.

Santorum Question 2 (Dividends & Cap Gains):

Has lowering the cost of capital – through the dividend and capital gains reductions in the jobs and growth package – resulted in increased investment in our economy? Has this played a role in the ensuing job creation? Has this played a role in increasing the revenues to the federal government?

Answer:

Yes, I believe the economy has benefited from the lower tax rates on dividends and capital gains as indicated by the strong increases in investment, job creation, and GDP growth that have occurred since these rates were enacted in 2003. The lower rates should be made permanent. Investors care about future after-tax returns and extending the lower rates on dividends and capital gains, which would permanently reduce the uncertainty investors face when making current investment decisions.

The lower rates have also helped stimulate capital formation and business investment at a key point in the business cycle. It is important to keep in mind that businesses do not just plan a few months in advance – they need certainty in the tax code for business planning. The extension of the lower rate introduced some much-needed certainty, encouraging continued business expansion, new investment, and job growth.

I also believe the lower tax rates on dividends and capital gains have contributed to the current strength of the economy and that the strong economic growth we have experienced in the past 3 years is largely responsible for the recent increases in federal tax revenues.

Santorum Question 3 (Individual Development Accounts):

Over the past decade, the percentage of after-tax, disposable income saved has declined precipitously; the latest recorded personal-savings rate in the U.S. fell to an embarrassingly low negative 0.5%. This low savings rate lags far behind that of other industrial nations, constraining national economic growth and keeping many Americans from entering the economic mainstream. What benefits might Individual Development Accounts or KIDS accounts have for the low-income individuals in improving the lives of these individuals. What other asset building provisions have you explored that might benefit individuals and families?

Answer:

I certainly agree with your concern about the Nation's low savings rate and the need to increase it. The President has made a number of proposals to encourage greater savings. I am not familiar with the details of the specific accounts you mentioned, but if confirmed, I intend to learn more about them. Addressing our low savings rate is certainly one issue that we need to consider carefully as we work to reform our tax system.

Santorum Question 4 (Charitable Giving):

We have seen the amazing role charities have played in the relief effort after Katrina and Rita. In fact it was their performance that was lauded over that of the respective governments. As you know I have been working for years to pass the CARE Act – including the nonitemizer, the IRA rollover, the food donation and the S Corp provisions, all of which at one point have been supported by this Administration. What will you do as Secretary to support increased charitable giving? Will you support the enactment of the CARE Act?

Answer:

The charitable sector makes vital contributions to our society. Increasing incentives to give will improve the charitable sector's ability to serve Americans in need. While I am not familiar with the details of your legislation, if confirmed, I look forward to learning more about it and to working with my colleagues in the Administration and with Congress on efforts to promote charitable giving.

Santorum Question 5 (Charitable Giving):

Some have linked increased charitable giving incentives to so-called "charitable reforms." While the charitable sector supports increased transparency, and, as you know, the CARE Act addresses this concern, there is a fear within the sector that charitable reforms that have been proposed will go too far and actually have a negative impact on charitable giving. Do you believe that incentives for charitable giving must be linked to "reforms"? or do you think we should pass incentives now and reforms when they are ready and supported by the entire charitable community?

Answer:

The charitable sector is a vital part of our society, and the vast majority of charities do important work that improves people's lives. Increasing taxpayer incentives will improve the sector's ability to provide critical services. However, the whole sector is hurt when donors claim improper deductions and when charitable organizations abuse their tax-exempt status. I believe that the goals of encouraging donations to charity and encouraging good practices by charities and donors are consistent ones. If confirmed, I look forward to working with Congress in its efforts to promote charitable giving and to protect charitable resources from misuse.

Santorum Question 6 (Telephone Excise Tax):

You may know that the Treasury's recent decision to concede the telephone excise tax cases that were collected but were not based on time and distance has left only the "local plans" covered. As such, that means this tax is hitting the lower-income families – those that can't afford the more expensive flat rate plans – the hardest. Do you support the full repeal of the telephone excise tax?

Answer:

Yes, I support repeal of the telecommunications excise tax. If confirmed, I look forward to working with Congress to repeal this tax.

Santorum Question 7 (Telecommuting Bill):

Nearly 40 million Americans telework today – whether a few days a week or their entire work schedule – and according to experts, 40 percent of the nation's jobs are compatible with telework. My Telework Tax Incentive Act to provide a \$500 tax credit for the employer or employee, whoever absorbs the expense for setting up the at-home worksite. An employee must telework a minimum of 75 days per year to qualify for the tax credit. In my opinion, the best part of telework is that it improves the quality of life for everyone – the employee, the employer and the community. What is your view of teleworking and would you support the passage of the Telework Tax Incentive Act?

Answer:

I understand the importance of teleworking, and its potential benefits in terms of strengthening families, reducing road congestion and pollution, and limiting costs for employers. If confirmed, I look forward to working with you on this important issue.

Santorum Question 8 (TRIA):

What is the status of the President's Working Group on Financial Markets study on the long-term availability and affordability of terrorism risk insurance?

Answer:

I understand that the PWG is currently considering the long-term availability and affordability of terrorism risk insurance as part of its analysis to prepare the report due on September 30, 2006. I expect these issues will be addressed in the report.

Santorum Question 9 (TRIA):

How is the group studying the ability of private market mechanisms to handle this risk and the willingness of capital markets to take on this risk?

Answer:

I believe the most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance will come from the private sector. If confirmed, I would look forward to working with the other members of the PWG and Congress on this important issue.

Santorum Question 10 (TRIA):

It is my understanding that natural catastrophe bonds have added relatively little capacity for traditional natural catastrophe reinsurance, despite the fact that bonds have been available in the natural catastrophe context for more than a decade. Is specific attention being given to the role of alternative risk transfer methods such as catastrophe bonds?

Answer:

I understand that the PWG is currently considering the role of alternative risk transfer methods such as catastrophe bonds as part of its analysis to prepare the report due on September 30, 2006.

Santorum Question 11 (Section 29):

For several years, through letters, phone calls and meetings, I, along with Senators Specter and Rockefeller, have communicated with the IRS and the Department about the IRS' existing guidelines for the issuance of private letter rulings under Section 29 as they relate to Steel Industry Fuel. The IRS has said it is no longer issuing PLRs for "new processes," although I am told that it has issued three PLRs for a new process.

Despite repeated requests for the IRS to reconsider these guidelines because they appear not to be consistent with the guidance to taxpayers provided in an earlier Revenue Procedure, the IRS has refused to change its position.

Throughout the process of trying to get the PLR process moving for Steel Industry Fuel, IRS staff and officials indicated that the threshold for action was Congress clarifying that SIF was intended to be eligible for Section 29. Despite intense congressional interest and a clarification of congressional intent in the Energy Policy Act of 2005, IRS and Treasury have still refused to change their ruling position. Chairmen Grassley and Thomas also sent a joint letter to Treasury calling the IRS to consider such rulings and guidance on an expedited basis to those taxpayers who had pending ruling requests at the time of the IRS-imposed moratorium.

Why is congressional intent regarding this matter being ignored?

Answer:

I understand your longstanding concern on this matter. I am not a tax expert, and I have not been briefed on the specifics of this issue. If confirmed, I look forward to learning more about it and what responses are appropriate.

Santorum Question 12 (Section 29):

Will you agree to take another look at this decision, taking into account congressional intent and the merits of this process?

Answer:

I understand your longstanding concern on this matter. As indicated in my response above, if confirmed I look forward to learning about the details of this issue and the bases for the position taken to date by the Treasury Department and the Internal Revenue Service.

Smith Question 1 (Payroll Taxes & S Corps):

Over the past six years, the Bush Administration has joined Congress in supporting the small business community in a variety of ways, including reducing their tax burden through across-the-board rate relief.

More recently, however, the Treasury Department's Inspector General for Tax Administration (TIGTA) has proposed applying payroll taxes to all the net income of certain S Corporations, even when that income resulted from capital investment.

Adopting this policy would, in effect, be a massive and unfair tax increase on America's small business community.

What are your thoughts on TIGTA's recommendation?

What are your thoughts on whether subjecting the net earnings of pass-through entities like S corporations to the payroll tax violates the long-standing principle that payroll taxes be applied to wage income?

Answer:

I am not a tax expert, and I am not familiar with the specific issues you raise. If confirmed, I look forward to learning about this issue and to the opportunity of discussing it with you in greater detail.

Smith Question 2 (Mortgage Interest Rate Deduction):

In January 2005, the President appointed a bipartisan panel to study the federal tax code and to propose options to reform the tax code for the purpose of simplification and overhaul. The panel issued a report in the fall of 2005 that included a proposal to change the mortgage interest deduction.

What is your position on the mortgage interest deduction?

Are you committed to maintaining the mortgage interest deduction should there be an attempt at tax reform in the future?

Answer:

Tax reform is very important issue, and one in which I'm personally interested. I understand the President has made clear that he strongly supports homeownership, and I commend him for the increase in homeownership that has occurred over the past several years. I also believe that any tax reform plan should be evaluated as a whole. If confirmed, I plan to review the recommendations, and I hope to work with the President and Congress in developing a tax reform proposal that is workable and can be implemented.

Smith Question 3 (IRS Enforcement):

Part of the Treasury Department's Inspector General for Tax Administration (TIGTA) testimony states "the S corporation form of ownership has become a multibillion dollar employment tax shelter for single-owner businesses."

While the TIGTA's testimony recognizes that the IRS currently has the ability to ensure small business owners pay the appropriate amount of payroll taxes, he notes that "determining what is reasonable compensation to pay a business officer is complex and subjective."

Would it be your position as Treasury Secretary that all S Corporations are merely tax shelters created in order to avoid paying payroll taxes?

Answer:

From my experience, I understand that there are many reasons for choosing one form of business structure over another, including simplicity, tax issues, and limits on liability. I believe that S corporations are an important option for structuring a business, especially for smaller enterprises.

Smith Question 4 (Proposed Regulation):

Treasury recently issued regulations dealing with the treatment of sellers of property and qualified intermediaries in deferred like-kind exchanges (under Code sections 468B and 7872). At a June 6, 2006 hearing held by the IRS, several independent small business qualified intermediaries, including one from Oregon, testified that these regulations, if finalized in current form, would significantly harm competition in the industry and have an adverse effect on hundreds of small businesses and their employees, as well as undercut competition in the marketplace. It is unclear what the tax policy rationale was for promulgating these rules, but the negative impact of these rules is clear.

In light of recent testimony, is Treasury considering significantly revising or withdrawing these proposed regulations?

Answer:

I have not been briefed on details of these regulations. If confirmed, I look forward to studying this issue further.

Smith Question 5 (R&D Credit):

Congress has repeatedly extended the Research & Development Tax Credit as a way to create high-paying and high-value research and development jobs in the United States. This has been our national policy for many years, and this policy has broad bipartisan support in both the House and the Senate.

Despite this clear national priority, I recently learned that the IRS may reverse a 17 year old rule regarding the R&D treatment of inter-company sales between a U.S. corporation and its subsidiaries. Specifically, the IRS has just begun advising its field agents in Chief Counsel Advice 200620023 that the term "gross receipts" for purposes of calculating the R&D credit now must include inter-company sales, reversing its prior position published most recently in 2002. For many U.S. companies, this change will diminish, if not eliminate, the R&D tax credit.

First, it would artificially and retroactively increase the gross receipts of companies that brought home foreign earnings during 2005 under the Homeland Investment provisions. As a result, their R&D credit will be diminished or wiped out in current and future years. As a strong advocate of the repatriation dividend in the Jobs Act, I can assure you it was not Congress' intent to punish U.S. businesses in this manner. Second, on a prospective basis, the ruling could push U.S. R&D activities offshore to countries which provide a more favorable tax regime for research activities. Finally, the ruling could lead to the export of more manufacturing jobs, as U.S. based multinationals leave their foreign

earnings abroad rather than repatriate them just to see their research credit penalized. This will reduce the number of new jobs created in the U.S.

I urge you to review this matter carefully and prevent this misinterpretation from pushing R&D and jobs offshore.

What is your position on this matter?

Answer:

I fully support the benefits of the research and development tax credit to our economy. However, I have not been briefed on this particular regulatory matter. If confirmed, I look forward to taking a closer look at this issue.

Smith Question 6 (Competitiveness of U.S. Capital Markets):

Of the 25 most recent large IPOs, 24 occurred outside the United States. Many have attributed the increase in overseas listings as a direct result of expensive and complex regulatory regimes – namely section 404 of Sarbanes-Oxley. The capital markets are of critical importance to the economic health of our nation and as the global economy expands, companies now have the ability to move across the globe to raise capital and have shown no hesitation in doing so.

- a) Are you concerned that the center of global capital markets is shifting away from the U.S.?
- b) If so, what can we do about it?

Answer:

One of the issues that I am most interested in is ensuring the competitiveness of the U.S. capital markets. Therefore, I have some concern about the increase in companies that choose to list in places other than the United States. There are many reasons for this development such as the legal system in the United States, growth in the sophistication of the overseas markets, and regulatory requirements in the United States, including Sarbanes-Oxley. I share your view that the capital markets are of critical importance to the health of our nation, and I will work tirelessly to ensure that our capital markets stay competitive.

Smith Question 7 (CFIUS Reform):

There is currently legislation pending in Congress to make changes to the national security screening of foreign direct investment in the United States. While I agree that some strengthening of the CFIUS process is necessary, it seems to me that we could raise barriers to foreign investment that would be very negative to our economy.

Given your 30 some years of experience in investment banking, having sat on both sides of the table – both sellers of U.S. businesses and foreign firms looking to make purchases here – can you give me your sense of the stakes?

What is the U.S. interest in maintaining an open investment regime?

Answer:

CFIUS performs a very important function – helping to ensure that national security is protected in a post-September 11th world, however, we must continue to welcome the foreign investment into the United States so we can maintain the strength of our economy and create millions of jobs for American workers.

Should I be confirmed, I will serve as Chairman of CFIUS. It is important that Congress have confidence that CFIUS is fulfilling this critical responsibility. I look forward to working with Congress to ensure that its concerns are addressed in the process, including providing adequate scrutiny to investments that involve a foreign government.

A reduction in foreign investment would cost American workers good jobs, reduce innovation, and lower the growth of the U.S. economy. Moving away from an open investment policy could lead other countries to impose restrictions on U.S. investors. That too would cost American jobs and cut U.S. exports. Therefore, any reforms to the CFIUS process should send a signal that the United States is serious about national security but welcomes legitimate foreign investments.

Smith Question 8 (S Corps):

I applaud the Bush Administration and the Treasury Department for working closely with Congress to pass incentives for the private sector to grow and expand, further strengthening our economy – specifically instituting much-needed certainty in today’s economy by extending the capital gains and dividends tax rates. However, we have more work to do, particularly reforming burdensome and obsolete tax rules that hamper the growth of America’s S corporation businesses – typically small and family-owned companies that are engines of U.S. job growth.

We are hindering the further growth and investment of these companies by failing to address and modernize antiquated tax rules, such as those that penalize S corporations for excess passive investment income and those that force S corporations from holding on to uneconomical, so-called “built-in-gains” assets for ten years before they can access capital and redeploy it into their businesses. These and other antiquated rules not only tie the hands of small and family business owners; they also create an unlevel playing field between S corporations and other corporate structures, such as Limited Liability Corporations (LLCs). Punitive taxes on S corporations have no place in an economy filled with LLCs, which are themselves free from costly restrictions while they enjoy all the benefits that accord to S corporations.

Over the past six years, the Bush Administration has joined Congress in supporting the small business community in a variety of ways, including reducing their tax burden through across-the-board rate relief. I hope you can continue to support small businesses through specific relief for S corporations from excess passive investment rules and from built-in gains taxes after the first 7 years of S corporation status.

Can you commit to me that your staff will work with my office to further legislative proposals that would decrease the burden of the built-in gains tax and the excess passive income rules on S corporations?

Answer:

I share your views on the importance of small businesses to the American economy. The tax law imposes a number of burdens on small businesses. Your question asks about some of the technical rules that apply to small businesses that become "subchapter S" corporations under the tax law. While I am not familiar with these specific rules, if confirmed, I look forward to working with Treasury Department and Internal Revenue Service staff to consider problems these rules might raise for small businesses. If confirmed, I also look forward to working with the Administration and Congress to continue reducing or eliminating burdens on small businesses wherever possible.

Crapo Question 1 (Dividends & Capital Gains):

Mr. Paulson, I am a strong believer in the benefits of reducing the double-taxation of corporate income. These lower rates have cut taxes for millions of Americans, including a large number of senior citizens and have provided the financial markets with a more transparent view of a company's financial health, since dividend payments provide tangible proof of claims of profitability.

Thanks to an extension passed earlier this year, the current rates do not expire until the end of 2010. I would certainly like to make them permanent. Do you agree that these lower rates have benefited the economy and should be made permanent?

Answer:

Yes, I believe the economy has benefited from the lower tax rates on dividends and capital gains as indicated by the strong increases in investment, job creation, and GDP growth that have occurred since these rates were enacted in 2003. The lower rates should be made permanent. Investors care about future after-tax returns and extending the lower rates on dividends and capital gains, which would permanently reduce the uncertainty that investors face when making current investment decisions.

The lower rates have also helped stimulate capital formation and business investment at a key point in the business cycle. It is important to keep in mind that businesses do not just plan a few months in advance – they need certainty in the tax code for business planning. The extension of the lower rate introduced some much-needed certainty, encouraging continued business expansion, new investment, and job growth.

Crapo Question 2 (Derivatives):

I'm very concerned about the potential efforts in this Congress to change the manner in which we regulate derivatives or to impact the manner in which derivatives operate in the economy. As you know, the President's Working Group on Financial Markets has explained why proposals that we have faced in the last couple of years for additional regulation of energy derivatives were not warranted, and has urged Congress to be aware of the potential for unintended consequences.

- a) Do you share this view?
- b) Do you agree with the view of Alan Greenspan and others that derivatives have helped create a far more flexible, efficient and resilient financial system?
- c) Are you aware of any evidence that additional reporting requirements or other regulatory actions would reduce energy prices and price volatility or are energy prices and price volatility determined by the market?

Answer:

I believe these proposals could have significant unintended consequences for the risk-management functions that the markets – whether over-the-counter or exchange-based – perform in our economy. It is my view that absent a clearly demonstrated need, we should be wary of major changes to the manner in which we regulate our derivatives markets.

The importance of derivatives markets in the U.S. economy should not be taken lightly, as businesses, financial institutions, and investors throughout the economy rely on these markets to manage their risks and to protect themselves from market volatility. These markets have contributed significantly to our economy's ability to withstand and respond to various market stresses and imbalances.

Although I have not studied this issue in great detail, it has been my experience that increasing reporting requirements does not affect market fundamentals; rather they are influenced by supply and demand factors.

Crapo Question 3 (TRIEA):

The Terrorism Risk Insurance Extension Act of 2005 (TRIEA) expires at the end of 2007. Among its provisions was a mandate to the Presidential Working Group on Financial Markets (PWG) to analyze the long-term availability and affordability of terrorism insurance, and to report their findings to Congress no later than September 30, 2006.

- a) What are the financial mechanisms available to enhance the private market capacity to take on this risk upon expiration of Terrorism Risk Insurance Extension Act of 2005?
- b) What are your views of creating a free market for insurers for terrorism risk that would allow them to underwrite, price, and adjust coverage for this risk?

Answer:

I understand that the PWG is currently considering these issues as part of its analysis to prepare the report due on September 30, 2006. I expect these issues will be addressed in the report. Over the long-term, the most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance will come from the private sector. If confirmed, I would look forward to working with the other members of the PWG and Congress on this important issue.

Baucus Question 1 (R& D Credit):

Mr. Paulson, one of my top priorities has been trying to make the popular Research and Development tax credit permanent. I was pleased that President Bush also requested this as part of his budget for the last few years. You may have some ads that have been running in the Wall Street Journal highlighting why Sony decided to locate its Computer Science Lab in France touting the government support for foreign businesses.

And there is another ad seeking to recruit businesses to locate their research in Ontario with the enticement of, "R&D tax credits are among the most generous anywhere."

Mr. Paulson, our R&D tax credit creates and maintains countless U.S. high-tech jobs, yet it has been expired now for six months. We passed a bill last month with billions of dollars in tax cuts, but nothing for the R&D credit. If this is the President's priority, can you explain why it hasn't been made permanent, let alone even extended for a year?

Answer:

Research and development in this country is fundamental to our continued economic success, and I believe the tax incentives in this area are important. Unfortunately, I cannot speak to those factors that have held up an extension of the R&D credit, although I have been made aware that permanence remains a high priority of the Administration. While I am not a tax expert, if confirmed, I look forward to learning more about this aspect of the tax law and to working with you and the Committee to ensure that the United States maintains its competitiveness in the area of research and development.

Baucus Question 2 (Tax Gap):

At your confirmation hearing, I asked for your commitment to deliver a plan by September 30 to close the tax gap. You responded that you wanted to consult with the IRS first. Commissioner Everson already has made this commitment.

Answer:

I share your concern about the tax gap and, if confirmed, am committed to working with the Finance Committee and Commissioner Everson to reduce it as much as possible. As you know, one of the main causes of the tax gap is the complexity of the current tax law. Accordingly, I would like to examine whether or not it's feasible to consider possible solutions to the Tax Gap in the broader context of fundamental tax reform. That plan must also include proposals to work within our current tax system to strike an appropriate balance between enforcement and taxpayer service. I would also be interested in your ideas for addressing this issue and if confirmed, look forward to working with you to develop specific proposals that will reduce the tax gap as quickly as possible.

Baucus Question 3 (Tax Gap):

After having had a chance to consult with the IRS, do I now have your commitment that you will work with Commissioner Everson to develop a plan that will be delivered to this Committee by September 30 of this year?

Answer:

If confirmed, I will work with Commissioner Everson to develop a program to address the tax gap as quickly as possible. While some progress can be made within our current tax system, I believe more dramatic increase in compliance will likely require fundamental reform of our tax system. Should I be confirmed, I look forward to working with Congress on the tax gap and the broader issues it raises.

Baucus Question 4 (Tax Shelters):

During your confirmation hearing, you testified that you understood the IRS was coming along quite well in its effort to combat abusive tax shelters. However, information recently received from the IRS indicates otherwise.

The IRS told the Finance Committee that it needed stronger penalties and disclosure rules to stop the proliferation of abusive tax shelters. In October, 2004, Congress passed the American Jobs Creation Act (AJCA), containing increased and new shelter penalties as well as stronger disclosure rules. Almost two years later, the IRS has failed to impose a single one of the new penalties and lacks key systemic processes to administer AJCA.

Why is it taking so long to implement the new anti-tax shelter laws?

Answer:

I understand that the elimination of abusive tax shelters remains a high priority for the Administration and the Finance Committee. While I am not a tax expert, my experience in the business world has shown me that a major cause of this issue is the sheer complexity of the tax code, and the best way to address the tax shelter problem is to reform and simplify the tax code. If confirmed, I would look forward to working with you to ensure that tools available to the IRS are fully utilized.

Baucus Question 5 (Tax Shelters):

Do I have your assurances that you will look into the matter to ensure the anti-tax shelter laws are enforced?

Answer:

If confirmed, I am committed to ensuring that the laws Congress has enacted to address tax shelters are implemented and enforced.

Baucus Question 6 (Tax Shelters):

Two years is too long to wait. Within the next 30 days, I am requesting a report from you that includes:

- a) An implementation plan, including timelines, identifying everything that still needs to be done to put the new tax shelter laws to work. (As the plan is completed, please provide regular updates on your progress.)
- b) Innovative ideas the IRS has to close the tax shelter tax gap, for example, electronic filing of the disclosure forms.

- c) An IRS tax shelter organization chart that includes every function that works on tax shelters and describes what role they serve. Are there gaps? Is there overlap? How can the tax shelter operation be run more efficiently? Is staffing and information technology commensurate with the high priority status of tax shelters?

Answer:

I understand that the Treasury Department and the IRS are committed to addressing the problem of abusive tax shelter transactions, and they have put a number of processes and procedures in place to do so. While I am not familiar with the organizational structure of the specific IRS functions that focus on tax shelters, if confirmed, I look forward to learning more about this issue and ensuring that all necessary steps are being taken to address this important issue. As I stated during the hearing, I would rather under promise and over deliver than over promise and under deliver and I am mindful of this as I contemplate the sheer magnitude of the challenges ahead and the policies and priorities that I must learn if given the privilege to serve at the Treasury Secretary.

Baucus Question 7 (Tax Administration):

Foreign Source Information Reports – IRS failed to use them to find unreported income.

This Committee recently learned that the IRS has failed for years to use the foreign source information reports received from our treaty partners (similar to the Forms 1099 that we use here in the US) to determine whether income earned overseas by US taxpayers is being reported to the IRS. We learned the paper reports just sat in boxes in Philadelphia without being reviewed. Now that the data is coming in electronic format, the IRS still is not using the information to find unreported income.

- a) With a \$345 billion annual tax gap, and the use of offshore accounts to avoid taxes proliferating, why would the IRS let this valuable information just sit there and go to waste?
- b) What do you intend to do to ensure that the IRS pursues unreported income from foreign sources?

Answer:

In this dynamic economy, it is important that domestic and international tax compliance remain a very high priority. I am not familiar with the specific events you cite, however, if confirmed, I look forward to learning more about the international tax compliance challenges facing the IRS and working with Commissioner Everson to ensure that they are addressed.

Baucus Question 8 (Tax Administration):

Fraudulent Refunds – For two years the IRS has failed get a new computer system up and running to detect fraudulent tax returns.

The IRS Criminal Investigation Division has a program called the Electronic Fraud Detection System that is meant to detect fraudulent refunds at the time the tax return is filed, stopping these refunds from being sent out. The IRS has spent two years and \$21

million to upgrade this system and it still is not up and running. The old system has been retired, so now the IRS doesn't have any program to detect fraudulent refunds.

- a) How could the IRS pay \$21 million for a fraud detection program and have nothing to show for it?
- b) Will the IRS go back and try to identify the fraudulent refunds claims filed during the 2006 filing season? [ANSWER: We were told the IRS does not intend to go back and recoup the fraudulent refunds.]
- c) What will you do to make sure there is a fraud detection program up and running for the 2007 filing season?

Answer:

I am not familiar with the specific events or programs you cite. If confirmed, however, I look forward to learning more about these compliance issues and to working with Commissioner Everson to ensure that they are addressed.

Baucus Question 9 (Tax Administration):

Limited Issue Audits – IRS skims the surface but tax shelters could be hidden below the surface.

To leverage its resources and to become more current in its examinations, the IRS uses several expedited or abbreviated audit techniques, including the limited scope audit and the LIFE (limited issue focused exam) audit. Agents examine only a few issues and do not have the time to look below the surface for tax shelters or other abusive transactions.

- a) Do you think that audits designed to pick the “low hanging fruit” are good policy? How effective are limited audits at finding Enron-type situations that are not apparent on the face of the tax return?
- b) What impact do you think limited audits have on the tax gap? Has quality been sacrificed so the IRS can get caught up on its audits?
- c) Are there alternative ways the IRS could conduct fast, efficient audits that would not sacrifice quality?
- d) Do you think the M-3 should be made public? Would that help find bad deals that are hidden in the tax return?

Answer:

I am not familiar with the specific techniques and issues you cite. If confirmed, however, I look forward to learning more about these compliance issues and to working with Commissioner Everson to ensure that they are addressed.

Baucus Question 10 (Tax Administration):

Slow decision-making by Treasury and the IRS exacerbates the tax gap.

Recently, Commissioner Everson sent a letter to the Committee identifying the “most significant” corporate tax compliance issues. Many of these issues have been under consideration for years, including cost sharing, transfer pricing and the universal service fund.

- a) What prevents the Treasury and IRS from publishing prompt guidance on important compliance issues?
- b) These may be tough issues, but once the facts patterns have been determined, does the passage of time make it any easier for the government to take a legal position?
- c) What steps can Treasury and IRS take to expedite the issuance of guidance to address compliance problems?
- d) What impact does the lack of guidance have on corporate compliance and the tax gap?

Answer:

I am not a tax expert. While I agree that steps need to be taken to improve compliance and reduce the size of the tax gap, I need to learn more about these specific issues. If confirmed, I look forward to working with the Treasury Department and the IRS to ensure that these issues are addressed, and I look forward to working with the Senate Finance Committee and Congress to consider ways we can simplify our tax code.

Baucus Question 11 (Tax Administration):

Data warehousing – IRS use of information collected by the states.

States are creating databases of publicly available data, for example, business licenses granted, that can be compared to tax return information in order to detect unreported income or unwarranted deductions. The states report they are collecting hundreds of millions of dollars in tax revenues as a result of this tool.

- a) To what extent is IRS/State coordination of data warehousing viable?
- b) What impact would the use of data warehousing to detect noncompliance have on the tax gap?

Answer:

I am not familiar with this specific issue. It sounds as if you may have identified a promising area for development, and, if confirmed, I look forward to learning more about it and getting back to you.

Baucus Question 12 (Tax Administration):

An IRS employee checked his or her laptop computer as luggage before taking a flight. The computer contained confidential employee information including names, social security numbers, addresses and fingerprints. Unfortunately, when the flight arrived, the computer didn't. It has not been recovered. Coupled with the recent theft of 26.5 million veterans' accounts from the VA, security of confidential data is a concern.

How will you ensure that IRS policies on data security are adequate, especially with the frequent use of laptop computers that can be lost or stolen?

Answer:

I share your concerns about protecting confidential employee information and look forward, if confirmed, to working with the IRS and the rest of the Treasury Department to assure that systems are in place to protect this sensitive data.

I also appreciate the importance of protecting the confidentiality of tax return information. Taxpayers should have confidence that their sensitive financial information will be protected in the hands of the IRS. I understand that the tax law has special provisions protecting tax information and that the Treasury Department and the IRS take their obligation to adhere to and enforce these provisions very seriously. If confirmed, I look forward to learning more about these provisions and working with the Finance Committee to ensure that the confidentiality of tax information continue to be safeguarded.

Baucus Question 13 (Tax Administration):

Recently, the IRS agreed to send letters on behalf of the VA to the 26.5 million veterans whose confidential information was stolen from a VA employee's home. The letters did not include a VA address. As a result, it is likely that veterans who want to write to the VA for information about their case will send their letters to the IRS PO box that appears on the envelope. So far, over 500,000 letters have come back to the IRS as "undeliverable", but the IRS will not tell us how many letters it has received addressed to the IRS PO box.

- a) Why did the IRS agree to send out letters that did not contain a mailing address to the VA, especially after the Finance Committee was assured that the address would be included?
- b) How is the IRS going to handle the extra workload generated as a result of veterans writing to the IRS address?

Answer:

The theft of a computer containing veterans' confidential information is a very serious matter, especially with respect to the potential for identity theft and other problems. I am not familiar with the IRS's involvement in this matter, but I think it is important that when faced with such a significant loss of personal financial data, the federal government use its collective resources wherever possible to help address the issue.

Baucus Question 14 (Tax Reform):

Mr. Paulson, the President's tax reform panel has submitted recommendations for major changes to our tax system and I understand the Treasury Department has already performed a dynamic analysis of these plans. Targets of these recommendations include the mortgage interest deduction, employer-provided health insurance, charitable deductions, and state and local taxes. Further, businesses could be hit with the loss of interest and depreciation deductions.

I think you would agree with me that both individuals and businesses need to know what the long-term tax implications will be. For a family signing a 30-year mortgage or a

small business owner buying an expensive capital asset, loss of these tax benefits would be devastating.

Can you assure this Committee that you will work with us as an equal partner in designing any fundamental tax reform or major simplification plan?

Answer:

Tax reform is very important issue, and one in which I am personally interested. I understand that the Treasury Department is evaluating the recommendations from the President's tax panel, and a top priority for me, if I am confirmed as Secretary, will be to complete that review process and make recommendations to the President on a fair and simple tax system.

Fostering economic growth, ensuring U.S. competitiveness in the global economy, addressing abusive tax shelters, and ensuring that the tax burden is distributed fairly are important goals of tax reform. I am confident that tax reform can achieve those goals. If confirmed, I look forward to working with Congress on this important issue.

Baucus Question 15 (Tax Shelters):

After almost two years, why hasn't the IRS imposed any penalties for failing to disclose an abusive tax shelter?

Answer:

I am not familiar with the details of this situation. I share your concern about the importance of eliminating abusive tax shelters and closing the tax gap. If confirmed, I look forward to working with Commissioner Everson to ensure that the IRS is fully utilizing the tools that Congress provided to it to address these issues.

Baucus Question 16 (Tax Shelters):

Two years is too long to wait for IRS to implement the new anti-shelter tools provided by Congress. Within the next 30 days, I want a report from you that includes,

- a) An implementation plan, including timelines, identifying everything that still needs to be done to put the new tax shelter laws to work. NOTE: As the IRS finalizes the implementation plan, regular updates describing the processes that are developed should be provided.
- b) A specific plan of completion and implementation for the database.
- c) Innovative ideas the IRS has to close the tax shelter tax gap, for example, electronic filing of the disclosure forms.
- d) An IRS tax shelter organization chart that includes every function that works on tax shelters and describes what role they serve. Are there gaps? Is there overlap? How can the tax shelter operation be run more efficiently? Is staffing and information technology commensurate with the high priority status of tax shelters?

Answer:

I am not familiar with the details of this situation. I share your concern about the importance of eliminating abusive tax shelters and closing the tax gap. If confirmed, I look forward to working with Commissioner Everson to ensure that the IRS is fully utilizing the tools that Congress provided to it to address these issues.

Baucus Question 17 (Budget and Current Account Deficits):

Mr. Paulson, your predecessor has been quick to dismiss the relationship between the budget deficit and our growing current account deficit. While there have been exceptions in recent history, I believe that the relationship between a growing budget deficit and a growing current account deficit is still valid.

Do you believe that ballooning budget deficits have an impact the current account deficit? If so, to what extent are they linked?

Answer:

Reducing the fiscal deficit at home is sound economic policy, regardless of its impact on the current account. I believe we must encourage Americans to save more, but solutions to the problem of global imbalances will require a coordinated effort among the major world economies. Japan and Europe must find the political will to make structural reforms to their economy that will stimulate growth. And, greater currency flexibility in Asia is also part of the equation as is growth fueled by domestic consumption.

Baucus Question 18 (China Agenda):

Mr. Paulson, I'm glad the administration has nominated a seasoned China hand like you to this post. Your experience will surely serve you well.

How will your experience at Goldman Sachs inform your view of the opportunities and obstacles in China? What did you from Goldman Sachs's part ownership of a Chinese bank that could be valuable as Treasury Secretary?

On China's currency, the administration's policy to date has clearly failed. What do you plan on doing differently to move China more quickly to a currency that more closely approximates its true market value?

As you know, Senator Grassley and I have introduced legislation that would scrap the currency manipulator provisions in the Trade Act of 1988. Do you believe that our legislation, if implemented, would be an asset to your China policy?

Answer:

Strong U.S.-China relations are extremely important for our country. In my former position, I had the opportunity to spend a good deal of time in China, and I built important relationships on those visits. This experience has given me valuable insight into working with the Chinese government and people. If confirmed, I look forward to using my experience to pursue policies important to the strength of the U.S. economy, such as a flexible currency exchange rate and open markets.

My predecessors deserve more credit for their accomplishments than they are given. China has taken a number of important steps towards economic reform and has made several important commitments that will be the basis for further reform. I have never had the responsibility of negotiating with China on their currency regime, but if confirmed, I will press them on the issues essential to achieving that objective. I have found my meetings with you and the Chairman to be extremely informative, and should I be confirmed, I look forward to working with you on developing tools to help us achieve our goals.

Baucus Question 19 (Current Account):

Mr. Paulson, your predecessor, Secretary Snow, repeatedly called our current account deficit a “sign of strength” of our economy. Would you use these same words to describe the current account deficit?

Assuming that you believe the current account deficit is a problem, what do you plan to do to reduce it? What will you do differently from your predecessor? Is a more competitive dollar part of your plan to narrow the deficit?

When we have faced large economic imbalances in the past, we have sat down with our major economic partners to hammer out a solution. I believe that time has come to sit down with today’s large and emerging economic powers to come up with a plan to allow for an orderly correction to global economic imbalances. Do you agree? Will you seek a multilateral “Plaza-like” solution?

Answer:

From my experience, I have seen that the United States is a preferred destination for foreign investment, which is the sign of the strength of our economy. However, addressing global imbalances, of which our current account deficit is just one manifestation, is an important long-term issue. It is a global issue that will involve a global strategy. If confirmed, I look forward to working with other major economies to implement policies that will lead to faster, more balanced growth abroad, which will help address these imbalances.

Baucus Question 20 (OFAC):

Please provide the number of FTE’s allocated, FTE hours spent, fines collected and enforcement cases opened within the Office of Foreign Assets Control (OFAC) in 2003, 2004, 2005 and through May 2006, with respect to terrorist financing and economic sanctions programs within OFAC. Please indicate the number of FTE’s, hours and enforcement cases, and fines by total value, for each country and each terrorist group on which OFAC resources have been spent.

Answer:

As I indicated in the hearing, if confirmed, this is one area of Treasury where I really need to get up to speed quickly given the important role Treasury plays in cracking down on terrorist financing and implementing other critical economic sanctions. Unfortunately, I have not been briefed on these issues nor am I familiar with the particular information you have requested and the extent to which such information can be shared due to law enforcement and intelligence sensitivities. If confirmed, I intend to review policies and procedures throughout Treasury including OFAC to ensure that available resources are being deployed as efficiently as possible within the context of each office's mission.

Baucus Question 21 (OFAC):

I am concerned about unnecessary OFAC restrictions being placed on legitimate religious ecumenical organizations and churches with longstanding relationships with denominations in Cuba. Will you make every effort to work with the Committee and with these religious organizations to ensure they are not subject to undue restriction of their purposeful travels to Cuba, nor to licensing policies that, in effect, discriminate against one denomination, faith, ecumenical organization or church over any others?

Answer:

I understand the President's Cuba policy. My job, if confirmed, would be to enforce the law in this area. If confirmed, I would be happy to discuss this issue with you.

Baucus Question 22 (OFAC):

Please provide the numbers religious organization license applications that have been received, approved, or denied since 2000, including the first quarter of 2006. How many organizations that were granted a travel license to Cuba under 31 CFR § 515.566(a) for the purposes of religious travel at some point before 2003 have, since 2003, been subject to restricted license renewals or renewals now only under 31 CFR § 515.566(b)?

Answer:

I understand that the President's Cuba policy has generated much discussion and even controversy with regard to travel and trade restrictions among other issues. At this point, however, I have not been apprised of what organizations, religious or otherwise, may have been granted travel licenses to Cuba. I look forward to hearing more about these issues in greater detail if I am confirmed.

Baucus Question 23 (Terrorism Insurance):

I understand the Treasury Department is leading a Presidential Working Group that is scheduled to issue a report on September 30, 2006 on how the United States should handle terrorism insurance. Can you tell me what attention is being given to modeling for various types of terrorist attacks and the projected economic loss and will that data be considered in the report?

Answer:

Your questions raise important issues, which I understand the President's Working Group (PWG) will be evaluating for its September report. I believe that the PWG will be

considering what improvements have taken place in the ability of insurers to price terrorism risk insurance, including in the development and use of modeling. If confirmed, I look forward to learning more about this issue.

Baucus Question 24 (Terrorism Insurance):

Given the potential for severe catastrophic losses caused by a terrorist using a nuclear, chemical, biological or radiological weapon (NBCR), what are your views on the role of the federal government in insuring against those losses and enabling our economy and society to deal responsively and responsibly with such terrorist strike?

Answer:

I understand that the PWG is looking into specific questions regarding the terrorism insurance market for the types of events you mentioned and will report on them in the September report. If confirmed, I look forward to learning more about this issue.

Baucus Question 25 (Terrorism Insurance):

In your view if the federal government were to assume financial responsibility for significant NBCR type terrorist losses, would that have an effect on how insurers, reinsurers and other sources of private capital view and underwrite the so-called conventional terrorism risk?

Answer:

If confirmed, I will be briefed in detail on this important issue, and look forward to working with the other members of the PWG to complete its work and report the findings to Congress in a timely manner.

Baucus Question 26 (U.S. Economic Competitiveness)

Mr. Paulson, looking at our economy today, we see a widening inequality gap, a negative savings rate, and a ballooning record current account deficit. Energy costs are reaching unimaginable heights, and our education system is failing too many Americans. At the same time, the world is rapidly catching up in terms of innovation, research, and education. You are certainly aware of these facts, and I was pleased hear your statements that we must take steps to maintain our competitive edge in the world. Many in Congress share this view and I have put forward a comprehensive plan for improve our economic competitiveness.

Could you tell us what specifically you plan to do to improve our competitiveness? More importantly, how will you partner with Congress to implement this agenda? How will you incorporate the initiatives that are already developing in Congress?

Answer:

I believe we are the most competitive economy in the world. Foreign investors with capital to invest are bringing it to the United States, a sure sign of a dynamic, growing economy.

To keep that edge, we need to be a technological leader. And, a well-educated, flexible labor force that responds quickly to changing business trends is a key to maintaining our global competitiveness.

I also agree with the President that we need to focus on research, private-sector investment in technology, and education and training for American workers. While I am not an expert on all the proposals making their way through Congress, if confirmed, look forward to delving into the details and working with you to find achievable solutions.

Rockefeller Question 1 (GDP Growth):

When nominating you to be the new Treasury Secretary, the President described the U.S. economy as prosperous. But the President's rhetoric is just not consistent with the actual experiences of working Americans. It is insulting to those who are struggling so hard to make ends meet in this economy, and for me, it raises doubts about whether this administration is serious about addressing the needs of low and middle income families.

For example, the President bragged that 5.2 million new jobs have been created since August 2003. But in reality, this administration's record on job creation is not very good. There have been only 1.5 million new private sector jobs since President Bush took office. And in May, only 75,000 new jobs were created. All experts agree: that is not sufficient monthly job growth to even support population growth.

I appreciate the need of the President to put the best face on his policies. However, when those policies are simply not working, the administration needs to acknowledge failures and change the policies.

You are bringing a lot of Wall Street credibility to the office for which you've been nominated. I hope that you will guard that credibility by dealing honestly with the failures and problems of today's economy. In accepting this nomination, did you talk to the President about a need to provide candid and honest assessments of his economic policies?

I am interested in knowing how you will define success for yourself and this administration. Is GDP growth sufficient? Or will you measure success based on the economic security of working Americans?

Answer:

Over the past six years, the economy has endured a number of serious events, including the bursting of the technology bubble, the terrorist attacks on September 11, 2001, the recession, the global war on terror, corporate scandals, and natural disasters. The President responded with well-timed tax relief, which helped to produce the current strong economic growth.

While the economy continues to do well, I recognize that there is more to do both in terms of keeping the economy growing and helping ensure the economic security of working Americans. A key issue on this latter point is take-home pay, which is related to

productivity. Productivity, however, is a double-edged sword – over the long-term, increased productivity leads to wage growth; in the short-term, productivity allows the economy to produce more with lower wage pressures.

The tax cuts have helped in the short-term to improve the take-home income for Americans, while the long-term benefits of improved productivity on wages catch up. There is a gap between wage growth and compensation growth, notably reflecting the rise in health-care costs. I believe we still need to tackle the issue of high health-care and energy costs. In addition, wage growth has historically lagged behind economic growth, and I expect to see wages increase if we can keep the economy growing. If confirmed, I will promote policies that over time increase will help keep the economy moving forward and create opportunities for Americans.

Rockefeller Question 2 (Budget/Tax Cuts/PAYGO):

Since coming to office, the President has signed into law almost \$2 trillion in tax cuts, and an extraordinarily large share of those tax cuts have benefited the most fortunate Americans.

At the same time, the nation's deficits and debt have exploded. Essentially, we are borrowing money, much of it from foreigners, in order to provide tax cuts, primarily to the wealthiest Americans. That seems extraordinarily unfair to the next generation of Americans who will have to pay higher taxes in order to pay back those debts.

The President has continually claimed that the tax cuts were necessary to improve the economy. However, the fact is that deficit-financed tax cuts are bad for long-term economic growth. The neutral Congressional Research Service evaluated the likely impact of the investor tax cuts, and determined that the long run effects are likely to be negative and could be large over time if debt financed.

Alan Greenspan indicated that he believes any extension of the President Bush's tax cuts should be offset. (*Before the House Budget Committee, February 2004, Greenspan said that he supported the original PAYGO rule that would require tax cuts to be offset.*)

Do you agree that it's just not smart to borrow more for more tax cuts?

Will you push the President to make fiscal discipline a real priority in the next few years?

Answer:

I feel very strongly that the tax cuts played important role in economic recovery. I remember vividly what things looked like in 2001 and how they were after the technology bubble bust, September 11th, the recession, global war on terror (including Afghanistan and Iraq), and the hurricane disasters. I am very pleased with economic expansion and job growth that the tax cuts have encouraged, and I believe the tax cuts have changed behavior and increased investor confidence.

Currently, we have a deficit and debt that are in the historically normal ranges as a percentage of the GDP. Over the long-term there are a number of challenges, namely entitlements. I believe it is better to be working from a position of strength with a strong economy to deal with these long-term issues. I also believe that increasing taxes will not address long-term serious problems we are facing – inflation, energy costs, health care costs, and entitlements. If confirmed, I look forward to working with my colleagues in the Administration and with Congress to find productive ways to reduce the deficit while continuing to encourage economic growth and stability.

Rockefeller Question 3 (Tax Reform):

Early last year, President Bush created a tax reform panel. The panel delivered its recommendations to the Treasury Department last fall, but no further action has been taken on tax reform.

It seems to me that Congress is going to have to face the need for what amounts to real tax reform in the near future. Not just populist tax reform talk, that would have people believe that everyone can have a smaller tax bill and file their return on a postcard. We need real reforms that make our system fairer and more efficient.

We need to permanently address the alternative minimum tax which threatens to affect tens of millions of upper-middle class Americans later this decade. And we have to face the fact that our revenues are not sufficient to cover our spending needs.

While the President is fond of telling the public that Congress simply needs to “tighten its belt” to deal with the deficits, that is not a serious solution. The deficits have been \$300 to \$400 billion in the last several years, while ALL non-defense, non-homeland security appropriations come to just over \$400 billion. “Tightening our belt” will not solve the deficit problem.

The President has put all of his focus on calls for his tax cuts to be extended. But instead, I hope that you will commit to work constructively with Congress to craft fair, tax reform. I have introduced legislation to simplify the overly complicated Earned Income Tax Credit. And I have long supported efforts to improve the value of the child tax credit for low income families. I hope that these are the kinds of tax reforms you will embrace.

Simplification cannot be the only goal of reform efforts. The Congress needs to reevaluate the current distribution of tax burden. And considering the widening gap between the rich and poor in this country, I hope that the administration will see the wisdom in asking the most fortunate Americans to shoulder a larger share of the tax burden.

When will you follow up on the work of the President’s tax reform commission and submit recommendations to the President?

Do you commit to work with the Congress on reforms that will make our tax system simpler and more fair?

Will you work with Congress to close loopholes so that abusive shelters cannot be used to avoid paying a fair share of taxes?

Answer:

Tax reform is very important issue, and one in which I am personally interested. I understand that the Treasury Department is evaluating the recommendations from the President's tax panel, and a top priority for me, if I am confirmed as Secretary, will be to complete that review process and make recommendations to the President on a fair and simple tax system.

Fostering economic growth, ensuring U.S. competitiveness in the global economy, addressing abusive tax shelters, and ensuring that the tax burden is distributed fairly are important goals of tax reform. I am confident that tax reform can achieve those goals. If confirmed, I look forward to working with Congress on this important issue.

Rockefeller Question 4 (China):

I understand that as the chairman of Goldman Sachs you have had an opportunity to travel extensively in Asia, particularly China. I think that this experience may serve you very well. I am very concerned about the loss of America's manufacturing base as factories and jobs are outsourced to China, India and other countries with low labor costs or environmental standards.

How do you think America can promote strong economic ties with other countries without losing our competitive advantage? How can we better enforce fair trade laws to protect our own workers? What can be done to encourage a fair currency policy in Beijing?

Answer:

An openly traded currency, the value of which is determined by market forces, will be my objective if confirmed as Secretary. China has taken steps to increase the flexibility of their currency, but I believe they must do more. I will also press China to rebalance their economic growth to rely more on domestic demand instead of exports, improve their reform their financial sector, and level the playing field with respect to intellectual property. I know that Ambassador Schwab is committed to strengthening our trade enforcement laws and look forward to working with her and Secretary Gutierrez to make certain that we hold accountable not only China but other countries as well.

Rockefeller Question 5 (Economy):

Your private sector experience should give you have the ability to provide a fresh perspective and new ideas for the President. And when necessary, I hope that you will be willing to give difficult advice to the President.

Could you please tell me an area of economic policy in which you think the administration needs to change course? How will your perspective alter the administration's economic policies?

Answer:

If confirmed, I plan on giving the President frank and candid advice in my role as Secretary, and I am looking forward to bringing my energy and enthusiasm to a number of issues. Although I am sure I share a general view with most members of the economic team on good policies to encourage economic growth and rising standards of living over the long term, we each bring a unique perspective.

I think the appropriate economic policies depend partly on the circumstances the Administration is facing. When the economy was sagging and employment growth was weak, I believe it was the right choice to emphasize broad-based tax cuts to restore incentives, put people back to work, and leave more of working Americans' income in their own pockets.

While the economy is now growing solidly, and the unemployment rate is low, I believe we need to take steps to ensure the continued strength of our economy. Among the areas where I think we need to find feasible solutions are fundamental tax reform and entitlement reform. If confirmed, I look forward to working with Congress on these critical issues facing our country.

Rockefeller Question 6 (Health Care):

During the Finance Committee's FY2007 budget hearing on February 7, I asked Secretary Snow several questions about health savings accounts (HSAs) and the TAA Health Coverage Tax Credit (HCTC), to which I have yet to receive satisfactory answers. So, I'm going to pose some of those same questions to you, in hopes that you can provide more complete responses.

As you may know from Secretary Snow, I remain concerned that HSAs continue to be pushed by the Administration as a meaningful health insurance option. The use of HSAs could significantly undermine the employer-based insurance system on which most people rely. As healthier and more affluent workers shift to HSAs, older and sicker workers will be left in traditional employer-sponsored policies. This type of adverse selection will drive up premiums for traditional employer-based coverage, which is much more comprehensive than the high-deductible insurance policies that accompany HSAs, further encouraging firms to provide less desirable coverage or to drop health coverage altogether. Past research by the RAND Corporation, the Urban Institute, and the American Academy of Actuaries indicates that premiums for comprehensive coverage under traditional health insurance policies could at least double if the use of HSA-like policies becomes widespread.

At the budget hearing earlier this year, I asked Secretary Snow the following question:

"The President's fiscal year 2007 budget includes two main proposals allegedly aimed at increasing health insurance coverage – individual tax credits and the expansion of HSAs. How many currently uninsured Americans do you estimate each of these initiatives would cover? What is the basis for your estimates?"

The response from the Treasury Department, which I finally received yesterday, was as follows: "Indeed the Treasury Department estimates that these proposals would increase the number of HSAs by 50 percent, from 14 million in 200X to 21 million in 200X."

Can you tell me what specific years the Treasury Department is citing here? Also, of the 14 to 21 million, can you tell me how many are currently uninsured? Of those that are currently uninsured, can you tell me how many would receive coverage through an individual tax credit and how many would receive coverage through an HSA? Finally, could you provide me with a data source for these estimates?

Answer:

I have not received briefings on the particular estimates and information you cite and, therefore, cannot provide any degree of clarity on this issue. I understand, however, that Secretary Snow is attempting to provide additional responses to your questions.

Rockefeller Question 7 (Health Care):

One of the responses I received yesterday from the Treasury Department was regarding my question on the 14 steps that must be completed by TAA-eligible workers before advance payment of HCTC begins.

The Treasury Department stated, "We want to make sure that all who want health coverage can obtain it as quickly and as simply as possible. We think these administrative efforts have improved the process and we believe ongoing efforts will further improve the system. Until the results of these efforts can be fully assessed, we do not believe legislative changes would be desirable and might prove to be counter-productive."

What are the Treasury Department's most recent enrollment estimates for the TAA HCTC as well as the source and date of those estimates? Please provide total enrollment as well as individual enrollment figures for displaced workers and early retirees.

How many people does the Treasury Department estimate are eligible for the TAA HCTC? Why does this program continue to only benefit a small fraction of the vulnerable workers and their families who qualify for help?

Can you provide me with a detailed list of the "administrative efforts" to improve enrollment in the TAA HCTC that the Treasury Department mentioned in its response?

When will the Treasury Department's administrative efforts be "fully assessed" as mentioned in the Department's response? Please provide me with a specific timeline.

Answer:

I agree that we should do what we can to ensure that these individuals have access to available health-care coverage as soon as possible. However, I am not in a position to respond to your specific questions regarding enrollment numbers and steps that the IRS

has taken. If confirmed, I look forward to learning about this issue and working with you on this important issue.

Rockefeller Question 8 (Treasury Responses):

As you may notice, I have been frustrated by the lack of timely responses from the Treasury Department to questions I have submitted during past hearings. I am hoping that you will bring to the Treasury Department the straightforward and results oriented approach that has served you well in the private sector.

Will you commit to provide responses to written questions submitted in conjunction with a Finance Committee hearing within two weeks of the date of the hearing?

Answer:

I understand how important it is to have strong lines of communication between the Administration and Congress. If confirmed, I will make every effort to ensure that the Treasury Department responds to congressional letters and inquiries as quickly as possible.

Rockefeller Question 9 (Health Care):

It has come to my attention that the Department of Treasury may be considering a change in its interpretation of IRC § 213 (d) as it relates to the coverage of dietary supplements and meal replacement products under Health Savings Accounts (HSAs), Flexible Spending Accounts (FSAs) and by individuals who deduct medical expenses above 7.5% of their adjusted gross income. If this is indeed the case, I would like to know the parameters of such a change.

As you are probably aware, not all dietary supplements and meal replacement products have approved FDA health claims. I am concerned that blanket approval of all dietary supplements and meal replacement products for preferential tax treatment could be viewed as tacit approval by the federal government of the merits of all these products, including those without an FDA-approved health claim and with known side effects.

Can you tell me whether or not the Department of Treasury is considering a change in its interpretation of IRC § 213 (d) relative to the coverage of dietary supplements and meal replacement products?

If so, are you collaborating with the Food and Drug Administration in this area?

Would an approved FDA health claim be the basis for tax-preferred coverage under an HSA, FSA or by individuals who deduct medical expenses that exceed 7.5% of their adjusted gross income?

Answer:

Unfortunately, I can shed no further light on this issue as I have not been briefed on it and lack familiarity with the points you raise. If confirmed, I look forward to learning about this issue in the near future.

Bingaman Question 1 (NAD Bank):

Last night we received answers to questions for the record asked of Secretary Snow at the Feb. 7th hearing on the FY '07 budget. I must admit I am disappointed that it took such a long time to get back such weak and incomplete responses. In particular, I am concerned that once again, it appears the Administration is trying to slow walk NADBank to death. I think all of us involved in the process admit that the program is in need of improvement, but that can only be accomplished if the Administration participates. To date, the Administration refuses to offer more in the way of guidance than to let us know they believe it is inefficient.

As you will note in the responses to my previous questions, there was no answer as to why the Administration has not taken up the recommendations made by Congress to improve the Bank. Could you please respond to that now? Also, can I get a commitment from you that you will work with us to figure out what the problems are and how they can be corrected?

Answer:

Thank you for bringing your concerns regarding the future of the NADBank to my attention. If confirmed, I look forward to learning more about the Bank and its mission and working with members of Congress to address their concerns.

Kerry Question 1 (Tax Cuts):

This Administration's tax policy is basically debt financed tax cuts that benefit those in the top bracket. These tax cuts expire at the end of 2010. Do you think that the tax cuts that benefit families with incomes above \$200,000 are necessary? If so, how do you plan on paying for them or are you comfortable adding substantial amounts to the deficit? In a February 15, 2001 Wall Street Journal article you advocated for tax cuts because of a growing budget surplus. Do you still support the tax cuts despite record level deficits?

Answer:

I share the President's belief that the tax relief has played an important role in our economic recovery and has helped sustained the economic expansion. Importantly, the tax relief has changed behavior and increased investor confidence. While eliminating some of the significant biases in our tax system, the tax relief has also helped stimulate capital formation and business investment at a key point in the business cycle.

I believe strongly that increasing taxes would compromise our continued economic growth. In order to maintain economic confidence, it is very important to have a stable, reliable tax policy and to make the tax relief permanent.

Kerry Question 2 (Tax Cuts):

Earlier this year, I wrote Secretary Snow requesting information referenced in the Treasury's Tax Relief Kit. This report makes the claim that "every taxpayer who paid income taxes will get relief this year." The document does not include the amount or

percent of tax cuts by income group. Will you make this information available to this Committee?

Answer:

As a nominee, I am not in a position to provide any specific information with respect to the effects of the tax cuts. If confirmed, I will look into this issue and be happy to discuss the matter with you in greater detail.

Kerry Question 3 (AMT):

The National Taxpayer Advocate, Nina Olson, has stated that the alternative minimum tax (AMT) punishes taxpayers for having children and living in certain states. The Administration only proposes temporary fixes to the AMT. Each year these temporary fixes become more expensive. Outright repeal has a cost of over \$600 billion. Without action, the AMT will become our de facto tax system. What are your recommendations for addressing the AMT?

Answer:

The AMT has created a perverse situation. It was originally created to ensure that a very few high-income individuals would pay at least some taxes. Now, however, it affects more and more middle-income earners, and it has become a major source of tax system complexity. It also creates significant frustration among taxpayers who have to calculate their taxes twice and pay the higher amount.

While I am not a tax expert, I recognize that there is no easy solution. One way or another, fixing the AMT will have a big impact on the budget and the economy and on the tax system that results from fundamental tax reform. Because of the complexity of our income tax system, and the interrelationships between many of its provisions and budgetary considerations, the long-term AMT problem should not be dealt with in isolation. Rather, solutions to the problem associated with the AMT over the long-term should be developed in the context of broader reform of the tax system. If confirmed, I look forward to working with Congress on this important issue.

Kerry Question 4 (Estate Tax):

Last week, the House passed a so-called compromise on estate tax repeal. The Senate may vote on it later this week. The House bill does not reflect a true compromise, because it loses most of the revenue collected by the estate tax. It lowers the rates on the wealthiest estates. Do you support outright repeal of the estate tax? How do justify the loss in revenue? At a time when the baby boomers will start retiring, wouldn't it make more sense to use this revenue on strengthening Social Security and Medicare?

Answer:

The President has been clear that he wants to see the estate tax repealed. I know the committee and others are working on this issue. I am not in a position to comment on the merits of the various proposals. If confirmed and this has not been resolved, I look forward to getting involved on behalf of the President.

Kerry Question 5 (International Taxation):

I am concerned that outsourcing continues to be a problem. Some firms even outsource the preparation of tax returns. Our current tax system encourages U.S. multinationals to increase offshore investment. We need to substantially change our international tax system. Have you given any thought to this issue?

Answer:

If confirmed, one of my major objectives will be to ensure that U.S. businesses and U.S. workers are as competitive as possible in today's global economy. The U.S. economy is among the strongest in the world largely because it is highly flexible and is able to adapt to changing circumstances. Fostering a positive business environment is important to encourage businesses to base their operations here. To remain competitive in a constantly changing environment, the United States also needs to ensure that U.S. companies compete on a level playing field. Changes in our international tax system, however, need to be considered in the broader context of reform of our overall tax system. If confirmed, I look forward to working with you and Congress to ensure that the U.S. companies and workers remain competitive.

Kerry Question 6 (EITC):

I share your concerns about the tax gap. However, I am concerned that there is too much of a focus on auditing earned income tax credit (EITC) taxpayers. In fiscal year 2004, the IRS conducted 48 percent of its audits on EITC taxpayers. EITC error represents a very small portion of the overall tax gap. Will the IRS continue to concentrate on EITC taxpayers?

Answer:

I am not familiar with the details of this issue. However, if confirmed, I look forward to learning more about the EITC and working with the IRS to ensure that all tax taxpayers are treated fairly.

Kerry Question 7 (Global Warming and Tax Incentives):

I believe we have similar concerns about global warming. Do you think we should take another look at the tax incentives that the oil and gas industry benefit from?

Answer:

I am not an expert on the corporate tax code or the provisions affecting this particular industry. I believe, however, that energy security and independence is critical, and we need to work on finding doable solutions

Kerry Question 8 (China):

Last year, the Chinese government announced it would adopt a more flexible exchange system, allowing the yuan to float against a narrow basket of currencies. Since then, the yuan has increased in value by only a few percentage points against the dollar. What actions will you take to ensure that China allows for a free float of the yuan on the international market?

Answer:

An openly traded currency, the value of which is determined by market forces, will be my objective if confirmed as Secretary. China has taken steps to increase the flexibility of their currency, but I believe they must do more. I will also press China to rebalance their economic growth to rely more on domestic demand instead of exports, reform their financial sector, and level the playing field with respect to intellectual property.

Kerry Question 9 (China):

Currently, Treasury has not identified China as a country that manipulates their currency. Can you explain the reasons for this and will this policy continue?

Answer:

My predecessors deserve credit for their handling of this issue as China has moved toward a more flexible exchange rate. That said, we share the same objective going forward – to see China’s currency value set by the market forces. I have spent a good deal of time and built important relationships in China, and if confirmed, I look forward to using this experience to address this issue.

Kerry Question 10 (Foreign Taxation)

I am concerned with recent signals coming from the Korean government on tax and other regulatory matters affecting foreign investment. One of the most active foreign investors is Lone Star Funds, which includes the Massachusetts Technology Basic Retirement Plan, has been the subject of aggressive prosecution and discriminatory tax treatment by Korean tax authorities. If this behavior continues, it could have a negative impact on U.S. investors. I would appreciate it if you press Korea to demonstrate its commitment to the transparent, fair and nondiscriminatory treatment of U.S. and foreign investors.

Answer:

Thank you for bringing this issue to my attention. Should I be confirmed as Secretary, I will look into the treatment of U.S. investors and advocate policies to emphasize an open market to foreign direct investment and to stress open access and equitable treatment of U.S. investors in foreign markets.

Lincoln Question 1 (Cuba Policy):

Mr. Paulson, I am sure you are aware of the Office of Foreign Assets Control (OFAC) rule change that has reduced our agricultural trade with Cuba by 22 percent since it was implemented in February 2005. In my view, and that of many of my colleagues, this rule only serves to make legal trade more onerous and expensive, while limiting our farmers’ ability to sell much needed food to the people of Cuba.

Before Castro came to power, Cuba was the number one market for U.S. rice, with approximately 500,000 metric tons sold annually. Due to misguided trade policies, Cuba’s now 750,000 metric ton rice market is primarily dominated by the Vietnamese. So, it seems to me, this policy only serves to hurt the American farmer. We should be

making every effort to follow the intent of the Trade Sanctions Reform and Export Enhancement of 2000, which allowed for agricultural and medical product sales to Cuba.

My distinguished colleague, Senator Baucus, has worked tirelessly to get this rule change reversed, and I understand that the House has again included language in Treasury Appropriations to prohibit funding for its implementation. Mr. Paulson, can you speak to the Administration's intent regarding this rule change, and if confirmed, do you plan to work with Congress to resolve this issue satisfactorily?

Answer:

I understand the President's policy on Cuba, and that my job will be to enforce the law. If confirmed, I look forward to learning more about this issue and to discussing it with you in greater detail.

Lincoln Question 2 (Tax Reform):

The report from the President's Advisory Panel on Tax Reform is now under consideration at the Treasury Department. I note that the panel recommended that many defined contribution plans be streamlined into "Save at Work" accounts, but made no specific mention of employee stock ownership plans, or "ESOPs."

ESOPs are among the most effective retirement savings plans available to American workers. Indeed, the tax code was updated in 1996 and 1997 to allow ESOPs to own Subchapter S businesses, and this has been a great boon to the retirement savings of many workers - now employee-owners - in these companies, including in my own home state.

Would you share with me your views about how - as tax reform moves forward - we can preserve and promote private ESOP-owned companies, and how we avoid making changes to tax laws that would inadvertently burden these structures?

Answer:

Encouraging savings and promoting economic growth are top priorities for me. I appreciate the role that employee ownership can provide for economic growth. If confirmed, I look forward to learning more about the role of employee ownership in retirement savings and to working with you and others in Congress on fundamental tax reform.

Wyden Question 1 (TFI):

All of the following questions pertain to the program for accessing financial records described by Undersecretary Levey on June 22, 2006:

- a) If confirmed, will you provide the Committee with any legal opinions that the Treasury Department possesses regarding this program, as well as the procedures for sharing information that is obtained, and the results of any internal or external audits that have been done?
- b) Will you notify the Committee of any instances of employee misconduct that have occurred since the program was begun?

- c) What are the consequences of disclosure of this program? What do you think has been the impact on relations with US allies? What has been the impact on international markets?
- d) To your knowledge, do any entities other than the US government have the capability to monitor the records of US financial institutions overseas? Do any entities have the power to alter these records?

Answer:

As a nominee, I have not been briefed on the details of this program, which I understand from recent media reports has been a classified program. If confirmed, I intend to review all aspects of this program closely and will ensure that the Treasury Department responds appropriately to your questions.



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STEVEN J. MCCORMICK
President and Chief Executive Officer

June 19, 2006

The Honorable Charles E. Grassley
Chair
Committee on Finance
United States Senate
Washington, D.C. 20510-6200

By Hand

Dear Mr. Chairman:

This letter contains the responses of The Nature Conservancy (the "Conservancy" or "TNC") to the questions contained in your letter of June 8, 2006, which was addressed to Mr. Henry M. Paulson, Jr., in his capacity as Chair of the Conservancy's Board of Directors.¹

As the Committee is aware, in June 2003, the Conservancy initiated a comprehensive effort to strengthen its general governance and its specific policies and procedures, including many of the policies and procedures applicable to issues examined by the Committee in its 2003-2005 inquiry. The resulting changes were intended to (1) enable the Conservancy's Board of Directors to provide increased strategic direction and undertake more active oversight; (2) incorporate many of the governance principles contained in the Sarbanes-Oxley Act; (3) promote tax law compliance by all parties to conservation transactions in which the Conservancy is a participant; (4) address on a comprehensive and consistent basis issues involving actual or potential conflicts of interest; (5) provide more specific rules governing key conservation programs such as conservation easements, conservation buyer transactions and sales of conservation lands to governments; and (6) ensure high-level advance review of transactions that may present financial, legal and ethical or reputational risks to the Conservancy as a whole.

When I testified before the Committee at its public hearing on June 8, 2005, I stated that the Conservancy was proud of the results of its efforts and welcomed the positive treatment that our reforms received in the report on the Conservancy prepared by the Committee's staff. We nevertheless recognized then, and recognize now, that our commitment to governance, accountability and transparency require ongoing diligence and review. I am therefore pleased to provide you with an update on our continued progress at the Conservancy in ensuring that we

¹ We ask that the Committee consider this letter and all enclosed documents as "confidential/proprietary," in accordance with the prior agreements reached between the Committee staff and the Conservancy in connection with the Committee's 2003-2005 inquiry. Please also note that, in order to provide you with as accurate statistical information as possible, certain responses contained in this letter are limited to the period beginning July 1, 2005 (the beginning date of the Conservancy's fiscal year) and ending on April 30, 2006, as that is the most recent date as of which complete information has been entered into the Conservancy's data retrieval systems.

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continue to carry out our conservation mission in accordance with the letter and spirit of all applicable laws and our organizational values.

As our responses to your questions demonstrate, we have, since the publication of the Committee's staff report, continued to strengthen our policies and procedures. For example, within the area of federal tax law compliance, which is of special interest to the Committee, we have significantly strengthened our program for monitoring compliance with the terms of the more than 1600 conservation easements we hold; continued to implement procedures to promote compliance with IRS valuation regulations by those from whom we receive non-cash contributions; made significant improvements to our IRS Form 990 filings to increase their utility as a disclosure device to the general public as well as to the IRS; taken steps to ensure that the tax policies and procedures we adopted in April 2005 to ensure that the Conservancy would not participate in abusive tax shelters of the type specified by Congress in enacting section 4965 of the Internal Revenue Code (the "Code") in 2006; reviewed our conservation buyer program in light of the guidance issued by the IRS in Notice 2004-41; and created the position of Director of Tax Services. The Director is leading a broad review of all our tax compliance activities and established procedures to ensure continued proper reporting with respect to the tax on unrelated business income.

CONSERVATION EASEMENTS

1. Explain what TNC has done over the past year to improve its monitoring of conservation easements to assure that each easement achieves dedication of the real property for conservation purposes. In particular, I would be interested in learning about any local, regional, or national monitoring programs or initiatives that you have established or undertaken during this time.

As described more fully in the Conservancy's prior submissions to the Committee, in 2003 the Conservancy chartered an Easement Working Group (EWG) to conduct a comprehensive review of its easement practices. One of the key recommendations contained in the EWG's report addressed the question of enhanced monitoring of conservation easements. Among other things, the EWG recommended the adoption of specific monitoring timetables (annually in most cases) and that monitoring activities be tracked through the Conservancy's Conservation Land System (CLS). The CLS is the Conservancy's computerized data base of land and easement information.

In accordance with the EWG's recommendation, the Conservancy updated its conservation easement monitoring standard operating procedure (SOP) and added a monitoring tab (easement data information fields) to the CLS. As so modified, the CLS enables the Conservancy to take prompt remedial action on issues that arise during the monitoring process. In addition, the Conservancy conducted two training sessions for its staff focused upon the new

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easement monitoring SOP and monitoring implementation. With these tools in place, the Conservancy set a goal of having the new easement monitoring process fully implemented for all its easements by January 3, 2006.

Based upon information that has been entered by the Conservancy's field staff who have direct responsibility for monitoring easements, the CLS can generate reports showing the status of easement monitoring within the Conservancy. These reports give management a simple and readily accessible tool to determine the current monitoring status of easements held by the Conservancy. As of December 2005, there were monitoring reports in the CLS for 96 percent of the approximately 1600 easements held by the Conservancy. A portion of the remaining four percent of the easements was acquired in 2005 and is not scheduled to be monitored until 2006. In other cases, the operating units have monitored the easements but have not yet entered the data into CLS. As of June 14, 2006, there were monitoring reports for 99 percent of the TNC-held conservation easements. The data base will be revised officially as of the end of each calendar year so that the Conservancy will be able to have an annual easement monitoring status report.

2. Explain what TNC has done over the past year to enforce the terms and conditions of its conservation easements to assure that each easement achieves dedication of the real property for conservation purposes. Has TNC commenced any litigation or contacted any landowners during this time regarding enforcement of such easements?

As noted above, as of December, 2005, the monitoring results for 96 percent of the approximately 1600 conservation easements held by the Conservancy had been entered into the CLS. Each monitored easement was assigned to one of three categories of compliance status: in compliance, in review or "in violation." As of January, 2006, there were 18 easements that were categorized as "in violation." As of June, 2006 the number of easements "in violation" status had been reduced to 13 by virtue of corrective actions taken by landowners, pursuant to contacts with the Conservancy. For each of the 13 easements so identified, a Conservancy lawyer and a representative from the Conservancy's operating unit responsible for overseeing the easement contacted the easement landowner to discuss the status of the easement violation and develop a plan for resolving the violation.

Conservation easements identified as being "in violation" fall into four broad categories: (1) situations where the landowner has undertaken vegetation management activities (such as cutting trees, or applying herbicide) not in accordance with the terms of the easement; (2) situations where the landowner has conducted inappropriate activities or uses on the land (such as use of ATV's, grazing, or dumping) not in accordance with the terms of the easement; (3) situations where the landowner has constructed structures on the property (such as a house, a dock or other outbuildings) not in accordance with the terms of the easement; and (4) situations where there is some dispute as to an interpretation of a term of the conservation easement.

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Easement violations and a plan to address the violations are presented periodically to the Board of Directors' Audit Committee for review and approval.

The majority of the 13 easement violations fall into categories one and two. The Conservancy has issued demand letters or cease and desist letters in nine cases, has entered into settlement discussions in one case, and is preparing to enter litigation in one case. In the remaining two cases, the Conservancy is in negotiations with the landowner.

3. Explain what steps TNC has taken to improve the valuation of conservation easements for purposes of donors claiming the proper charitable contribution amount on their tax returns.

As described more fully in the Conservancy's prior submission to the Committee, the Conservancy has taken specific steps to promote compliance with IRS regulations governing the valuation of gifts of land (including interests in land such as conservation easements). Specifically, in 2003, the Conservancy adopted, and continues to apply, a standard operating procedure (SOP) under which it will execute an IRS Form 8283 for a donor (as required under IRS regulations to substantiate receipt of the gift) only if:

- (a) the form contains all information required to be provided by the donor to the IRS;
- (b) the donor provides to the Conservancy a copy of the appraisal to be used by the donor to establish the tax value of the gift shown on the form;
- (c) the donor's appraiser provides the Conservancy with a written certification that he or she (i) is State-certified; (ii) has used generally accepted appraisal standards in making the appraisal; (iii) has the requisite expertise and experience to make appraisals of conservation lands and conservation easements; (iv) is not barred from practice before the IRS, the Department of the Treasury or other administrative bodies; (v) has taken into account any value enhancements to other property of the donor or parties related to the donor; and (vi) has otherwise satisfied all of the requirements for a "qualified appraisal" prescribed by the IRS; and
- (d) if the donor is a related party or a major donor (as defined by the Conservancy's internal standards that are more restrictive than those required by the Code) with respect to the Conservancy, the appraiser must also certify that he or she is aware of this fact and that it did not influence the appraiser's valuation.

As the Committee staff is aware, these procedures exceed the requirements of existing federal tax law, which require that donees such as the Conservancy execute IRS Form 8283 only to certify actual receipt of the gift.

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VALUATION OF NONCASH CONTRIBUTIONS

1. Provide summary information regarding the aggregate reported values of the following categories of charitable contributions received by TNC since June 1, 2005:

- a. *Conservation easements*
- b. *Intellectual property*
- c. *Stocks and other publicly traded securities*
- d. *Closely held stock and other closely held business interests*
- e. *Cars, planes, and boats*
- f. *Trade lands*
- g. *Other non cash contributions*
- h. *Total noncash contributions*
- i. *Total cash contributions*

From July 1, 2005 through April 30, 2006, the Nature Conservancy received a total of \$385,836,250, of that amount \$100,522,555, consisted of noncash contributions. The total amount is comprised of the following:

• Gifts of Conservation Land	\$17,482,913
• Gifts of Conservation Easements	\$55,641,836
• Gifts of Publicly Traded Securities	\$20,332,342
• Gifts of Closely Held Securities	\$496,236
• Gifts of Trade Lands	\$4,438,803
• Gifts of other goods and services*	\$2,130,425
• Gifts of Cash	\$285,313,695

* The gifts of other goods and services are of the type required to be reported pursuant to the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 116. This amount, representing 2.3 percent of the total above, includes numerous transactions and cannot be easily categorized by type of good/service without considerable additional analysis that was not feasible with the specified response time.

2. Describe the steps TNC has taken to improve the accuracy of appraisals relating to noncash contributions made to TNC.

The most significant volume of non-cash contributions that the Conservancy receives are in the form of gifts of land and of conservation easements in land. The steps the Conservancy has taken to improve its review of appraisals relating to those gifts are described above. With respect to other forms of non-cash gifts, the Conservancy ensures that all relevant IRS gift substantiation forms are complete and accurate and that appropriate supporting documentation,

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including appraisals, is attached. In accordance with current legal requirements, the Conservancy does not certify as accurate the donor's appraisal but reviews such appraisals to ensure that they are prepared by qualified appraisers and that the facts and circumstances surrounding the appraisal are reasonable.

CONSERVATION BUYER PROGRAM

1. Provide the number of CBP transactions TNC has completed since June 1, 2005. Of this number, how many have been with TNC's directors, officers, local chapter officials, or employees?

During the period July 1, 2005 through April 30, 2006, the Conservancy completed 30 "conservation buyer" transactions. None of these transactions were between the Conservancy and its directors, officers, local chapter officials or employees. Such "related party" transactions have been prohibited by action of the Conservancy's Board of Directors since June 2003.

a. In addition, provide the total purchase paid by TNC, total sales price received by TNC, and total purported charitable contributions received or to be received by TNC, with respect to each category (total, insider) of these transactions referred to above.

Number of Conservation Buyer Transactions	Number with TNC Directors, Officers, Chapter Officials, Employees	Total Purchase Price Paid by TNC	Total Sales Price Received by TNC	Total purported Charitable Contributions Received by TNC
30	0	\$26,285,595.52	\$50,227,177.59	\$534,988.49

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b. Provide the information described in item a. above for each of the 5 largest such transactions completed by TNC.

	ST	Project Name	Conservation Buyer	Total Purchase Price Paid by TNC	Total Sales Price Received by TNC	Total purported Charitable Contributions Received by TNC
1	AZ	Black River Headwaters (Taylor)	GOC, LLC	\$3,000,000.00	\$2,700,000.00	\$0.00
2	WY	Upper Wind River Landscape (Eastman)	ANK, Inc.	\$2,687,612.00	\$2,974,000.00	\$0.00
3	CA	Merced Grasslands/San Luis NWR Complex (Conservation Farms & Ranches-Merced) Amend	Urrutia, Leon And Grace I Revocable Trust	\$0.00	\$3,433,062.50	\$0.00
4	WY	Upper Wind River (Fox) Upper Wind River (Parker 1-3) Upper Wind River Landscape (Winchester Land & Cattle Company, Inc.)	Lucas, Robert I.	\$6,479,480.00	\$4,964,341.00	\$0.00
5	WY	Snake River Floodplain Corridor (Moulton)	Linger Longer West, LLC	\$0.00	\$19,900,000.00	\$0.00

2. Provide the number of CBP transactions in which TNC presently is in negotiations. Of this number, how many involve TNC's directors, officers, local chapter officials, or employees?

Because of the decentralized nature of the Conservancy's operations with its 363 state and local offices, it is impossible to determine precisely the number of CB transactions in preliminary negotiations and which have not yet begun the process of formal review and approval. Regardless of the number of transactions which may be in negotiations, the Conservancy's policy prohibiting sales to or purchase from related parties would apply.

There is one conservation buyer transaction with a state chapter advisory board member that received specific and advance approval by the Conservancy's Board of Directors in January, 2006, but that transaction has not closed. This matter was reviewed carefully by the Audit Committee and based on the merits of the case, was approved by the Board of Directors as an exception to the policy. Advisory board members are not compensated for their services, have no legal or fiduciary duties with respect to the organization and do not meet the definition of a related party contained in the Code.

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a. In addition, provide the total purchase paid or to be paid by TNC, total sales price received or to be received by TNC, and total purported charitable contributions received or to be received by TNC, with respect to each category (total, insider) of these transactions referred to above.

See above.

b. Provide the information described in item a. above for each of the 5 largest such transactions pending and in which TNC is or expects to be a party.

See above.

3. Provide the Board and committee documentation supporting TNC governance review of these transactions under TNC's CBP review policy.

Under the CBP review policy adopted by the Board in June, 2003, and as previously described to the Committee, all CB transactions must comply with requirements to ensure that such projects achieve legitimate conservation purposes, are based on proper valuations, are adequately exposed to the market, meet community standards and do not involve a "related party." Depending on the dollar size of the transaction, such projects are completed by state and local offices of the Conservancy under delegated authority by the Board to TNC regional managing directors. The documentation supporting conformance with TNC CB procedures is contained in many files and databases throughout the Conservancy. The Conservancy would be happy to provide additional information with respect to specific transactions.

4. Has TNC had conversations, formal or otherwise, with the IRS regarding CBP and the IRS settlement initiative? If so, please summarize TNC's actions to cooperate with the IRS and TNC's CBP participants relating to the IRS settlement initiative.

Conservancy personnel have not had any conversations with the IRS regarding CB transactions and the settlement initiative. Conservancy personnel have notified participants in its CB transactions of Notice 2004-41 and responded to questions and appropriate requests for information from CB participants.

5. Has TNC sought or obtained any tax opinions or other tax advice regarding the federal income tax treatment to TNC or to any other party to a CBP transaction since the issuance of Notice 2004-41? If so, please provide copies of such requests and any advice provided to TNC in response to such requests. If not, please explain why TNC has not sought such advice, given the IRS position with respect to such transactions.

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The Conservancy has not sought any further tax opinions with respect to this issue, but did present the issue to its internal Risk Assessment Committee which, after reviewing the matter, concluded that the Conservancy would continue to pursue CB transactions, advise all parties to such transactions about the existence of the IRS Notice, and require a certification from CB buyers that they obtain and rely on their own tax advice with respect to the tax treatment in such transactions. The Conservancy also decided to suspend its participation in the one specific form of CB transaction identified in the Notice unless and until the IRS issues guidance to clarify the issues associated with transactions structured in the manner described in the Notice.

6. Describe the steps taken by TNC to assure that, consistent with its recently enacted policy changes, CBP properties are available for acquisition by the general public rather than limited as a practical matter to purchase by TNC insiders or friends or relatives of local chapter officials.

It is the Conservancy's Board policy that the property be placed on the open market for a minimum of 30 days to ensure adequate exposure of the property to the market prior to sale. One way to do this is to place the Conservation Buyer property on the Conservancy's internet site (<http://www.nature.org/conservationbuyer/>). The Conservancy currently has 29 properties listed for sale on its website.

7. Has TNC given consideration to terminating its conservation buyer program? If not, why not, given the potential and significant abuse relating to improper charitable contribution deductions?

The purposes of the Conservancy's conservation buyer program, the opinions of independent tax counsel received with respect to the program and the reforms adopted by the Conservancy with respect to the program have been described fully in the Conservancy's prior submissions to the Committee. Moreover, as discussed above, the Conservancy has reviewed Notice 2004-41 and concluded that its program, which includes types of transactions outside the scope of the Notice, conforms to the position of the IRS set forth in the Notice. The Conservancy has not terminated its conservation buyer program. The program is an important tool to enable the Conservancy to accomplish meaningful conservation objectives and has been structured in accordance with relevant laws and IRS regulations and rulings.

EMISSIONS CREDIT ARRANGEMENTS

1. Provide the number of emissions credit transactions TNC has completed since June 1, 2005. Of this number, how many have been with TNC's directors, officers, local chapter officials, or employees, or entities related to such persons by ownership or by representation on the entity's governing body? Name the other parties to such arrangements?

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The Conservancy has not completed any emissions credit transactions since June 1, 2005.

2. Provide the number of emissions credit transactions in which TNC presently is in negotiations. Of this number, how many involve TNC's directors, officers, local chapter officials, or employees, or entities related to such persons by ownership or by representation on the entity's governing body? Name the other parties or potential parties to such arrangements.

The Conservancy is not in negotiations for any emissions credit transactions.

3. Provide the Board and committee documentation supporting TNC governance review of these transactions under TNC's policies.

Not applicable.

4. Provide the amount of fees, compensation, or other payments TNC has received or expects to receive under the transactions described in items 1 and 2.

None.

5. Has TNC had conversations, formal or otherwise, with the IRS since June 1, 2005, regarding TNC's emissions credit arrangements? If so, please summarize the content and nature of these discussions.

The Conservancy has not had any conversations with the IRS with respect to such arrangements during the time period covered by this letter.

6. Has TNC sought or obtained any tax opinions or other tax advice regarding the federal income tax treatment to TNC or to any other party to an emissions credit arrangement since June 1, 2005? If so, please provide copies of such requests and any advice provided to TNC in response to such requests. If not, please explain why TNC has not sought such advice, given the staff's concern with these transactions as expressed in its June 2005 report.

No such tax opinions have been sought.

7. Do any of the transactions described in items 1 and 2 above involve the alleged charitable contribution of amounts by another party to TNC?

Not applicable.

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8. State whether TNC intends to continue to report payments it receives from such arrangements as contribution revenue on line 1 of the Form 990.

As the Conservancy has not completed any new emissions credit transactions since July 1, 2005 and no such transactions are presently in negotiation, no action has been taken with respect to the reporting of this income. The Conservancy is considering whether to report payments from emission credit arrangements as program service revenue on line 2 of the Form 990 in the future.

JOINT VENTURES AND FOR-PROFIT SUBSIDIARIES

1. Provide the number of joint venture transactions TNC has completed since June 1, 2005. For this purpose, use the definition set forth in TNC's governance policies. Of this number, how many have been with TNC's directors, officers, local chapter officials or employees, or entities related to such persons by ownership or by representation on the entity's governing body?

The Conservancy has a "Related Entity" Policy and a standard operating procedure (SOP) for "Significant Business Interests in Separate Legal Entities". The Policy requires notification to and approval by the Conservancy's Finance Department of any joint venture where the Conservancy owns a greater than 50 percent interest. Since July 1, 2005, there have been no such notifications. The SOP requires notification to and approval by the Conservancy's Finance Department of any joint venture where the Conservancy has a "significant business interest". Since July 1, 2005, there have been no such notifications.

2. Provide the number of for-profit subsidiaries formed by TNC since June 1, 2005, and state the nature and purpose of such entities.

There have been no for-profit subsidiaries formed by the Conservancy since July 1, 2005.

3. Describe the internal review process used by TNC to approve or disapprove TNC's involvement in the joint ventures or for-profit formations described above, and to assure that its participation in such arrangements substantially furthers TNC's exempt purposes.

In 2004, the Conservancy's Board of Directors adopted a policy requiring Board approval for the formation and operation of any related organizations to ensure that the related entities are consistent with the Conservancy's goals and objectives and that related risks are identified and appropriately managed. (Related entities where the Conservancy has a significant business interest, i.e. \$100,000+ investment, but not a controlling interest must be approved by the President.) Implementation of the Policy and Procedure is the responsibility of the

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Conservancy's Finance Department, which reviews proposals and monitors Conservancy activity in this area.

4. Describe the nature of the joint venture and identify the names of the other parties to any joint venture described in item 1 above.

Not applicable.

5. Has TNC amended any of its governance and review policies to address those situations in which TNC may own less than a controlling interest in the arrangement or entity, or for which TNC's interest in the arrangement is not a formal equity interest in an entity (e.g., emissions credit arrangements).

As described more fully in the Conservancy's prior submissions to the Committee, the Conservancy's Board of Directors adopted a specific policy with respect to such matters on January 30, 2004. Revisions to that policy were adopted by the Board on June 10, 2005. In addition, a related standard operating procedure (SOP) was issued in February 2004 following review and approval by the Audit Committee of the Board.

UNRELATED BUSINESS INCOME

1. Provide a copy of TNC's Form 990-T for its most recently completed taxable year for which such form has been filed with the IRS.

Issues with respect to disclosure of Form 990-T are under consideration by the Committee staff in response to Conservancy's letter to the staff dated June 14, 2006.

2. Describe the internal process used by TNC to assure that it properly reported all unrelated business income on its Form 990-T for such year. If TNC used outside counsel or accountants as part of such process, describe the outsider advisor's role in the process.

The Conservancy's internal process, as currently in effect, for ensuring that it properly reports all Unrelated Business Income (UBI) on its Form 990-T is based on its standard operating procedure (SOP) for Unrelated Business Income Tax (UBIT), as first adopted in June, 1996 and revised in February 2000 and 2001. This SOP requires that before entering into any transaction that potentially could result in UBIT liability, an operating unit must first contact the appropriate member of the Conservancy's legal staff. In consultation with the Conservancy's Director of Tax Services (a newly created senior level position in the Finance Department), a final determination is made as to whether UBIT liability will in fact be created. The Chief Financial Officer (CFO) or the President must approve in advance activities giving rise to UBI expected to be no greater than \$100,000. The Conservancy's Finance Committee of the Board

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must approve in advance activities giving rise to UBI over a threshold of \$100,000. If there is UBIT, all revenue and expenses with respect to that activity are separately tracked in the Conservancy's financial records. This process is, in the Conservancy's view, adequate to identify and properly report all UBI with respect to new activities.

In addition to the procedure now in place to identify and properly report UBIT liability attributable to new activities, the Conservancy has undertaken an internal review of its current activities for UBIT exposure as part of an ongoing overall tax review being conducted by the Director of Tax Services and others. In addition to enhancing Form 990-T compliance, the results of this review are being used as a basis for educational outreach to operating unit personnel in order to assist them in identifying in the future activities that may generate UBIT.

The Form 990-T itself is prepared by the Director of Tax Services and reviewed by members of Senior Management for accuracy and completeness. Additionally, items of income and deduction are also independently verified for accuracy by the Conservancy's [internal] audit function prior to filing the return with the IRS.

3. Has TNC sought or obtained tax advice or a tax opinion with respect to its trade lands program since June 1, 2005?

No.

4. Has TNC sought or obtained tax advice or a tax opinion with respect to any of its joint ventures or its management services fees since June 1, 2005?

No.

5. Has TNC sought or obtained tax advice or a tax opinion with respect to its travel tour programs since June 1, 2005?

No.

INSIDER DEALS AND EXECUTIVE COMPENSATION

1. Describe how TNC has improved its transparency, Form 990 reporting, and internal approval process, with respect to transactions with insiders.

A policy approved by the Board of Directors on September 30, 2004, prohibits both the purchase of real estate (or any interest therein) from and the sale of real estate (or any interest therein) to any "related party". For this purpose, a related party includes:

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- a. Any individual who is, or who was at any time during the 12-month period ending on the date of the purchase or sale, a member of the Board of Directors, Trustee, or an employee of the Conservancy;
- b. Any individual who is a close relative of such an individual; or
- c. An entity in which the individual owns and/or his close relatives own directly or indirectly more than five percent of the equity interest therein.

In addition, the Conservancy strengthened its Conflict of Interest policy through the adoption of Standard Operating Procedures and by including Board members, Chapter Trustees/Advisors, close relatives, major donors, related organizations, and other insiders as covered persons.

The Board of Directors, working with the Conservancy's executive management team, instituted a number of management systems to ensure the Conservancy remains in compliance with its policies and procedures governing transactions with local chapter trustees and officials. In appropriate cases projects reviewed by senior staff are presented to the Board of Director for their prior review and approval. These management systems include:

1. Conflicts review committee comprised of senior staff.
2. Project review committee comprised of senior staff.
3. Risk Assessment committee comprised of senior staff.
4. Conservation Projects and Practices Review Committee comprised of members of the Board of Directors that review all projects requiring Board approval prior to submitting its recommendation to the Board's Audit Committee for approval by the full Board of Directors.
5. The Board of Directors has mandated that all staff receive training on the organization's policies and procedures and provide a signature that they fully understand and will comply with all policies and procedures. As of July 15, 2006, 97 percent of the Conservancy's 3600 employees will have completed such training.
6. The Board of Directors has mandated that all Chapter Trustees complete compliance certification.
7. The Audit Committee of the Board of Directors meets in executive session with the Chief Ethics and Compliance Officer during each meeting of the Committee.

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8. Any transactions approved as a result of this process between the Conservancy and an Officer, Director of Key Employee, as defined by the Code if forwarded to the Director of Tax Services for inclusion of the Conservancy's Form 990.

2. How many transactions have been reviewed under TNC's conflict of interest policy since June 1, 2005? Of such number, how many have been approved without modification, approved with modification, disapproved, or are pending?

During the period July 1, 2005-April 30, 2006, the Conservancy reviewed 235 matters that potentially involved a conflict of interest or the appearance of such a conflict. Each matter details the actual conflict or an appearance of conflict and includes a plan for the disposition of the conflict which may include prohibition, modification, recusal and or disclosure as actions to address the conflict or appearance thereof. Of that number, 145 were approved without modification; 78 were approved with modification; 8 were disapproved and 4 are still pending.

3. Describe the steps taken by TNC to improve its oversight of transactions involving local chapter trustees and officials.

See response to question 1 under Local Chapters.

4. Provide all documentation supporting TNC's efforts to comply with Section 4958 and, if applicable, the rebuttable presumption standard. If TNC has not undertaken to satisfy the rebuttable presumption standard, explain why it has not done so.

The Conservancy retained PricewaterhouseCoopers (PWC) in September 2005 to conduct an Executive Total Compensation Assessment and to provide specific suggestions/recommendations for an optimal executive total compensation program for the Conservancy. A planning session with the Conservancy's Board of Directors' Committee on Governance, Nominating and Human Resources was held on September 20, 2005. Subsequent meetings were held with PWC, Conservancy personnel, and the chair of the Board's Committee on Governance, Nominating and Human Resources Committee, James C. Morgan.

This five-phase project includes a thorough review of the Conservancy's executive compensation philosophy, a diagnostic of current executive compensation practices and peer/comparator and published compensation survey data obtained on key executive positions. The compensation data will be used to inform Board and management decisions on executive compensation.

On June 15, 2006, the Governance, Nominating and Human Resources Committee reviewed the findings of PWC. Based on the preliminary findings from PWC, it appears that PWC will provide the Conservancy with an opinion letter stating that the Conservancy does comply with the rebuttal presumption standard with respect to executive compensation.

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5. Has TNC attempted to comply with the rebuttable presumption standard with respect to its executive compensation arrangements? Has TNC engaged compensation consultants to provide independent comparability data, and if so, what steps has TNC taken to assure the comparability data used is based on similarly situated offices and organization?

See response above.

6. Confirm that TNC no longer provides loans to officers or employees.

As described more fully in its prior submissions to the Committee, the Conservancy in 2003 adopted a policy prohibiting loans to officers or employees and it continues to adhere to that policy.

FORM 990 AND RELATED REPORTING REQUIREMENTS

1. Describe how TNC has materially modified its Form 990 reporting since the Committee staff commenced its investigation of TNC. In particular, explain how TNC has addressed transparency with respect to its insider deals, largest program service accomplishments, and other arrangements, such as emissions credit arrangements, that are highly unusual and have not been disclosed to the IRS through prior reporting.

The Conservancy continues to work to improve its Form 990 disclosures, as it always has, in compliance with the statutory regulations. The Conservancy has taken important steps to improve the transparency and public understanding of its Form 990 filings. Guided by recommendations from the Governance Advisory Panel created by the Conservancy in 2003, the Conservancy's Form 990 for its fiscal years ended June 30, 2004 and June 30, 2005 included more information about the Conservancy's governance and its direct charitable programs and accomplishments.

Key examples of increased transparency include: a complete list of every grant the Conservancy awarded; expanded reporting of executive compensation; extensive information about the Conservancy's performance including its approach to projects, the work performed, and conservation results; and information about the Conservancy's governance structure and new policies and procedures that were put in place over the last year.

Much of the information reported on the Form 990 is derived from the contents of the Conservancy's annual report and public website. The annual report is posted on www.nature.org and both are frequently updated. The Form 990 for the fiscal year ended June 30, 2005 and two previously filed Forms 990 are available on the Conservancy's website. On an ongoing basis, the Conservancy will continue to seek additional ways to improve the quality of its

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Form 990 filings. The Conservancy regards its Form 990 as an essential document demonstrating its commitment to enhanced public accountability.

The Conservancy has instituted a thorough tax return preparation and review process that is designed to ensure transparency and full compliance with its Form 990 tax reporting requirements. This process begins with the production of the underlying financial information by the Conservancy's Finance Department and the collection of necessary non-financial information from various other departments. This information is reviewed for completeness and accuracy by the Director of Tax Services with regard to applicable reporting requirements. Upon completion of the draft of the return, the Conservancy's Internal Audit Department independently verifies appropriate portions of the return. An updated draft is circulated to Senior Management to ensure that the return properly reflects the Conservancy's activities in all material respects. Next, the Conservancy's outside tax return preparers perform a detailed review of the return and sign the return as paid preparers. Finally, the Audit Committee of the Board reviews the return in accordance with its charter.

All of these steps and certain of the recommendations of the Governance Advisory Panel (created by the Board in 2003) have led to significant revisions to the Conservancy's Form 990 that are intended to place the Conservancy in the vanguard of transparency and compliance when it comes to public disclosure by tax-exempt organizations. Specifically, the Conservancy has enhanced its reporting, increased the amount of disclosure, or increased the level of internal review and scrutiny related to Grants and Allocations on Part II, Program Service Accomplishments on Part III, Changes in Activities and Relation to Other Organizations on Part VI, Reporting Information Regarding Taxable Subsidiaries and Disregarded Entities in Part IX, and Statements About Activities on Part III of Schedule A.

2. Has TNC reported any material changes in operations, structure, or activities, since June 1, 2005? If so, provide a copy of such reports.

The Conservancy has not reported any material changes in operations, structure or activities since June 1, 2005.

3. Has TNC amended its articles or bylaws since June 1, 2005? If so, provide a copy of such amendments.

The Conservancy has not amended its articles or bylaws since June 1, 2005. The Conservancy's bylaws were last amended in April, 2005. A copy of the revised by-laws were attached to the Conservancy's Form 990 for the year ended June 30, 2005.

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4. Congress recently enacted Code Section 4965, which addresses participation by exempt organizations as accommodation parties in certain abusive tax shelter transactions. Describe whether TNC is a party to any transactions described within new Section 4965, and if so, the nature and TNC's role in such transactions. Also provide the names of all other parties to such transactions and state the basis for the transaction's status as a prohibited tax shelter transaction (listed, confidential, contractual protection). Provide any documentation that shows the Board or relevant committee reviewed TNC's role in any such transaction.

The Conservancy is not a party to any Listed Transactions, as defined by section 6707A(c)(2) of the Code, or to any prohibited Reportable Transactions, as defined by section 6707A(c)(1) of the Code and thus is not subject to the provisions of IRC §4965.

Consistent with the practices of many tax-exempt organizations, the Conservancy provides general information to third parties with respect to the potential tax consequences of contributions to and conservation transactions with the Conservancy, but it has long had a written procedure prohibiting the providing of legal and tax advice to third parties.

As described more fully in the Conservancy's prior submissions to the Committee, on April 7, 2005, the Conservancy adopted a more comprehensive Standard Operating Procedure (Tax SOP) to promote tax compliance by both the Conservancy and those who participate in transactions with the Conservancy. Among other things, this new procedure places explicit limits on the types of conservation transactions in which the Conservancy will participate. Specifically, the Conservancy will not enter into any conservation land transaction that provides tax benefits to a third party unless (1) the transaction enhances, directly or indirectly, the ability of the Conservancy to carry out its conservation mission; and (2) the Conservancy determines that the transaction:

- (a) is not a "reportable transaction" within the meaning of section 6111 or 6707 of the U.S. Internal Revenue Code, relating to tax shelters;
- (b) has not been structured to enhance the ability of any person to avoid a tax reporting or substantiation obligation under any federal, state or local tax law; and
- (c) is substantially similar to the types of transactions previously approved by the Conservancy.

In general, a type of transaction will be approved by the Conservancy only if an independent and qualified tax counsel could reasonably render an opinion that, upon audit by the IRS or other appropriate tax authority, the anticipated tax benefits "should" be upheld by the tax authority or a court, as opposed to opinions that merely say it is "more likely than not" that the tax benefits claimed would be allowed, or that there is a "reasonable basis" for such a claim.

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5. Explain the steps TNC will take to assure compliance with new Section 4965.

Section 4965 was enacted in 2006 and imposes penalty taxes on tax-exempt organizations that participate in "listed transactions" or "prohibited reportable transactions". The Conservancy's 2005 Tax SOP effectively prohibits participation by the Conservancy in any of the transactions encompassed by section 4965. Responsibility for ensuring compliance with the Tax SOP adopted by the Conservancy rests with the Legal Department, which reviews all transactions undertaken by the Conservancy for compliance with the Conservancy's policies and procedures and applicable laws and regulations. Any unusual transactions are brought to the attention of the General Counsel, as appropriate, are subject to additional levels of review.

The Conservancy has several additional policies and procedures in place to assure compliance with all tax laws, including section 4965. First, the Conservancy's Policy on Compliance with Tax Laws and Donations of Land and Interests in Land requires conformity both with the letter and the spirit of the law. Second, the Conservancy's adherence to this policy and to the Tax SOP is monitored by its Legal Department as part of their standard review of contractual arrangements. When questions arise regarding the tax aspects of a proposed transaction, the Conservancy's Director of Tax Services is consulted for consultation regarding the potential tax aspects of the proposed transaction. Third, the Conservancy's Director of Tax Services monitors changes in tax law that may impact the Conservancy's operations. This includes tracking revisions to the IRS' list of abusive tax shelters and transaction to ensure that the Conservancy has not or does not enter into any such transactions. Finally, the Conservancy's CFO is required to annually certify annually to its outside tax preparer through the completion of a detailed Reportable Transactions Compliance Checklist whether it has been a party to any such transactions.

TAX OPINIONS AND OTHER TAX ADVICE

1. Has TNC sought or obtained tax opinions or other outside advice regarding the federal income tax consequences to TNC, a TNC official or employee, or a party to a transaction with TNC, since June 1, 2005? If so, provide a copy of such requests, opinions, and advice.

No.

2. Has TNC been a party to a tax indemnity agreement or similar arrangement sine June 1, 2005? If so, describe the arrangement and TNC's rights and obligations there under.

No.

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LOCAL CHAPTERS

1. Describe the steps TNC has taken to improve oversight of its state and local chapters and the officials responsible for managing and operating such chapters.

On September 30, 2004, the Board of Directors approved a policy entitled Roles and Minimum Standards for Governing The Nature Conservancy. This policy document makes explicit:

- the role of the Board of Directors as ultimate holder of legal and fiduciary responsibility for Conservancy operations
- the roles of chapter Boards of Trustees as advisory boards that help local management implement the mission of the Conservancy and help the Board of Directors oversee the functioning of local programs
- the required minimum performance standards for each chapter Board of Trustees, and
- the description of the Trustee Council, a mechanism to facilitate two-way communication between the Board of Directors and the chapter Boards of Trustees.

The Conservancy has made substantial progress in ensuring implementation across all state and local chapters of the 19 minimum standards enumerated in the Roles and Minimum Standards document. These minimum standards were adopted to help the Board of Directors and senior management improve oversight of state and local chapters. For example, as of June 15, 2006:

- 45 of 53 domestic chapters have adopted the uniform “Chapter Operating Principles” created to ensure uniform chapter structure and operations across the Conservancy. The remaining chapters are scheduled to adopt the new operating principles within the next two months.
- 46 of 53 domestic chapter Boards of Trustees have completed compliance training to ensure that all chapter Trustees are in compliance with relevant Conservancy policies and procedures. Following training, each Trustee is asked to sign a compliance pledge to confirm adherence to these policies and procedures. Each of the remaining chapters has training scheduled in the next two months.

In conjunction with the distribution of the “Roles and Minimum Standards for Governing The Nature Conservancy”, the Conservancy produced and distributed a comprehensive Trustee Handbook to assist chapters in developing the leadership and oversight responsibilities of their Boards of Trustees. The Conservancy currently employs a small group of staff members to assist

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chapters with training in this area. As the Conservancy developed additional materials in subsequent years, the Trustee Handbook has been enlarged and improved. Currently, the Trustee Handbook contains:

- Roles and Minimum Standards for Governing The Nature Conservancy.
- Trustee Advisory Council materials.
- Best Practices for Excellence in Board Performance, a collection of model performance standards in eleven areas of board operations, including planning, oversight, financial management and conservation activities.
- Board Evaluation Tool, for use in evaluating performance against both minimum standards and best practices.
- Trustee Ethics and Compliance information.
- Information on implementing the standard Chapter Operating Principles.
- Materials for standard Trustee orientation, including a video overview of the Conservancy, suggested meeting agenda, orientation presentation template and suggested handbook materials.

2. Has TNC terminated any state or local chapter since June 1, 2005, or terminated a state or local chapter official's status or relationship with TNC since that date?

The Conservancy has not terminated a state or a chapter officials' status or relationship with the Conservancy during the time period covered by this letter.

MISCELLANEOUS

1. TNC reported to the staff that the value of assets held in TNC's donor advised funds as of March 31, 2005, was \$4.3 million. Provide the value of assets held in TNC's donor advised funds as of May 31, 2006. Describe how TNC has assured compliance with its recently enacted policy regarding donor advised funds.

As of April 30, 2006, the Conservancy had 11 funds within the Donor Advised Fund; the total amount of the Fund was \$8,238,745 million. The Conservancy continues to operate within the Guidelines that are established in the TNC Donor Advised Fund Procedures, Distribution Guidelines, and the Memo of Understanding. Donors must and do distribute at least five percent of the value of their fund every year and over time, at least 20 percent of the fund's principal and

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income must be distributed to the Conservancy. Donors are informed of these requirements through quarterly reports that state the value of the fund, the amount distributed and where, and the amount that remains to be distributed for that year. Prior to making any advised distribution to an organization, the Conservancy contacts that organization and requests a copy of its 501(c)(3) determination letter. Furthermore, the distribution letter that accompanies the disbursement to the charity states that by endorsing the check, the organization acknowledges the payment does not represent the payment of any personal pledge or other financial obligation of the donor and that no benefits will be offered in connection with the distribution.

2. Explain how TNC assures compliance with employment tax reporting with respect to all of its employees.

The Conservancy contracts with an outside payroll service with substantial expertise in employment tax reporting to complete its bi-weekly payroll. With appropriate oversight by the Conservancy, this provider also completes and files all federal and state employment tax reporting with respect to the Conservancy's employees.

The Conservancy also maintains standard operating procedures in this area (Definition of Employees, Employee/Independent Contractor Designations, Standard Work Hours) and provides tools such as a questionnaire entitled "Is Your New Worker an Employee vs. Independent Contractor Questionnaire" to ensure compliance with employment tax reporting and to make correct determinations on worker classification. These SOPs, along with others, are part of the Conservancy's ongoing comprehensive compliance training program for all TNC staff.

IRS AUDIT

1. Provide the following items with respect to the completed IRS examination:

- a. *A copy of the IRS letter concluding the examinations;*
- b. *A copy of the IRS proposed adjustments and notice of deficiency, if any, with respect to TNC's Form 990-T;*
- c. *A copy of all information documentation requests (IDRs) pertaining to the examination and TNC's written responses to the IDRs;*

Issues with respect to the disclosure of the materials requested in the preceding subparagraphs (a) through (c) are under consideration by the Committee staff in response to the Conservancy's letter to the staff dated June 14, 2006.

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d. A copy of any materials submitted to the Board of Trustees or Board committees relating to the IRS audit of TNC.

All information related to the IRS audit of the Conservancy was communicated orally to the Board of Directors or Board committees.

2. Has TNC been notified by the IRS that the IRS intends to audit any other TNC taxable years?

The Conservancy has not been notified that the IRS intends to audit any other taxable years of the Conservancy.

3. Describe any steps taken by TNC as a result of the IRS audit that TNC expects will help TNC improve its compliance with federal tax laws.

As discussed elsewhere in this letter, the Conservancy has revised its tax return preparation and review process to ensure transparency and full compliance with its Form 990 tax reporting requirements; revised its internal process for ensuring that it properly reports all unrelated business income on its Form 990-T and confirmed that its previously adopted Tax SOP will ensure compliance with section 4965 of the Code.

The Conservancy has also created a new senior level position of Director of Tax Services. The Director of Tax Services, who has responsibility for overall tax compliance, reports directly to the Chief Financial Officer and consults regularly with the Legal Department on tax matters. In addition to the processes outlined above, the Conservancy conducts an ongoing tax review in order to ensure compliance with federal tax laws.

As discussed more fully in its prior submissions to the Committee and highlighted in this letter, the Conservancy has also updated or created numerous standard operating procedures to ensure that the Conservancy meets or exceeds the requirements of federal tax law.

FINAL FINDINGS

1. Provide a list of all the recommendations of TNC's Governance Advisory Panel and the current status of TNC's compliance with those recommendations.

Please see material included in the attached chart, included as Exhibit 1.

2. Provide copies of all internal audits (including drafts) from June 1, 2005.

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Issues with respect to the disclosure of internal audits (and drafts) are under consideration by the Committee staff in response to the Conservancy's letter to the staff dated June 14, 2006.

3. Reports of the Risk Assessment Committee to the Board of TNC (and any subcommittee).

Please see material included in the attached chart, included as Exhibit 2.

4. A description of all land and other transactions involving major donors and Board members that were subject to advance review and approval by the Board under the conflicts procedure.

Please see material included in the attached chart, included as Exhibit 3.

5. A description of all requests for substantive modifications of easements that were approved or disapproved by TNC.

Please see material included in the attached chart, included as Exhibit 4.

* * * * *

While many of the documents referred to in this letter are available on the Conservancy's website, we will be happy to provide copies of those documents directly to you. My colleagues at the Conservancy and I stand ready to respond to any questions you or your staff may have.

Respectfully submitted,



Steven J. McCormick
President and Chief Executive Officer

EXHIBIT
1

EXHIBIT 1

ACTIONS TAKEN ON
GOVERNANCE ADVISORY PANEL RECOMMENDATIONS
As of 6/06

Note: The original recommendations for the Board of Governors as outlined in the Panel's preliminary proposal of January 23, 2004, are shown below. Edits have been made to differentiate between the original and final recommendations. A strike-through indicates a word or phrase was deleted in the final report, and characters in bold signify an addition to the Panel's final report.

RECOMMENDATION	ADOPTED	ACTION PENDING
<p>Board of Governors</p> <p>1. The current Board of Governors ("BOG") would select the Members of a new Executive Committee ("EC") to consist of the Chairman, two Vice Chairman, President, Secretary/Treasurer, and the Chairman of six Committees, for a total of ten eleven Members of the new EC. The Chair and the two Vice Chairs would each inform themselves as to the activities of two Committees and would each act as liaison to two committees.</p>	1/29/04	<p>Adopt the recommendation with the following change: The Chair and two Vice Chairs would each inform themselves as to the activities of two Committees and would each be assigned ex-officio to two committees.</p> <p>CURRENT: Same as above.</p>
<p>2. The Committees would consist of approximately five Members each, would be drawn from the entire membership of the BOG, and would meet at least quarterly. The Chairman Governance Committee would lead the process in consultation with the Chair by which Members of the BOG are assigned to Committees. The President would not serve on Committees. Because each BOG Member would make a serious and significant commitment of time to Committee work, to the extent possible no one would be asked to serve on more than one Committee, although the Chairman could attend any Committee meeting ex-officio, as could the President, unless excused by the Members of the Committee. Written charters stressing each Committee's accountability for its missions would be prepared by each Committee, and reviewed annually for submission to the Governance Committee, then to the EC, and finally to the BOG. The Vice Chairs of each Committee, who would serve on the BOG but not on the EC, would be responsible for each Committee's liaison efforts with local chapters. Further, while it is inevitable that the work of one Committee may overlap with that of another, such overlap is not necessarily undesirable.</p>	1/29/04	<p>Adopt the recommendation with the following change: The Vice Chairs of each Committee, who would serve on the BOG but not on the EC, would be responsible for each Committee's liaison efforts with local chapters. Further, while it is inevitable that the work of one Committee may overlap with that of another, such overlap is not necessarily undesirable. The Governance Committee is responsible for developing a communications strategy and plan for chapter boards.</p> <p>CURRENT: Same as above. We do not have vice chairs for the Committees</p>

ADOPTED ACTION PENDING

1/29/04

RECOMMENDATION

1/29/04

1. The Committees would be:
 - a. Audit
 - N.B.: At some point in the future, the EC might shift certain of these assignments to other Committees if they result in precluding the Audit Committee from a sharp focus on basic Audit Committee tasks.
 - b. Strategy
 - c. Governance
 - d. Conservation Project Review
 - N.B.: The purpose of this Committee would be to ensure adequate oversight and risk management of TNC's conservation programs, with a particular emphasis on large or novel conservation projects - i.e., high-dollar value conservation buyer transactions and transactions with government entities, compatible human use activities, etc.
 - e. Finance
 - f. Marketing and Philanthropy.

4. It would be important for some of the EC Members to be persons who are not current Members of the BOG. This would be accomplished as soon as reasonably possible. All BOG Members would be given an extensive orientation course and ~~a Committee~~ the Governance Committee would regularly review BOG Member performance. Over time, some Members who leave the BOG would not be replaced so that the size of the BOG did not increase beyond its current size due to the fact that any person elected to the EC would automatically become a member of the BOG.

5. Members of the BOG and EC would be independent of TNC pursuant to standards to be established, but at a minimum, no Member of the EC could hold any other TNC position, except for that of President ~~and Trustee~~. It would be, however, desirable if some Members of the EC had previously served as trustees.

No action required.

CURRENT: The work of the Board is primarily done through the committees, with committees making recommendation to the full Board for approval. Conservation and strategic issues (such as conservation strategies, marketing, philanthropy, and policy) are managed by the full Board.

- Executive Committee
- Audit Committee
 - i. Subcommittee: Conservation Projects and Practices
- Finance Committee
- Governance, Nominating, and Human Resources Committee

Discuss Board orientation and Board Member performance at future Governance Committee meeting.

Governance Committee to re-examine Board structure in 1 to 2 years.

CURRENT: The Board of Directors is comprised of not less than nine nor more than twenty-one members (currently at 21). Each member is offered a day-long orientation, with subsequent 2-3 hour "board workshops" offered at each meeting of the board that serves as continued education through structured "deep dives" into issues central to TNC mission and operations.

The Panel added a restriction in its final report barring any Board member from simultaneously serving as a Chapter Trustee of the organization. We recommend that the Board not adopt this amendment and instead, adhere to the recommendation adopted on January 29, 2004, that allows for simultaneous service as a Chapter Trustee.

CURRENT: Same as above.

RECOMMENDATION	ADOPTED	ACTION PENDING
<p>6. TNC financial supporters would be eligible for election as BOG and EC Members, but no Member or his/her company could take an income tax deduction for any gift of land to TNC nor could any Member or his/her company purchase land from or sell land or easements to TNC while serving as a Member. Monetary gifts would of course be permitted but Members and their companies would not be permitted to have cause-related marketing agreements with TNC.</p>	1/29/04	<p>Recommendation stands as approved except for the following phrase which needs to be modified so as to permit tax deductions after a transaction has been subject to extraordinary scrutiny to mitigate any real or perceived conflicts. [... but no Member or his/her company could take an income tax deduction for any gift of land to TNC ...] CURRENT: same as above. TNC Adopted: 1. Policy on gifts by Board Member 2. Policy on Board Exceptions to Policy</p>
<p>7. While BOG and EC Members would not be chosen to represent TNC "constituencies," selecting Members who have expertise and competency in various areas in addition to conservation and the environment would be strongly encouraged, especially in governance, but also in other areas such as international affairs, ethics, audit and accounting, finance and investment, tax policy, conservation science, public and governmental affairs, real estate, law, etc.</p>	1/29/04	<p>Governance Committee to implement. CURRENT: Compete. The Board is a diverse group of leaders, who bring a variety of talents, experiences and expertise to the governance of the Conservancy.</p>
<p>8. BOG and EC Members would be elected for staggered three-year terms. Members would be eligible to serve three two consecutive three-year terms, and would be eligible for election again a one year after serving three two consecutive three-year terms.</p>	1/29/04	<p>Recommendation is to maintain three consecutive three-year terms. Also recommend amending by-laws to allow the Chair one year of additional service after his/her term as Chair. CURRENT: Same as above.</p>
<p>9. The EC would have in-person meetings at least quarterly. The EC and the Committees could and would meet telephonically between regular meetings. The BOG would meet two or three times a year, and could meet telephonically. Quarterly EC meetings ideally would consist of a working dinner followed the next day by a session running at least four hours. The BOG would meet twice yearly. Other than the President, BOG and EC members would not be compensated.</p>	1/29/04	<p>In order to comply with Better Business Bureau standards, the Board must meet, at minimum, three times a year. CURRENT: The Board of Directors is comprised of not less than nine nor more than twenty-one members (currently at 21). The work of the Board is primarily done through the committees, with committees making recommendations to the full Board for approval. Conservation and strategy issues (such as conservation strategies, marketing philosophy, and policy) are managed by the full Board. ---Executive Committee ---Audit Committee ---Subcommittee: Conservation Projects and Practices ---Finance Committee ---Governance, Nominating, and Human Resources Committee</p> <p>The Board holds 4 in-person meeting per year and meets when needed</p>

RECOMMENDATION

ADOPTED

ACTION PENDING

via teleconference. The Executive Committee meets when it is impractical or unfeasible for the full Board to meet between regularly scheduled meetings. **The President is the only member of the Board who is compensated.**

Recommendation is being implemented.
CURRENT: Same as above.

1/29/04

10. The Chairman would be responsible for the development of the agenda for each EC meeting. The outside EC Members would devote a portion of each meeting to a session which would not include the presence of the President.

1/29/04

11. An independent, outside auditor and the Director of Internal Audit would be appointed by the EC annually upon the recommendation of the Audit Committee and would report to the Audit Committee. **The fees for the outside auditor would be set by the Audit Committee. The Audit Committee would decide no less frequently than every five years whether a new outside auditor should be selected, and if the then-current auditor is retained, a new lead partner would be selected.** The General Counsel and a new Compliance Director would be selected by the President, subject to the approval of the EC. The Internal Audit Director's position description would be expanded to include responsibilities similar to those in U.S. Government departments held by Inspectors General, i.e., an internal investigatory function. The General Counsel and the new Compliance Director would report directly to the EC as well as to the President. ~~An annual legal audit would be performed.~~ **Annual audits of legal issues and science programs would be performed.**

Suggested amendments:
 An independent, outside auditor and the Director of Internal Audit would be appointed by the **EC** annually upon the recommendation of the Audit Committee and would report to the Audit Committee. The fees for the outside auditor would be set by the Audit Committee. The Audit Committee would ~~decide~~ **recommend** no less frequently than every five years whether a new outside auditor should be selected, and if the then-current auditor is retained, a new lead partner would be selected. The ~~General Counsel and a~~ new Compliance Director would be selected by the ~~President, Chief Administrative Officer,~~ subject to the approval of the ~~EC~~ **EC** Audit Committee. The Internal Audit Director's position description would be expanded to include responsibilities similar to those in U.S. Government departments held by Inspectors General, i.e., an internal investigatory function. The General Counsel will report to the President, and the new Compliance Director would report directly to the ~~EC~~ **EC** Audit Committee as well as to the ~~President~~ **President** C.A.O. ~~Annual audits of legal issues and science programs would be performed.~~

Legal to present annually to Audit Committee a summary of legal risks and litigation. Strategy Committee to review Science agenda annually to ensure Science is supporting key business decisions.

CURRENT: Same as above except the following:

- 1. The Audit Committee, through its Conservation Projects and Practices Subcommittee reviews the science agenda and audits the effectiveness of our conservation work.

RECOMMENDATION

ADOPTED

ACTION PENDING

12. In the interest of accountability to the internal and external and numerous and varied constituencies that have an interest in TNC, a major focus of the EC would be the promotion of transparency in all facets of TNC's governance, businesses, programs, and performance, including oversight of all mandatory and discretionary reporting.

Recommended action: Staff to present to EC periodic reports on compliance with mandatory reporting requirements and voluntary disclosure.

13. The new structure would be phased in as soon as possible ~~as approved by the~~ ~~Envision Committee and the BOG.~~ Thereafter, the EC would develop formal elaborated guidelines for its future operation and conduct. These guidelines would include, among other things, Committee charters more particularly specifying the respective responsibilities and organization of each of the Committees including the EC. ~~Thereafter, every attempt would be made to work closely with local chapters to explain to them the rationale for the new structure in the hope that the local chapters would buy in to it. The EC and new Committee system would begin operations as soon as possible, but no later than July 1, 2004, the beginning of TNC's fiscal year. Thereafter, the EC would develop and present to the BOG, for its approval, formal elaborated BOG Guidelines for its future operation and conduct. These Guidelines would include, among other things, Committee charters more particularly specifying the respective responsibilities and organization of each of the Committees.~~

1 29-04

Charters underway. Staff to develop Board of Governors operational guidelines.
EC to develop charter.

CURRENT: The Nature Conservancy currently has formal adopted charters, and has made public on its website: nature.org:
1. Bylaws that governs the organization (governance principles)
2. Charter of governance responsibility for the Board and Board members.
3. Charters and membership for each of its Board committees.

14. The Panel believes that a central issue of board governance is ensuring that the board serves as an active and objective body for monitoring management activities. Because non-profits receive private donations and public benefits, it is essential that a non-profit board ensure that managers use organizational assets for their intended purpose, and scrupulously operate in a transparent, lawful, and ethical manner.

CURRENT: As a charity, The Nature Conservancy holds itself accountable to its members, the public and all creatures that have a stake in the preservation of the world's natural resources.

The Nature Conservancy is highly rated by charity watchdog organizations:
• The Nature Conservancy meets all of the Better Business Bureau (BBB) Wise Giving Alliance Standards for Charity. Accountability:
• The American Institute of Philanthropy has awarded The Nature Conservancy an "A-" rating.
• The Nature Conservancy's strong performance is recognized by Charity Navigator as exceeding or meeting industry standards.
• Forbes magazine rated The Nature Conservancy's fundraising efficiency at 88% in its annual survey of the largest U.S. charities.

RECOMMENDATION

15. Board duties should include:
- Articulating expectations and standards related to organizational culture and the "tone at the top"
 - Establishing the basic policies of TNC and reviewing any proposed deviations from them
 - Selecting, monitoring, evaluating, compensating, and if necessary, replacing the President, and in some circumstances, senior staff
 - Reviewing and approving management's strategic and programmatic plans (consistent with the non-profit mission) and monitoring performance against the strategic and programmatic plans to evaluate whether the organization is being properly managed
 - Reviewing and approving the organization's financial objectives and major plans and actions
 - Reviewing and approving significant transactions
 - Reviewing and approving the auditing and accounting principles and practices used in preparing the organization's financial statements
 - Providing oversight of disclosure and transparency, risk assessment, internal controls, and processes designed to promote legal and ethical compliance
 - Assessing the board's own effectiveness.

Chapter Governance

- Minimum standards should build upon a combination of historic best practices and the restructuring of the Chapter Board. The following areas should be addressed:
 - Committee structure, membership and charters
 - Audit and evaluation practices
 - Eligibility and participation requirements for chapter trustees
 - Terms and term limits
 - Minimum meeting requirements
 - Reporting requirements
 - A trustee orientation training program

Being addressed through the Trustee Role Project.

CURRENT: Completed. *Roles and Minimum Standards for Governing The Nature Conservancy* document and policy approved by the Board of Directors on September 30, 2004.

In conjunction with the distribution of the "Roles and Minimum Standards for Governing The Nature Conservancy", the Conservancy produced and distributed a comprehensive Trustee Handbook to assist chapters in developing the leadership and oversight responsibilities of their Boards of Trustees. The Conservancy currently employs a small group of staff members to assist chapters with training in this area. As the Conservancy developed additional materials in subsequent years, the Trustee Handbook has been enlarged and improved. Currently, the Trustee Handbook contains:

RECOMMENDATION

ADOPTED ACTION/PENDING

EXHIBIT I

- Roles and Minimum Standards for Governing The Nature Conservancy.
- Trustee Advisory Council materials.
- Best Practices for Excellence in Board Performance, a collection of model performance standards in eleven areas of board operations, including planning, oversight, financial management and conservation activities.
- Board Evaluation Tool, for use in evaluating performance against both minimum standards and best practices.
- Trustee Ethics and Compliance Information.
- Information on Implementing the standard Chapter Operating Principles.
- Materials for standard Trustee orientation, including a video overview of the Conservancy, suggested meeting agenda, orientation presentation template and suggested handbook materials.

2. The Panel believes that chapter boards should review and ratify the most important decision confronting local chapters, subject to the ultimate authority and oversight of the BOG and the EC. These decisions should parallel the types of decisions made at the BOG and EC level as well as the standards for making such decisions, and would likely fall in the following categories:
 - Chapter strategy, particularly its alignment with TNC's overall strategy
 - Operations – e.g., approval of annual budgets, hiring targets, financial plans, fundraising practices
 - Land transactions – e.g., any and all potentially "high risk" transactions
 - Compliance with policies and procedures – e.g., TNC-wide policies requiring chapter compliance such as conflict of interest
3. Given the need for greater coordination and integration between the BOG, EC and chapter trustees, it is the Panel's recommendation that TNC identify mechanisms to ensure better transparency and communication among the various leadership groups.

Being addressed through the Trustee Role Project.

CURRENT: Completed. *Roles and Minimum Standards for Governing The Nature Conservancy* document and policy approved by the Board of Directors on September 30, 2004. (See above.)

Being addressed through the Trustee Role Project

CURRENT: Completed. *Roles and Minimum Standards for Governing The Nature Conservancy* document and policy approved by the Board of Directors on September 30, 2004.

RECOMMENDATION	ADOPTED	ACTION PENDING
<p>Programs, Transparency, and Accountability Valuations & Appraisals in Land Donations & Conservation Easements</p>	<p>TNC created the Trustee Council to serve as a vehicle for greater communication and transparency between Chapter Boards and TNC's Board of Directors. The Council has held two meetings in the last year and a half as well as numerous conference calls.</p>	<p>Revised Policy and Standard Operating Procedure for Internal Revenue Service Forms 8282 and 8283 approved by BOG on 3/12/04.</p>
<p>1. The Panel suggests that potential donors be informed at the outset of the transaction that TNC will closely examine the qualifications of the appraiser, the methods used, and the appraisal itself. (TNC should consider whether the review of the donor's appraisal could take place at the time the gift is made, not after the fact when the Form 8283 is submitted. Because the Form 8283 need not be completed before the donor files a tax return, it may not be submitted for many months - especially if the taxpayer seeks an extension of the filing date - after the end of the calendar year in which the donation was made.)</p>	<p>Revised Policy and Standard Operating Procedure for Internal Revenue Service Forms 8282 and 8283 approved by BOG on 3/12/04.</p>	<p>Revised Policy and Standard Operating Procedure for Internal Revenue Service Forms 8282 and 8283 approved by BOG on 3/12/04.</p>
<p>2. In addition, the Panel recommends that TNC undertake a "desk review" of all aspects of a proposed conservation transaction, which would include a review of the donor's appraisal, to determine whether the transaction is appropriate.</p>	<p>Revised Policy and Standard Operating Procedure for Internal Revenue Service Forms 8282 and 8283 approved by BOG on 3/12/04.</p>	<p>Revised Policy and Standard Operating Procedure for Internal Revenue Service Forms 8282 and 8283 approved by BOG on 3/12/04.</p>
<p>3. The Panel believes that TNC must demonstrate that it is willing to "walk away" from an otherwise advantageous transaction where all aspects of the transaction do not meet TNC's new standards, including where a donor wishes to claim a tax deduction based on an appraisal that is not justified.</p>	<p>Compliance Office, including training program, to be established in FY05. Completed. Ninety-seven percent of 3600 TNC employees have completed Compliance Training in FY06.</p>	<p>Compliance Office, including training program, to be established in FY05. Completed. Ninety-seven percent of 3600 TNC employees have completed Compliance Training in FY06.</p>
<p>4. Finally, the Panel notes that the February 12, 2004 "Processes for Managing Reputational Risks" Memo (at page 24) recommends training in TNC compliance policies, which the Panel certainly encourages; the Panel recommends that such training be expanded to cover tax issues relevant to both TNC and donors. The Panel also suggests that TNC encourage law and business schools to include these subjects in courses</p>	<p>TNC Easement Working Group made specific recommendations in this area which have been adopted and implemented.</p>	<p>TNC Easement Working Group made specific recommendations in this area which have been adopted and implemented.</p>

Programs, Transparency, and Accountability Monitoring & Enforcement of Easements

- The Panel believes that TNC should regularly monitor compliance with easements, should require property owners to disclose plans for changes in easements, and take rigorous enforcement action where landowners act inconsistently with easement terms.

ADOPTED ACTION PENDING

RECOMMENDATION
Programs, Transparency, and Accountability
Compatible Human Use

- | | |
|--|---|
| <p>1. TNC has long recognized that conservation of biodiversity must allow for a reasonable amount of human use of conservation lands. It is important that TNC be able to demonstrate that it is consistently follow a policy of allowing only those human uses that are compatible with TNC's conservation goals and adhere to it.</p> | <p>Revised Policy on Ownership and Management of Lands and Waters approved by BOG on 3-12-04.</p> |
| <p>2. The Panel believes that the Board's articulation of TNC's compatible human use policy [as presented at the June 13, 2003, BOG meeting] is appropriate. In addition, the Panel agrees with the recommendation in the Memo that a committee composed of senior staff be formed to review "innovative, large scale, or untested proposed human uses." The Panel would also suggest that any proposed transactions approved by this committee be presented to the newly-formed Conservation Project Review Committee for final approval. For purposes of transparency, the Panel recommends that TNC also include an explanation of its compatible human use policy, with examples, in its Form 990.</p> | <p>See above. Compatible use policy procedure is included in the description of changes in Governance, Policies and Procedures.</p> <p>New TNC Project Review Committee appointed and underway.</p> |

5/17/04

5/17/04

Programs, Transparency, and Accountability
Executive Compensation

- | | |
|--|---|
| <p>1. Both for purposes of public perception and for maintaining its tax-exempt status, TNC should maintain a consistent policy of paying executives amounts comparable with those paid by other similar not-for-profit organizations. It is especially important that the Governance Committee play an active and independent role in reviewing the performance and setting the compensation of the President, as well as reviewing and approving compensation of senior staff positions, and the compensation of the President and senior staff should be disclosed great detail in the Form 990. Any compensation consultant retained by TNC should be chosen by the Committee.</p> | <p>The Governance Committee is responsible for the performance evaluation and compensation of the President.</p> <p>All aspects of the compensation of the President and senior staff are disclosed in the Form 990.</p> <p>CURRENT: Same as above.</p> |
| <p>2. The Panel could not agree more with the statement in the Memo (at page 5) that "it is important to ensure that TNC has a well-structured and transparent policy toward determining compensation levels for its senior executives." Accordingly, the Panel recommends that the EC adopt the suggestions of the TNC Compensation Working Group (outlined on pages 5-6 of the Memo) with respect to the manner in which the new Governance Committee should oversee matters of senior management compensation.</p> | <p>Governance Committee charter encompasses this responsibility.</p> <p>CURRENT: Same as above.</p> |

RECOMMENDATION

**Programs, Transparency, and Accountability
Lobbying**

- 1. In order to maintain its tax-exempt status, section 501(c)(3) organizations such as TNC are required under the Internal Revenue Code to limit their lobbying activities to less than a "substantial part" of their overall operations. In this regard, as noted in the Memo, the TNC Board of Governors has approved an expenditure of up to only two percent of TNC's charitable budget on lobbying activities. The Panel believes that this threshold is more than consistent with the letter and spirit of IRS policies.

No action required.

**Programs, Transparency, and Accountability
Compliance**

- 1. In the Memo (at p. 8), senior staff has suggested that the Compliance Director be housed in the office of TNC's General Counsel, and report to both the General Counsel and the Audit Committee. As set forth in the Panel's Board Proposal, the Panel recommends that the Compliance Director report directly to the EC as well as to the President. In addition, while the Panel recognizes that the costs of establishing the new position of Compliance Director will be significant, the Panel does not believe the Compliance Working Group should specify in advance that the Compliance Director should have no additional direct reports other than an administrative assistant. The Panel recommends that the Compliance Director be recruited from outside TNC.

Compliance Director to report to Chief Administrative Officer and Audit Committee.

Right size of budget to be addressed after start-up

Search includes both internal and external candidates.

CURRENT: Chief Ethics and Compliance Officer hired. The Chief Ethics and Compliance Officer and General Counsel report at every meeting of the Audit Committee. In addition, the Chief Ethics and Compliance Officer meeting in executive session with the Audit Committee at every meeting.

**Programs, Transparency, and Accountability
Reputation and Transparency**

- 1. Conservation Project and Activity Review
 - The Panel's Proposal in Part I recommended the creation of a Conservation Project Review Committee of the EC to ensure adequate oversight and risk management of TNC's conservation programs, with a particular focus on large or novel conservation projects. For example, the Conservation Project Review Committee would closely examine high-dollar value conservation buyer transactions and transactions with government entities, as well as proposed compatible human use activities. The Panel believes as does the BOG that such EC level review is essential to protect TNC's reputation.

Staff-lead Conservation Project Review Committee established January 30, 2004.

BOG Committee name change pending. Project Activities Review Committee (PARC).

ADOPTED ACTION PENDING

RECOMMENDATION

<p>assure legal compliance, and serve the organization's conservation objectives.</p> <ul style="list-style-type: none"> The Memo proposes to augment the work of this Committee by creating processes for managing risk at the staff level (Memo at pages 33-36), including the proposed creation of a staff level committee to oversee such processes (which committee itself would report to the Conservation Project Review Committee). The Panel agrees with this approach which should go a long way toward achieving this end and preventing any single project from damaging TNC's reputation. 	<p>New Project Review Committee established</p> <p>CURRENT: The Audit Committee, through its Conservation Projects and Practices Subcommittee reviews the science agenda and audits the effectiveness of our conservation work.</p>
<p>2. TNC's Form 990</p> <p>The Panel believes that the Form 990, which the Internal Revenue Service requires all non-profits to file annually, provides an opportunity for transparency and disclosure. Although the Form 990 does not require disclosure as detailed as that required in annual reports filed by public companies with the Securities and Exchange Commission, it can serve as a non-profit's version of what is now required by Sarbanes-Oxley for public companies. Therefore, the Panel suggests that TNC voluntarily disclose as much as possible (about its mission, policies, programs, goals, etc.) in its annual Form 990 in order to keep donors, the public, and interested governmental entities well informed about its activities. The Panel suggests that the changes and initiatives implemented since the June 13, 2003 BOG meeting be discussed in TNC's next Form 990, and that thereafter each Form 990 should include a report on the work of the Conservation Project Review Committee during the prior year. (The Panel observes that the Form 990 filed by Memorial Sloan-Kettering serves as an example of a model Form 990.)</p> <ul style="list-style-type: none"> Simply put, TNC could use its Form 990 in the words of one commentator, "to detail the activities, experiences, and ethical record of the organization during the previous year." 	<p>\$: 17.04</p> <p>TNC's fiscal year 2003 Form 990 includes an extensive narrative describing the mission, strategy and values of the organization, together with selected program service accomplishments from TNC's 2003 annual report.</p> <p>Staff exploring use of Form 990 and other vehicle, and will report to the EC.</p>

EXHIBIT

2

JUN 19 2006



**Summary of Decisions
FY 2006 Year to Date
Risk Assessment Committee**

June 2006

JUN 19 2006

To: Conservation Strategies Committee, Board of Directors

From: Bob Bendick for the Risk Assessment Committee

Subject: Update on RAC Activities

Cc: Mike Andrews, Philip Tabas, RAC Members

Per your request through Mike Andrews, I am providing an update on the activities of The Nature Conservancy's Risk Assessment Committee (RAC) in FY 06 to date.

Background

The Risk Assessment Committee was created in April 2004 to evaluate the risks of complex land acquisition, partnership and policy projects undertaken by field and headquarters units.

The Committee consists of 12 members representing various disciplines and regions of the Conservancy. Since our last report to you, the Committee has added Jim Petterson, Chief Communications Officer, to provide input on communications issues related to the Conservancy's activities. In addition, as originally envisioned, two members have rotated off the committee (Andrea Erickson, now Wyoming Chapter Director and Alan Holt, Senior Conservation Advisor, Pacific North America Region) and two new members have been appointed, Susan Anderson, (Northern Mexico Director, Mexico Country Program) and Mike Fuhr, Oklahoma State Director. These changes ensure that the Meso-American and Central Regions are represented. A full list of members is attached (Attachment 1). Terms are now being assigned to members so that the rotation process can continue in an orderly way.

Cases

During FY 06, the number of proposals submitted to the RAC slowed significantly for most of the program year, however, recently, the rate of submission has returned to its original pace. Seven decisions written during FY 06 are attached (Attachment 2). These include:

1. A carbon sequestration project
2. A grant from a private foundation
3. A land acquisition court case
4. An exchange of Federal land
5. Opposition to a property rights initiative within a state
6. An off-site mitigation design project
7. The acceptance of a conservation easement on a hunting plantation that also includes a golf course

JUN 19 2006

Please note that the attached decisions have been edited or generalized for distribution. (At the end of FY 06 a summary of decisions will be prepared and distributed to Senior Managers to assist in organizational risk management as has been past practice).

Mike Andrews continues to remind managers of the existence and function of the committee to ensure that appropriate projects come before the RAC.

Pending Cases

Three additional cases are likely to come before the RAC in the coming weeks:

1. A case involving contracting for prescribed fire services
2. A grant request to be submitted to the Shell Oil Corporation and its foundation
3. Potential TNC participation in reduction of fish trawling effort in sensitive areas of the Gulf of Mexico

RAC Operations

The Committee continues to discharge its responsibilities at minimal cost to the organization thanks to the willing and effective participation of its members and to excellent staff support from the RAC's Secretary, Amy Givens.

Please contact me if you have questions or concerns.

JUN 19 2006

Attachment 1

Risk Assessment Committee Members

Robert Bendick, Managing Director, Southern U.S. Region, Chair
Susan Anderson, Northern Mexico Director, Mexico Country Program
Charles Bedford, Director, Colorado State Program
Karen Berky, Chief Ethics and Compliance Officer
Michael Dennis, Director of Conservation Real Estate and Private Lands
Michael Fuhr, Director, Oklahoma State Program
William Ginn, Director, Global Forest Partnership
Jim Petterson, Chief Communications Officer
Katherine Skinner, Director, North Carolina State Program
Philip Tabas, Vice President/General Counsel
Robert Troya, Director of External Affairs, South America
David Weekes, Director, Washington State Program

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Attachment 2

Summary of Projects

Case RAC 1.06: Carbon Sequestration

Project Description: A U.S. Chapter Program and an Energy Company engaged in a partnership which involved the Energy Company providing funding for acquisition of 5,000 acres and afforestation of 2,600 acres of a priority tract, within a TNC Portfolio Conservation Area, in exchange for carbon offset rights on a portion of the property for 100 years. Acquisition and afforestation funding also included grant funds from NAWCA and NFWF, with transfer of a portion of the tract to USFWS and the balance to a conservation buyer. The project presents several risks that, when combined, have the potential to create public misperception. The commingling of carbon credit revenue and Federal funds represent the major risk to this project.

Decision: The project was approved with several conditions:

- The project team should request a letter from NAWCA confirming agreement with TNC's use of revenue generated from the sale of carbon sequestration credits as part of the project costs.
- An independent appraisal or verification of value should be obtained to substantiate the value of carbon sequestration credits being sold to the Energy Company. TNC should apply careful scrutiny to the appraisal(s), conservation easement terms and marketing of property to any conservation buyer.
- The project team should verify that the transaction will not be used by the Energy Company for marketing purposes. Any use of the project for public outreach, or in external documents, annual reports, etc. must be approved in advance by the Chief Communications Officer of The Nature Conservancy.
- The project team should develop a clear communications strategy and messaging platform to ensure that this project is presented effectively to any external audience, and to ensure that it is distinguished from other projects where carbon credits have been sold to utility companies for restoration on Federal lands.
- Representations should be made to or obtained from the Energy Company to ensure that it does not treat this transaction in a way that would give rise to inappropriate tax benefits.
- A member of the project team should contact USFWS to obtain further information regarding any official policy and process they have in place, or are in the process of establishing, regarding the sale of carbon credits to private parties over publicly-owned properties.

Reasons for Decision:

With the accompanying conditions, TNC can work with the appropriate government agencies to ensure that financing of the project utilizes Federal funds properly and without any extra benefit to TNC. In addition the conditions limit the energy company partner to receiving only those benefits permitted by the IRS.

PLEASE NOTE: A DECISION WAS MADE NOT TO GO FORWARD WITH THIS PROJECT, SUBSEQUENT TO THE DATE OF THE DECISION ON THIS PROJECT BY THE RISK ASSESSMENT COMMITTEE.

JUN 19 2006

Case RAC 2.06: Accepting a Grant from a Private Foundation

Project Description: A Country Program, in partnership with a National Trust (NT) within that country, a Sportfishing Conservation Association (SCA), and other critical partners, proposed a strategy to promote the establishment of a new marine protected area (MPA) on the west side of an island, which is a priority conservation area within the Country. Part of the strategy would involve accepting a grant from a Private Foundation of \$300,000 over three years. The potential risk to the organization stems from the fact that the Corporation which established the Foundation that wants to fund the Conservancy intends to open a marine mammal exhibit in 2008 as part of their expanded facility in a different part of the Country. Some might perceive acceptance of a grant from the Foundation as an endorsement by TNC of the capture of wild dolphins by the Corporation for use in an aquarium or an endorsement of keeping marine mammals in captivity.

The proposed project can have great value for marine conservation on the west side of the island — an area that is a very high priority for TNC. The Foundation is entirely separate from the Corporation and is making grants to other entities for marine conservation activities. The Corporation has taken steps to operate its aquarium at a high level with pending certification and qualified staff. Dolphins to be used in the new facility will not be captured in local waters. There is strong community support for expansion of the Corporation's resort and the aquarium. There would be greater risk in TNC not accepting the grant than in accepting it given the support for the Corporation within the local community and the evident interest of the corporation and foundation in marine conservation. TNC's Global Marine Initiative has indicated support for this project.

Decision: The project was approved with several conditions. While there is no evidence or implication that the grant from the Foundation is intended for any purpose but to advance marine conservation in the Country, to ensure that the grant will not be otherwise interpreted by outside parties:

- Any use of TNC's name or brand in conjunction with the grant or for any other purpose will require the express review and written permission by TNC.
 - The making of the grant should not be construed or used as mitigation for the permits required by the Corporation for expansion of its resort and aquarium.
 - The grant award should not have any conditions attached suggesting that TNC take any position or make any endorsement that it would not ordinarily make.
- The Country Program should have talking points prepared in advance and someone on point in the event a public relations issue develops.

Risks Identified and Reasons for Decision:

Information provided to the RAC demonstrated that the foundation was not attempting to exert any leverage through its grant, but was legitimately interested in marine conservation. There was no effort to get TNC to endorse the permits for its resort expansion or to involve us in the issues of marine mammals in captivity.

JUN 19 2006

Case RAC 3.06: Land Acquisition Court Case

Project Description: A Country Program has engaged in negotiations with a local Corporation to acquire an approximately 2,200-acre priority Tract for an agreed-upon purchase price of USD\$8,200,000. During negotiations, it was discovered that the Tract, as well as several other properties surrounding the Conservation Area, were involved in a legal action brought by a group of individuals seeking to obtain title to these properties through a two-step process wherein the properties would first be declared national lands and then title to the properties would be issued to the group. Should the group succeed in obtaining title to the Tract, there is reason to believe that the group would ultimately sell the Tract to developers at a price much higher than what TNC has been able to negotiate with the Corporation. Since the Corporation owners are not in a financial position to defend title to the property, the Country Program is considering entering into an Option Agreement to acquire the Tract with terms that include providing funding and legal assistance to the Corporation to defend title to the property. Funding provided by TNC would be credited against the purchase price of the property. Many issues about the project are unclear, including who actually controls ownership of the Corporation property and the identity of the group trying to secure the Corporation's property through government action. Because title to the Tract may now be held by the government, the lawsuit to be defended by the Corporation and funded by TNC would involve, and necessarily be against, the government. TNC is also uncertain as to the chances of the Corporation winning the lawsuit or how long the lawsuit could last.

Decision: The project was approved with several conditions:

- The payment to the Corporation should result in a binding agreement for the corporation to file suit against the taking of the land, provide TNC and its partners with all information about ownership, title and present condition of the land and sell the land to TNC or TNC in partnership with its conservation partner or other partners provided the suit is successful and title to the land is acceptable
- Upon entering the case TNC should make a renewed effort to obtain all relevant information on the Corporation and its holdings including an updated title search.
- While TNC may not want to actively publicize its involvement and may want our conservation partner to be the local face for the purchase, TNC should not try to hide its involvement and should use its own name where relevant in court documents, government applications and official filings.
- Pursuit of the Corporation land should be accompanied by a cooperative planning effort with the local community and with our conservation partner to design a protected area and develop management plans for the Conservation Area that will present economic as well as ecological benefits.
- The Country Program should prepare a communications plan that covers TNC's actions in the case of additional controversy.

Reasons for Decision:

The future of the land in question is, in fact, important to conservation in the entire region. Provided TNC works closely and openly with its local partner, the perception of opposition to

JUN 19 2006

local interests or to the government is not likely to be damaging as local citizens appear to want the property conserved. Many uncertainties remain as to whether the project is actually viable.

Case RAC 4.06: Federal Land Exchange

Project Description: A local real estate broker and a former Federal Official, on behalf of a financial backer, are working with a Representative to pass a Congressional land exchange bill that would trade as much as 30,000 acres of Bureau of Land Management (BLM) property for private land and conservation easements in several locations around the state. The Conservancy's highest priority lands for protection will be included in the exchange. The proponents approached Conservancy staff for recommendations on important conservation lands and have asked the Conservancy to consider supporting the legislation.

Exchange land and terms were identified; however, just prior to presenting the project to the RAC, the project team learned that the exchange may not move forward because the options have lapsed, legislation has not progressed and the financial backer is pulling the plug. However, the project team presented this issue to the RAC because the project may come back or may be revived in a different form. The project team would like advice on how they should be proceeding with this transaction if it does move forward or if they should consider putting together other approaches to these types of exchanges. The biggest risk related to this type of exchange project is the potential perception that TNC is facilitating exchanges of federal lands that may not result in net gains for conservation. There are political issues with this project that relate to government relations program decisions on land sale/exchange legislation.

Decision: It was concluded that the subject project was not ready for a decision by the committee. It was noted, however, that the Government Relations Department is currently working on policies and positions for The Nature Conservancy relating to the overall issue of the sale and exchange of natural resource lands by the U.S. Government.

The State Program was directed to provide information on the potential Land Exchange to Government Relations so that this information can be taken into account in development of the larger policy. When that policy is adopted, the subject exchange can and should conform to it.

The Risk Assessment Committee is willing to participate in or provide advice for the development of the land exchange policies or in review of individual cases at the discretion of Government Relations and of individual project sponsors.

Reasons for Decision:

No decision rendered because the project not ready to proceed, however, there is cause to develop TNC-wide policy on government land exchanges.

NOTE: A DECISION WAS MADE NOT TO GO FORWARD WITH THIS PROJECT, SUBSEQUENT TO THE DATE OF THE DECISION ON THIS PROJECT BY THE RISK ASSESSMENT COMMITTEE.

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Case RAC 5.06: Opposition to Statewide "Property Rights" Initiative

Project Description: A U.S. Chapter Program seeks approval to publicly oppose an initiative filed by the State Farm Bureau relating to the impacts of environmental regulation on property rights and values. The Chapter proposes to join the campaign steering committee, contribute funds, devote staff time and engage in public communications, including with our membership. The initiative will be on the ballot in November 2006, provided that the Farm Bureau collects the necessary 224,880 signatures of registered voters by July 7. The initiative would require compensation when any government regulation damages the use or value of private property, and forbid rules that prohibit existing legal uses of private property. Agencies would be required to consider the effects of and alternatives to regulating private property. Compensation would generally be required if rules are enforced that damage private property use or value, including rules prohibiting or restricting property uses that were allowed as of January 1, 1996. Development rules that prohibit existing legal property uses would also not be permitted. It's likely that more 'property rights' initiatives of this kind will emerge in other states.

Decision: The Chapter team clearly articulated the negative impact of this legislative initiative on TNC's mission in that state, and has clearly articulated their value added to the campaign to defeat it. Furthermore, a defeat in the State will assist other state efforts to deter similar initiatives expected in the future throughout the western states. The Chapter's team recommendations to publicly engage in this campaign, to serve on the Executive Committee, and to provide resources are supported. The project should proceed with the following conditions:

- The Chapter should identify issues that would require stepping away from the campaign (language, tactics, content) and maintain the ability to do so if the campaign progresses in a way that is unexpected and not in keeping with our values and/or desired outcomes. Should this happen, the option would remain open for TNC to participate in the debate separately from the coalition.

While a public role for TNC is not prohibited, a specific analysis of pros/cons of TNC's public face in the campaign should be undertaken for both the success of the campaign and for managing risk to key partnerships.

The Chapter should remain cautious about overstating general blanket support for government regulation, but in keeping with the excellent analysis already generated, remain focused on specific impacts on priority places, key constituents, and current legislative frameworks.
- Over the course of the campaign the Chapter should continue to evaluate new investments of time, money and public exposure in relation to whether it believes TNC's involvement or greater involvement is making a difference in the outcome.

Reasons for Decision:

The Chapter demonstrated that passage of the referendum would be very damaging to TNC's conservation mission, that the Conservancy's direct involvement could make a difference in the outcome, and that TNC could participate in a way that is consistent with its values.

JUN 19 2006

Case RAC 6.06: Off-site Mitigation Design Project

Project Description: The proposed project entails the receipt by a U.S. Chapter Program of funding from a Petroleum Company to support development of a science-based process to identify sites for the off-site mitigation of oil and gas drilling within the State. Oil and gas drilling has increased rapidly in this region. Given the nature of the geological formations where drilling takes place, wells are placed at a high density (currently one per 40 acres, but potentially one per 5 acres with pending regulatory actions). The density of drilling and the related site disturbances result in significant long term damage to the sagebrush habitat being affected. The project relates to mitigation of drilling in a specific Field covering 30,000 acres. However, much larger areas of the State are subject to this form of petroleum extraction. Large-scale habitat damage is, thus, likely. Because of the extent of petroleum extraction in the State and the habitat damage caused by drilling in this geology, the project could associate The Nature Conservancy with justifying or facilitating specific projects in the specific Field or with large scale loss of habitat at other sites. It has been past practice at TNC to engage in mitigation activities only after permitting decisions have been made. While off-site mitigation is now voluntary, it appears that it has been added as a requirement to the latest BLM Record of Decision for the Petroleum Company's drilling in that Field. Even so, TNC's involvement with the Petroleum Company might be perceived to facilitate current or future permitting of drilling. There may be a possibility that our recommendations for mitigation will be contrary to the policies or practices of regulatory agencies, thus putting us at cross purposes to those agencies. If the proposed mitigation study does not involve public agencies and the process is not otherwise public, it might lead to the perception that TNC is working behind the scenes to further the Petroleum Company's goals without proper involvement of the public who may be for or against drilling or mitigation for drilling. Overall our involvement with the Petroleum Company might be seen by other groups or members of the public as an effort to sidestep public involvement in decision-making about where and how oil drilling takes place. This would undermine TNC's standing in the community. The development of a science-based methodology focused solely on biodiversity might be perceived by some as not providing sufficient attention to some of the other secondary effects of energy development. TNC might then be seen as ignoring other impacts to serve its own interests.

Decision: The project should proceed but only under the terms and conditions listed below.

- The Chapter should ensure that the proposed study of off-site mitigation is, in fact, kept separate and apart from the Petroleum's permitting requests. It appears that off-site mitigation is a permit condition in the pending BLM Record of Decision for this specific Field and that a Monitoring and Mitigation Office would be established that could work with TNC on mitigation issues; this all should be confirmed.
- There should be a written legal agreement with the Petroleum Company that spells out the respective responsibilities of the organizations. The agreement should include a clause that stipulates that the Conservancy's name not be used by the Petroleum Company in conjunction with this project in news releases, marketing materials or online without the express written

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approval of the Conservancy. We should obtain their specific assurance that the results of the study will not be used to secure additional or modified permits in the Field or elsewhere.

- The project should involve representatives of the regulatory agencies and other key stakeholders in scoping and implementing the study and in reviewing the draft results.
 - The project, its timeline and its proposed final product(s) should be announced publicly prior to its inception and be accompanied by clear questions and answers, non-jargony messages and other material required to spell out its extent and intent. A proactive PR plan should be prepared by the Chapter that anticipates and addresses public controversy.
 - As appears to be the intent of the Chapter, the mitigation plan should be part of an effort to retain the biological integrity of the ecoregion as a whole so that there is a clear understanding that the recommendations may involve areas where there are petroleum reserves. The chapter should also explore a means for the long-term protection of these completed mitigation lands to ensure that future technology, economic conditions, or other unforeseen situations do not jeopardize their conservation status.
- The project should be consistent with the principles set out in the Energy and Biodiversity Initiative.

Reasons for Decision:

Engagement in the mitigation study would not be tied to granting of any permit by the energy company and, in fact, the permitting of additional drilling is already underway. However, the mitigation study could develop scientific information useful to government agencies and to energy companies in developing policies and approaches to future drilling and offsetting the impacts of that drilling. This would contribute to the success of TNC's mission in this area.

Case RAC 7.06: Accepting Donation of a Conservation Easement on a Hunting Preserve that also Includes a Golf Course

Project Description: A U.S. Chapter of TNC proposes to accept the donation of a conservation easement over a historically, culturally and biologically significant 4,000-acre Tract located within a TNC Portfolio Action Site. The Tract is an exclusive, 25-member country retreat, comprised of high-profile affluent individuals. Amenities include an historic plantation house, 25 home sites on which club members may build their own home, links golf course, spa, year-round hunting for seasonal game, equestrian activities, fishing on a contiguous river, and full-service staff to accommodate all of the above. The improvements associated with these activities are restricted to approximately 700 acres, the remaining acreage (approx. 3,300 acres) being forested wetlands, historic rice fields, and uplands. It is expected the easement donor(s) will seek federal and state tax deductions for the donation of the easement. cursory reviews of the likely value of the easement donation suggest the value could be as high as \$30-40 million. An easement donation of that value likely will draw public scrutiny. Additionally, due to its sizeable value, this easement donation likely would have to be reported on the Conservancy's annual IRS Form 990 filing, which could trigger additional public scrutiny of the donation and any associated tax implications. Additionally, the State Department of Revenue has been a national leader in the scrutiny of conservation easements within that state. Holding an easement over a golf course could present management and public relations challenges to the Conservancy and

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given the recent legislative scrutiny of conservation easements over golf courses, likely trigger the interest of the relevant Federal and state tax authorities.

Decision: The project should proceed, but only under the terms and conditions listed below.

- The project team recommends to the donors in writing at least two reputable qualified appraisers (as defined in accordance with TNC 8283 standard operating procedures) with extensive experience valuing easement properties to ensure a strong, well-researched and justifiable appraisal.
- The donor must agree to terms, specified in any documents governing the transaction between the donor and TNC, that s/he did not rely on representations made by the Conservancy or any of its agents as to the tax consequences of the easement contribution, that s/he relied on his/her own tax, legal and appraisal experts in assessing the valuation of the donation and determining the tax consequences to the donor and that s/he will indemnify and hold harmless the Conservancy for any legal or tax consequences to the donor arising from the donation of the easement.
- Due to the size, complexity and unique valuation matters associated with this potential easement donation, the Conservancy conduct, using an external certified appraiser, an appraisal review to be able to certify that the donors' appraisal of the easement is reasonable and justifiable, and in accordance with TNC 8283 SOP.
- In advance of accepting the easement donation, the project team extensively and thoroughly documents the conservation purposes that the protection of the property is designed to serve, the ecological significance of the property and the extent to which the protection of this property is in furtherance of TNC conservation objectives, thereby demonstrating the importance of and necessity for its protection. It is also necessary that TNC establish and make explicit specific easement terms and conditions limiting the owner' retained rights, that are necessary in order for the Conservancy to ensure that the specified conservation purposes for the property are actually met.
- If the easement donation is to include the 700-acre "improved area," or just the golf course, the project team consults the Conservancy's General Counsel prior to finalizing easement terms.

Reasons for Decision:

The larger property occupies a strategic location in a region of longstanding conservation priority. The letter of the law and TNC procedures can be following with respect to appraising the value of the easement. The golf course is a small part of the overall conservation value of the easement.

EXHIBIT
3

EXHIBIT 3

FINAL FINDINGS
QUESTION 4.

A description of all land and other transactions involving major donors and board members that were subject to advance review and approval by the Board under the conflicts procedure.

Board Member or # Major Donor Name	Proposed Transaction Giving Rise to Conflict	Asset Involved in Transaction	Value Involved	Date of Review or Approval by the Conflicts Committee	Date of Review by Board Audit Committee	Disposition
1 Jim Scott (spouse of Christine Scott)	Proposed donation of a conservation easement.	Gift of an interest in land	Est. \$750K	11/8/2005	11/8/2006	Approved by TNC Board of Directors Audit Committee with conditions
2 Henry M. Paulson, Jr.	Wendy Paulson sits on the Board of RARE, a non-profit organization dedicated to international bird conservation. The Conservancy and RARE signed an MOU to collaborate on certain conservation projects and to enter into a partnership to fundraise for international conservation projects.	Not applicable	Unknown	10/31/2005	1/19/2006	Approved by TNC Board of Directors Audit Committee
3 Carol E. Dinkins	TNC Board member serves on the Board of another non-profit organization with which TNC proposed to contract to develop a water sustainability certification project.	Contract for Services	\$50K plus direct expenses	1/18/2006	1/19/2006	Approved by TNC Board of Directors Audit Committee
4 Henry M. Paulson, Jr.	TNC would like to obtain supplemental group insurance benefits for TNC China staff through a local insurance carrier, Ping An Life Insurance. There was an open selection process that involved RFPs and a selection process after review of competitive bids. Goldman Sachs Group, Inc. owns approximately 15% of Ping An.	Contract for Services	\$11,381	1/27/2006	1/30/2006	Approved by TNC Board of Directors Audit Committee
5 Christine M. Scott	Donation of closely held stock.	Gift of Stock	\$50,049	1/31/2006	2/17/2006	Approved by TNC Board of Directors Audit Committee
6 Carol Dinkins	TNC Board member serves on the Board of another non-profit organization with which TNC proposed to contract to develop a Forest Insect and Disease Program.	Contract for Services	\$63,000	5/1/2006	5/1/2006	Approved by TNC Board of Directors Audit Committee

June 19, 2006

EXHIBIT

4

**DESCRIPTION OF REQUESTS TO TNC FOR
CONSERVATION EASEMENT MODIFICATIONS
July 1, 2005 – June 14, 2006**

ARKANSAS

Strawberry River (Collins)

Amendment Request: In connection with a second conservation buyer transaction with the same conservation buyer, the original CE was amended to add the acreage from the 2nd conservation buyer transaction, as well as to add additional acreage from other property owned by the conservation buyer to be covered under the easement, thereby increasing the amount of land protected pursuant to the amendment. The amendment also included clarification on where a single residence could be located.

Status: Approved.

CALIFORNIA

San Luis Obispo County

TNC is defendant in a pending condemnation proceeding (CCSD v. Covell) involving land over which TNC holds a conservation easement. The proposed judgment would provide for the taking by Cambria Community Services District of an approximately 1/4 acre water storage tank site on the boundary of a ranch on which TNC holds a conservation easement. This proposed taking would not modify the easement itself as to the balance of the ranch. The condemnation proceeding was resisted by TNC and the Landowner to no avail.

Status: pending. In litigation.

Consumnes River –White Mountain Company

The current owner of a tract over which TNC holds a conservation easement is proposing to add additional conservation rights to the existing easement by eliminating his right to build a house on the property.

Status: pending. In review.

COLORADO

Vista Verde

Landowner requested amendment 1) to relocate one approved building envelope from one portion of the property to another, and 2) to eliminate building restrictions within another building envelope thereby increasing the level of conservation on the property.

Status: pending; in review

Yager/Appel

Landowner requested amendment to increase size of currently existing residence. Request withdrawn after more careful review of easement language indicated that no amendment is necessary. Landowner intends to place additional easement over property to address existing

EXHIBIT 4

residence limiting ultimate size, giving up right to mine gravel and reducing overall square footage of agricultural buildings.
Status: pending. In review.

GEORGIA**Mill Pond**

Landowner informally requested TNC to assign its interest in the CE to another land trust.
Status: rejected.

Keel Creek (Tarver)

Landowner has requested permission for an exemption from certain requirements of his conservation easement in order to facilitate better prescribed fire management in special natural areas. GA TNC stewardship staff believe the requested exemption will improve overall conservation management of the special natural areas under easement.
Status: pending. In review

Laird property

Landowner has requested that TNC consider amending the easement on property to permit: 1) the release of a small amount of acreage for the purposes of establishing a nursery for production of longleaf pine and understory vegetation; and 2) the addition to the existing encumbered property an additional 50-acre in-holding so that the area subject to the conservation easement can be increased.
Status: pending. In Review.

MONTANA**Conrad Point (Drescher/Cross)**

Landowner proposed to build house a few feet higher than permitted under the easement. The height of the house is unrelated to the conservation purpose of the easement. The landowner agreed to impose additional conservation restrictions over what the easement currently requires in exchange for a relaxation of the height restriction. The amendment was approved in accordance with TNC procedures.
Status: Approved

OREGON**Sharon Fen (Lumber Mills)**

During regular easement monitoring, TNC discovered that a spring located on the property had been overlooked and not identified during the creation and drafting of the original easement. While the rationale for putting the other springs located on the property off-limits to development does not apply to the newly identified spring, TNC and the landowner are considering whether or not to update the easement.
Status: pending. In review.

SOUTH CAROLINA**City of Greenville**

The City of Greenville requested an amendment to a CE held by TNC because an adjacent landowner built a road which encroached on less than 1/3 of an acre of the City's property covered by the easement. The easement covers some 29,000 acres of land. The amendment was approved in accordance with applicable TNC procedures but has not yet been implemented.

Status: Approved

ACE Basin (Igleheart)

Landowner requested an amendment to the existing easement to allow the expansion of the property manager's existing residence by 280 square feet. The increase will be offset by a 280 square ft. reduction in the maximum size allowed for the main residence permitted under the easement. This amendment has been approved in accordance with TNC procedures.

Status: Approved

TEXAS**Little Blanco River (Wallace)**

Request: TNC-TXFO and landowner desire to include a vegetation management plan under the terms of the easement, which would allow for certain management of native plants that is otherwise prohibited by the easement. The purpose of the vegetation management plan is the restoration and enhancement of the original conservation values stated in the easement for the protection of the property.

Status: pending. In review.

VIRGINIA**Adams Glen (Kaye)**

Request by landowner to cut a grove of non-native white pine trees to expand pasture on property. In return the landowner would allow stream-bank restoration on a creek on the farm.

Status: Rejected. The conservation easement prohibits cutting of trees.

Dragon Run (Hancock 1-7)

TNC acquired 2200 acres of land and conveyed a conservation easement to an agency of the government of the Commonwealth of Virginia. Another Virginia state government agency will be acquiring the fee title to the property but would like to extinguish certain easement terms with respect to the property. The parties have agreed to amend and restate the conservation easement to: (a) remove all 16 subdivision rights, (b) allow timber management according to best management practices governed by the state government agency, and (c) allow a single forest resource center with a caretaker's residence and associated outbuildings. The parties are considering the impact of the changes to the easement.

Status: pending. In review.

WASHINGTON**Florence Lake**

Washington Department of Fish and Wildlife, the agency to which TNC transferred the Florence Lake conservation easement, has asked TNC to modify the easement to allow better habitat management. The Agency wants to move restrictions in one part of the easement and create additional easement area. Agency and TNC are considering impacts of proposed changes.
Status: Pending. In review.

WISCONSIN**Brule River (Taylor)**

Landowner requested that easement prohibition on structures within 200 feet of the river be modified to allow for construction of a new dock. Request was denied.
Status: Rejected. Currently negotiating a settlement agreement.

WYOMING**Lower Wolf Creek (Berry)**

Proposed amendment would allow construction of a falcon breeding barn facility within current building envelope where such structures are permitted and would reduce size of second building envelope located elsewhere on the property and would eliminate right to build such falcon breeding barn facilities in second building envelope. Easement amendment reviewed and approved in accordance with TNC procedures.

Status: Approved

U Cross Ranch (Plank)

Landowner requested TNC to extinguish the easement over property which TNC held a conservation easement in order for landowner to exercise certain retained rights. TNC refused.

Status: Rejected

Tensleep (Clay 2 aka Girl Scouts)

Amendment to extinguish building envelope and allow restoration, reconstruction and relocation, maintenance and improvement of all four, as opposed to just two, modular buildings originally located in a second building envelope.

Status: pending. In review

EXHIBIT 4

SLR Horse Creek (Davis aka YCross)

Request to amend easement to allow substitute additional acreage to enable the completion of an exchange of a 120 acre in-holding sold in violation of the terms of the easement. The 120 acre parcel remains under easement and landowner intends to include additional property acquired as part of the exchange under easement, thus increasing the overall number of protected acres.

Status: pending. In review

**Statement of Senator Gordon H. Smith
U.S. Senate Committee on Finance Hearing
Nomination of Henry Paulson As Treasury Secretary
June 26, 2006**

I am very pleased to support the nomination of Hank Paulson as Treasury Secretary.

Mr. Paulson is tremendously qualified for this important position. He is currently the Chairman and CEO of Goldman Sachs, a prestigious investment banking firm. He achieved this post through hard work and determination over a 32 year career in finance. He has a keen understanding of the financial markets and is very knowledgeable on both domestic and international economic issues.

Thanks to pro-growth economic policies over the last several years, Mr. Paulson is inheriting a strong U.S. economy. According to virtually every economic indicator, the U.S. economy is thriving. Our economy grew at a 5.3 percent rate for the first quarter of 2006. This is the fastest rate since 2003 and faster than any other major industrialized nation. In addition, we have an unemployment rate of 4.6 percent, which is below the average rate for each of the past four decades.

I am confident that under Mr. Paulson's leadership our economy will continue to grow. He supports keeping taxes low and will work hard to ensure that the Bush tax cuts become permanent. Mr. Paulson also will work to ensure that America maintains its competitive edge in the world. Throughout his career at Goldman Sachs, Mr. Paulson has developed extensive worldwide contacts. I am particularly impressed with Mr. Paulson's expertise in dealing with China. He has visited China on more than 70 occasions and has developed strong connections. These contacts will serve him well in helping American companies compete in today's global market.

I also hope to work with Mr. Paulson on my tax reform priorities. One issue that I'm particularly concerned about is depreciation. The current depreciation system is overly complex and dated due to the development of new technologies and industries. Last year I introduced the Tax Depreciation, Modernization and Simplification Act, which would modernize and simplify the depreciation rules. One key provision of the bill would provide Treasury with the authority to modify or create class lives for capital assets. I look forward to working with Mr. Paulson to enact this important legislation.

I also would like to thank Mr. Paulson for his willingness to discuss an issue of one of my constituents during our recent meeting. The Salem-Keizer School District made an overpayment of \$1.5 million to the Treasury as a result of an accounting entry error related to Zero Percent U.S. Treasury Security – State and Local Government Series bonds. Although Treasury in the past has stated that they don't have the discretion to take such corrective action, I am working with the Finance Committee to develop language that would confirm Treasury does have such discretion. I hope Mr. Paulson will help us fix this injustice.

Mr. Paulson will be both a strong and effective Treasury Secretary. I am very proud to support his nomination.

Thank you.

COMMUNICATION

action fund
management, LLC

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potomac, md 20854
t 301/258 2852
f 301/330 3440

BY FAX AND OVERNIGHT MAIL

June 23, 2006

Sen. Charles Grassley
Chairman
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Sen. Max Baucus
Ranking Member
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Re: Submission for the Record; Confirmation hearing for Treasury Secretary
nominee Henry M. Paulson, Jr.

Dear Sens. Grassley and Baucus,

We are submitting the attached document to be part of the record of the confirmation
hearing for Treasury Secretary nominee Henry M. Paulson, Jr.

The document is a complaint we filed with the U.S. Securities and Exchange
Commission on June 5, 2006 that involves Mr. Paulson.

We hope the Committee will carefully consider the issues raised in the complaint.

Please contact us for further information.

Sincerely,

Steven J.
Milloy

Digitally signed by Steven J. Milloy
DN: cn=Steven J. Milloy, o=US,
email=Steve@actionfund.com
Date: 2006.06.07 15:13:51 -0400

Thomas J. Borelli, PhD
Steven J. Milloy, MHS, JD, LLM
Managing Partners

Attachment

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BY FAX AND OVERNIGHT MAIL

June 5, 2006

Ms. Linda Chatman Thomsen
Director
Division of Enforcement
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Request for investigation into potentially false and misleading statements by the Goldman Sachs Group, its officers and directors

Dear Director Thomsen,

We are writing on behalf of the Free Enterprise Action Fund ("FEAF" or the "Fund"), a shareholder in the Goldman Sachs Group ("Goldman"), to request an investigation by the Division of Enforcement into potentially false and misleading statements of material facts made by Goldman and its senior management relating to Goldman's acquisition and disposition of certain real property located in Tierra del Fuego, Chile.

Action Fund Management, LLC ("AFM") is a registered investment adviser and the investment adviser to the FEAF.

I. Summary

Since at least December 2003, Goldman and its officers, directors and employees may have knowingly made false and misleading statements concerning Goldman's acquisition and disposition of certain real property located in Tierra del Fuego, Chile ("Chilean Land").

Goldman CEO Henry M. Paulson, Jr. ("Paulson") oversaw the expenditure of Goldman shareholder assets to acquire the Chilean Land in order to create a nature preserve rather than exercise its fiduciary duty to increase shareholder value in the conduct of Goldman's customary business. Goldman's acquisition of the Chilean Land involved The Nature Conservancy ("TNC"), an organization for which Paulson has served in leadership positions since at least 1994 and for which he currently serves as chairman. Shortly after announcing the disposition of the Chilean Land, Paulson was elevated from vice chairman to chairman of the TNC. Goldman donated the Chilean Land to the Wildlife Conservation Society ("WCS"), a group with direct ties to TNC and for which Paulson's son acts as an advisor/trustee.

The potentially false and misleading statements by Goldman and its officers and directors include statements made: (1) by Goldman's board of directors at its 2006 annual general meeting on March 31, 2006; and (2) by Goldman's officers, directors and employees in communications with the public and the media since December 2003.

The presumed purposes of the potentially false and misleading statements may include concealment from Goldman shareholders and the public of: (1) the actual motivation underlying Goldman's acquisition of the Chilean Land; (2) Paulson's personal ties to the two environmental groups involved in the Chilean Land transactions; (3) the full extent of TNC's, WCS' and Paulson's involvement in the Chilean Land transactions; (4) the personal benefits gained by Paulson from the Chilean Land transactions; (5) the possibility that Goldman may have significantly undervalued the Chilean Land in order to minimize

apparent impact upon Goldman shareholders and potential external scrutiny of the transactions; (6) the possible exaggeration of the alleged environmental benefits resulting from the Chilean Land transactions, especially in light of the fact that Goldman's actions actually helped bring to a halt one of the most potentially significant sustainable forestry projects ever proposed.

The potentially false and misleading statements may also have been intended to enhance the public images of Goldman and its officers and directors, and to deflect attention from the possibility that the Chilean Land transactions may have been in violation of Goldman's own Code of Business Ethics and Conduct.

The potentially false and misleading statements made by Goldman and its officers and directors may be material to, and in violation of, the Securities Exchange Act of 1934 and the regulations thereunder.

II. Background

In 1993, Bellingham, Washington-based Trillium Corporation ("Trillium") purchased a 630,000-acre tract of forest land located on the Chilean side of Tierra del Fuego (the "Chilean Land") from Cetec-Sel, a Vancouver-based logging company that had previously planned to aggressively harvest the timber and produce woodchips for the export market.

As early as 1994, Trillium possessed Chilean government permits that would have allowed the company to harvest the land using traditional forestry practices. Trillium instead opted to design a "sustainable" forestry plan (the "Rio Condor Project") regarded by many experts as highly innovative, pro-environment, and unprecedented in terms of scale and promise. Trillium voluntarily sought the input of local environmental groups for the Rio Condor Project which involved sustainable re-growth practices and technologies as well as conservation strategies which had been lauded by an independent team of scientists. In its final form, the Rio Condor Project would have set aside 70 percent of the Chilean land for conservation under the guidance of independent monitors.

Despite the strongly conservation-oriented, and sustainable-forestry nature of the Rio Condor Project, it was opposed by environmental activist groups which, ironically, had for decades been clamoring for such sustainable development projects. During the ensuing legal battle, Trillium made refinements to the Rio Condor Project in an effort to satisfy the objections raised by the environmental activists. Trillium, however, could not placate the activists, whose efforts to block the Project resulted in a 9-year delay that placed financial stress on the Rio Condor Project and, ultimately, made Trillium's property vulnerable to takeover.

Opponents were so determined to prevent Trillium from implementing the Rio Condo Project that, as their legal options were exhausted, they formed a coalition of over 200 North and South American environmental groups that launched an "adopt-a-forest" campaign to raise money to buy the land from Trillium. Around the time this campaign began, a key Trillium lender, called Capital Consultants collapsed.

When a Capital Consultants' portfolio of distressed debt – including a \$30 million note from Trillium secured by the Chilean Land – became available by auction in January 2002, MTGLQ Investors ("MTGLQ"), a Goldman Sachs affiliate, placed the winning bid on the debt portfolio. MTGLQ's bid was roughly one-third the face value of the portfolio of loans (i.e. \$0.33 cents on the dollar.)

In November 2002, Goldman sued Trillium to collect on the \$30 million note. On or about December 5, 2002, in settlement of the lawsuit, Goldman accepted title to the Chilean Land from Trillium.

In December 2003, Goldman publicly announced that it would donate the Chilean Land for the purpose of creating a nature preserve and that Goldman would commence an exhaustive search for the right non-governmental organization ("NGO") beneficiary to receive and manage the Chilean land.

One month later, in January 2004, Goldman CEO Paulson was elevated to the position of chairman of TNC, an environmental group that is in the business of acquiring private lands and rendering them

permanently off-limits to commercial and residential development. Prior to his elevation to the post of chairman, Paulson served as TNC's vice chairman and in other leadership roles since at least 1994.

In September 2004, Goldman officially donated the land to the WCS, a group for which Paulson's son acts as an advisor/trustee and that TNC describes on its web site as an "organizational partner."

In January 2006, concerned that the roles of Paulson and other Goldman officers and directors in the acquisition and disposition of the Chilean land may have violated Goldman's Code of Business Conduct and Ethics, the FEAF requested that Goldman's board of directors review the transaction. Goldman did not respond to the FEAF's January 2006 request

Subsequent to the FEAF request, a shareowner proposal (the "Proposal") was filed by the National Legal and Policy Center (the "NLPC") requesting that Goldman's board review the Chilean land deal under applicable Goldman corporate governance standards.

Immediately following the presentation of the Proposal by the NLPC at Goldman's annual general meeting of shareowners on March 31, 2006, Goldman board member John H. Bryan ("Bryan") read Goldman's prepared response to the Proposal. Mr. Bryan's statement – made in the immediate presence of Paulson – expressly denied that TNC had any role in the Chilean Land transactions.

Immediately following Bryan's statement, Steven J. Milloy of AFM ("Milloy") commented to the meeting that Bryan's statement was contradicted by TNC's tax records which indicate that Goldman paid TNC more than \$144,000 in consulting fees related to the Chilean land transactions. Neither Bryan, Paulson or any other Goldman board member responded to Milloy's comment.

III. Key Facts Underlying the Request for an Investigation

1. Goldman's Denial of Involvement of the Nature Conservancy

a. Statement at 2006 Annual Shareholder Meeting

Goldman board member Bryan, speaking on behalf of the entire board, expressly denied any involvement of TNC in Goldman's acquisition and disposition of the Chilean Lands.

This statement is directly contradicted by a disclosure on TNC's 2004 tax return that states,

Mr. Henry J. Paulson, Jr., is the Chairman and Chief Executive Officer of Goldman Sachs & Company.

Working through the Goldman Sachs Charitable Fund as the owner of HWY, LLC, a Delaware limited liability company, Goldman Sachs acquired certain properties in Chile and Argentina. HWY, LLC, as the new owner, then contracted with The Nature Conservancy for conservation-related consulting services and advice on the land management, oversight and ecological monitoring of these properties, in order to assist in the preservation, protection and maintenance of their natural features and ecological values. During the fiscal year ended June 30, 2004, TNC performed and was paid for the consulting services \$144,895 over an eleven-month period, based on the approximate market value of such services. Mr. Paulson is not a director or an officer of either Goldman Sachs Charitable Fund or of HWY, LLC, and he did not participate in this transaction.

The plain language of this disclosure indicates that Goldman worked with TNC on the land deal through organizations that are affiliated with Goldman (i.e., Goldman Sachs Charitable Fund and HWY, LLC).

b. The Possibility of TNC's Broader Role in the Chilean Land Deal

The fate of the Rio Condor Project is strikingly similar to another environmentalist-opposed and subsequently failed forestry project in Chile, where TNC acquired lands owned by Bosque S.A. through the bankruptcy process after closely monitoring the Project's deteriorating financial position resulting, in part, from activist opposition.

Paulson has been in a leadership role at TNC since at least 1994. Documents and records from Paulson, TNC and Goldman may reveal that the TNC played a greater and earlier role than the consulting work reported on its 2004 tax returns. If TNC played such a role with respect to the Rio Condor Project, this may also be relevant to the board's statement made at Goldman's 2006 annual general meeting.

An entire chapter of William Ginn's book, *Investing in Nature*, details two case histories involving two different tracts of Chilean forest land owned by two different timber companies – Bosque S.A. and Trillium. Although Ginn's does not focus on how environmentalists intentionally created the financial distress for both companies that subsequently made their assets vulnerable to takeover, he does elaborate on how closely TNC monitored the financial status of such projects.

According to Ginn, TNC had a "point person" in Chile whose close monitoring of the financing of the Bosque S.A. forestry project in 2003 led to TNC springing into action via strategic intervention using its ties with Bosque S.A. creditor, FleetBoston, and various environmental groups to acquire the company's land.

Not only had Trillium's financial troubles due to delays caused by environmental activists been reported in the news as early as April of 2001, but according to a September 1996 Inter Press Service article, Trillium CEO David Syre had already approached TNC seeking its approval of the Rio Condor Project – but TNC rebuffed him. Paulson was both employed by Goldman and in a leadership position with TNC at this time.

TNC's interest in financial troubles of companies holding Chilean lands and the organization's direct contacts with Trillium could possibly explain how Paulson became "aware that a private equity firm had amassed a large parcel on Tierra del Fuego that included a rare hardwood forest slated for logging" as he admitted in the 2005 *Pensions & Investments* article [see *infra*].

2. Goldman's Public Statements About The Chilean Land Deal

Various accounts of the events leading up to Goldman Sachs' takeover of the Chilean Land feature statements by Goldman executives portraying their acquisition of the land as an *unintended* outcome and their decision to donate the tract as stemming, more or less, from Goldman's alleged realization that the land had little commercial potential but tremendous ecological potential if used solely as a nature preserve.

A December 12, 2003 media release from Goldman states,

Goldman Sachs did not originally intend to acquire this land. But having acquired the notes secured by the properties, it explored a number of options to monetize both the notes and the properties secured by the notes including the sale of the land. But on further analysis, given the unspoiled nature of the tract of land, the Firm determined that this was a unique opportunity to permit the ecologically important features of the land to be conserved for the future, reflecting the viewpoint of the Firm's senior management.

A December 13, 2003 report in *La Tercera* quotes Goldman spokesman Peter Rose re-emphasizing the above themes:

In November of 2002, Trillium's arrears forced the bank to foreclose, receiving the land instead of money. 'December 5th of last year the title was transferred to our name', said Rose. He admits that they looked for buyers all over the world to take it off their hands. 'We work with money, not trees and animals' he said.....'So we decided to donate it. Not to the Chilean state, this was never a theme. Besides this lets us deduct the land's value from taxes.'

Moreover, Goldman's 2004 annual report refers to the decision to create the nature preserve as:

...the result of a creative approach to what initially appeared to be a routine transaction...

In direct contrast to the above statements, Paulson later admitted in a video posted on Goldman's own website, entitled, "Partners in Conservation," that Goldman knew precisely what it was going after prior to the actual bidding on the distressed debt. Paulson admits that Goldman executives were already clear on their intent to seize the land and to have the acreage turned into a nature preserve. In the taped interview for the video, Paulson recounts the how Goldman specifically pursued the Chilean Lands all along:

We have a unit in the mortgage finance department that seeks to buy distressed debt to turn a profit for Goldman Sachs. They had been examining bidding on a pool of eight or nine secured notes which were delinquent and they had come across the fact that one of these notes was secured by 800,000 acres in Tierra del Fuego which was really a very unique tract of land. If we were successful in winning this pool of mortgages, we could work to turn this 800,000 acres into a nature preserve."

Not only did management know precisely what it was after before the actual bidding took place, they apparently pursued it with determination. According to a report in *The Oregonian* (January 25, 2002), eight companies sent representatives to Capital Consultants' Portland offices to conduct due diligence on the portfolio prior to the auction but only four companies later engaged in the final bidding process. Bidding began at \$46.6 million and increased in \$500,000 increments. Over the course of 90 minutes, "after repeated breaks while bidders plotted strategy and conferred with their home offices, MTGLQ (a division of Goldman) entered the winning \$60 million bid."

But acquiring Trillium's note secured by the Chilean Land was only the first step. Goldman needed to ensure that it obtained the Chilean Land in settlement for the debt. A December 22, 2003, article in *The Oregonian* described the next steps:

Unlike [Capital Consultants], Goldman wasted no time taking collection actions [against Trillium]. In November 2002, lawyers at the Ball Janik law firm in Portland filed a complaint on behalf of a Goldman affiliate in U.S. District Court in Portland seeking the \$30 million from Trillium, [Trillium CEO David] Syre and a host of Trillium subsidiaries. Trillium initially fought back, claiming it was not bound by the terms of the Capital Consultants loan because [Capital Consultants' CEO] had breached the deal by not advancing additional millions to Trillium.

This fall, Trillium agreed to settle. On Dec. 5, the company agreed to transfer ownership of more than 850,000 acres in Chile and Argentina to Goldman in exchange for cancellation of the debt. Goldman considered a number of alternatives for the land, including leasing it to another timber company or selling it off.

In a December 2005 article in *Pensions & Investments* profiling CEO Paulson and his wife on a birding trip to the donated Tierra del Fuego lands, Paulson admitted to having had his eye on the status of Rio Condor's financing *before* the auction was even announced but continues to maintain the acquisition was, more or less, happenstance:

[Paulson] said that he was aware that a private equity firm had amassed a large parcel on Tierra del Fuego that included a rare hardwood forest slated for logging. Goldman Sachs distressed debt team came to him in 2002 with a loan portfolio that just happened to contain a loan that was secured by 680,000 acres of this very forest. "I kissed them on both cheeks!" he exclaimed. Goldman purchased the land in 2003 to donate it for conservation and preservation.

Presumably, if Goldman truly believed that the tract had little commercial value then Goldman should have, after performing due diligence on the portfolio, at least considered a less aggressive bidding strategy or, at settlement phase, focused on acquiring a more desirable form of reimbursement from "Trillium, [Trillium CEO] David Syre and a host of Trillium subsidiaries" as named in their lawsuit.

But as Paulson's own words make clear, his strategy all along was to acquire these very lands in order to create a nature preserve. In light of that intention, the question arises as to whether Goldman's claim that the land was of little commercial value was true or whether the claim may have simply been used as a rationale to justify giving away a newly acquired \$30 million shareholder asset in exchange for a mere tax deduction.

It should be noted that, in contrast to Goldman's claimed \$35 million valuation of the Chilean land that is listed on tax forms, the Chilean Office of Environmental Affairs (CONAMA) had valued the same land at \$100 million, according to the December 2003 article in *La Tercera*. When the reporter asked Goldman spokesperson Peter Rose to clarify the land's valuation, Rose simply claimed not to know for sure.

Goldman's recouping the value of the Chilean Land – worth at least \$35 million and likely much more – only as a tax deduction appears to have significantly shortchanged Goldman's shareholders. Goldman could have continued with Trillium's Rio Condor Project which had already been given the go ahead by Chilean authorities. By doing so, Goldman could have made a strong conservation statement *and* possibly delivered a significant profit to the company and its shareholders. The Chilean Land also has other natural resources in addition to timber that could have added to its valuation further.

Both news accounts at the time of the land acquisition and materials currently posted on Goldman's web site materials touting the land donation claim that Goldman intended to conduct an exhaustive search for the right organizational partner to help convert the Chilean Lands into a nature preserve.

Goldman selected the WCS to be the beneficiary. The Goldman website video narration states:

We discovered a lot of affinities between WCS and Goldman Sachs – a respect for technical excellence and innovation and a high degree of proactivity.

But one material "affinity" omitted from the video is that Henry Merritt Paulson, III, Paulson's son, is a member of WCS' Board of Advisors and a WCS trustee.

Contrary to the assertion of Goldman's board at the 2006 annual general meeting, TNC was involved in the Chilean Land transaction at least to the extent of receiving a \$144,000 consulting fee in 2003-2004, may also have had an earlier but so far undisclosed role in the transaction.

Paulson has a long history of association with TNC. His wife, Wendy, is a former board member. Paulson first became involved in a leadership role with the TNC during the 1990s. At the time of the Chilean Land acquisition, he served as a vice chair of TNC's board, but one month after Goldman's announcement that the Chilean Land would be given away to create a nature preserve, Paulson was elevated to chairman of the TNC.

Links between TNC and WCS are also extensive. WCS is listed as serving in at least two different capacities described as "Multilateral-Bilateral Partnerships" with TNC.

The WCS web site description of its partnership with Goldman highlights their joint intention to pursue "sustainable" solutions, including ecotourism, as key features of the nature preserve. On Goldman's web site, there are numerous references to the Chilean Lands as "unspoiled" and a quote from WCS President and CEO, Steven Sanderson, describing the significance of the land as follows:

This could be one of the great conservation gifts of our lifetime. It will stand with the establishment of the great protected areas of the world. This will be a tremendous legacy for the people of our generation to offer to the next.

These various statements provide the public with the distinct impression that the Chilean Lands are pristine and bear no mark of human impact and, as such, would provide a powerful lure for a sustainable ecotourism venture.

Yet a research study published in 2005 by a joint Colgate University/California State University team comes to different conclusions about the land's ecological status, its suitability as an ecotourism destination, and the sobering possibility that a realization of Trillium's Rio Condor Project may have actually proved to be a greater conservation gift.

The Colgate/CSU study – which noted that the original environmental opposition groups had perpetuated “mischaracterizations” as a “tactical strategy to kill support for [Trillium's sustainable forestry] project” – concluded that the ultimate fate of the land, as determined by Goldman's gift to WCS for the purpose of creating a nature preserve, was likely a less desirable outcome compared to Trillium's Rio Condor Project because it deprived the world of a pioneering and desperately needed example of large-scale sustainable development and because the Rio Condor project was already on track to preserve 70 percent of the acreage in question while also providing considerable benefits to depressed economy of the surrounding area.

The Colgate/CSU research team also notes that the Goldman/WCS nature preserve scenario was at least partially based on a faulty, if not false, rationale – long touted by opponents of the Rio Condor Project – that ecotourism was a suitable sustainable development option for the land and for the surrounding communities.

The researchers describe the landscape as “beautiful but not of national-park caliber,” as “too remote, too cold, and above all, too ordinary,” and as having “low species richness” and a lack of “world-class vistas” necessary to sustain an ecotourism venture benefiting Chile and its people. They also note that Chilean side of Tierra del Fuego lacks the economic diversity that has brought tourism to the Argentinean side. The researchers point out that claims about ecotourism as a sustainable development option are often used by environmental groups (who, in many instances, are also vying for control of targeted lands) but that very few such projects – even ones far better suited to ecotourism ventures than the former Rio Condor tract – manage to live up to the activists' inflated projections.

They also note that one half of Chile's southernmost Region XII, where the Rio Condor land is located, is already under protection; that the Patagonia steppe is a far more urgent conservation priority than the “lenga” forests which characterize the Rio Condor tract; and that the Rio Condor tract is far from “pristine” due to logging and burning that has gone on for decades, severe alteration of grasslands, road-building, mining of peat bogs for fertilizer, and extensive damage by pest species like beaver which were introduced by humans in the first half of the 20th-century and had colonized 100 percent of the tract by the 1970s.

Finally and contrary to Goldman's earlier statements, Goldman did not donate the Chilean Land directly to the WCS. Goldman, in fact, funneled the Chilean Land through the Goldman Sachs Charitable Fund (the “Charitable Fund”) in 2004.

Separate from the much larger and far more visible Goldman Sachs Foundation, the Charitable Fund is an inconspicuous arm of the company – apparently set up for the purpose of awarding modest academic scholarships (ranging from \$2,500 to \$7,500.) From 2001 to 2004, the only years for which tax documents were available, the Fund handed out several dozen small awards to students. The Fund's total annual disbursements were in the low six-figure range each year from 2001 to 2003. In 2004, however, the Charitable Fund's disbursements increased to \$35,725,250, representing the flow through of the Chilean Land to the WCS.

It is not known why Goldman Sachs chose this particular route for the transfer of the asset and since Goldman has not responded to inquiries regarding the Chilean Land transactions, but sections of Goldman Sachs own ethics code (*see below*) may provide clues.

Additionally, the TNC's 2004 tax form contains fairly conspicuous language attempting to distance Paulson from TNC involvement in the Chilean Land deal:

Mr. Henry J. Paulson, Jr., is the Chairman and Chief Executive Officer of Goldman Sachs & Company.

Working through the Goldman Sachs Charitable Fund as the owner of HWY, LLC, a Delaware limited liability company, Goldman Sachs acquired certain properties in Chile and Argentina. HWY, LLC, as the new owner, then contracted with The Nature Conservancy for conservation-related consulting services and advice on the land management, oversight and ecological monitoring of these properties, in order to assist in the preservation, protection and maintenance of their natural features and ecological values. During the fiscal year ended June 30, 2004, TNC performed and was paid for the consulting services \$144,895 over an eleven-month period, based on the approximate market value of such services. Mr. Paulson is not a director or an officer of either Goldman Sachs Charitable Fund or of HWY, LLC, and he did not participate in this transaction.

Paulson is, however, chairman of Goldman, Goldman is sole contributor to the Charitable Fund, and all four officers and directors of the Charitable Fund are employees of Goldman, according to the Charitable Fund's 2004 tax return, and subordinate to Paulson.

3. Goldman Corporate Governance Statements

Goldman has a Code of Business Ethics and Conduct (the "Code") that is published on its web site. The Code has at least four provisions that would appear to require independent review with respect to this unusual transaction:

1. The Code states,

It is the firm's policy that the information in its public communications, including SEC filings, be full, fair, accurate, timely and understandable.

The company appears to have violated the above tenet with their December 12, 2003 press release by stating,

Goldman Sachs did not originally intend to acquire this land. But having acquired the notes secured by the properties, it explored a number of options to monetize both the notes and the properties secured by the notes including the sale of the land. But on further analysis, given the unspoiled nature of the tract of land, the Firm determined that this was a unique opportunity to permit the ecologically important features of the land to be conserved for the future, reflecting the viewpoint of the Firm's senior management.

The facts and circumstances appear to indicate that Goldman intended to acquire the Chilean Land all along in order to convert it into a nature preserve.

2. The Code states,

A "personal conflict of interest" occurs when an individual's private interest improperly interferes with the interests of the firm.

Hank Paulson's personal interest in conservation, his personal ties to both of the environmental organizations benefiting from this transaction, and his promotion to chair of TNC's board immediately following the announcement of the land gift would seem to call into question whether his actions might constitute a "personal conflict of interest."

3. The Code states,

All firm assets should be used for legitimate business purposes only.

Giving away an asset does not seem to fulfill the traditional definition of "legitimate business purpose."

4. The Code states,

Waivers (of the code of business conduct and ethics) for executive officers (including Senior Financial Officers) or directors of the firm may be made only by the Board of Directors or a committee of the Board.

Goldman Sachs has not responded to inquiries or provided documentation as to whether the board or one of its committee's waived any or all of these potential violations of the Code.

It may be considered false and misleading for Goldman to publicly maintain that it operates by the Code when, in fact, it does not appear to have done so in the case of the Chilean Land transactions.

IV. Request for Investigation by the Division of Enforcement

It appears that Goldman's publicly touted version of Chilean Land transaction may be false and misleading in material ways. The Chilean Land deal has been, and continues to be, a significant part of Goldman's effort to market itself to the public. Goldman's actions, therefore, may be in violation of various provisions of the Securities and Exchange Act of 1934. Accordingly, we hereby request that the Division investigate the facts and circumstances surrounding the Chilean Land deal as soon as possible.

We have, or can readily obtain the documents and records used as the basis of this request. Please feel free to contact me at 301-258-2852 if you need any assistance with this materials or this request.

Sincerely,

Steven J. Milloy
Thomas J. Borelli
Portfolio Managers, Free Enterprise Action Fund

Steven J. Milloy

Digitally signed by Steven J. Milloy
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